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**Measuring Fiscal Federalism and
Decentralization in Latin America: Argentina
and Brazil in Comparative Perspective**

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ABSTRACT¹

Argentina and Brazil are two traditional federations in Latin America. Both countries have a formal institutional setting established by a written constitution that provides the main features of a classical federal framework. The main feature is the constitutional guarantee of subnational autonomy. In this context, federalism, decentralisation and autonomy are three interrelated terms. How do we know whether those subnational units are (or not) indeed autonomous? Autonomy is a construct that can be measured through indicators that relate to different aspects of decentralization. As a process, rather than a static structure, decentralization can transform the federal setting and widen or restrict subnational autonomy.

The question that arises, then, is how decentralized are these two traditional federations from Latin America? This paper seeks to measure and compare different (formal and informal) aspects of decentralization and fiscal federalism in Argentina and Brazil in order to determine the degree of fiscal decentralization to better understand subnational autonomy and its role within the federation. In doing so, this paper will use a number of variables to help measure the degree of decentralization.

INTRODUCTION: FISCAL FEDERALISM AND THE WAY TO MEASURE FISCAL DECENTRALIZATION²

Argentina and Brazil both have a formal constitution that expressly provides a federal state structure³. In addition to the formal declamation of their constitutional texts, the interest of this paper involves looking into the real or informal federal structure that effectively exists in both countries and its main aim is to measure and compare fiscal federalism in Argentina and Brazil.

In order to approach this issue, I address it from a double perspective: a constitutional and a political one. The constitutional approach is basically a legal perspective, and views federalism as ‘a legal principle of power division between two levels of governments’ (Thorlakson 2003:2). This perspective focuses on formal dispositions, mainly those written in the constitution. The constitutional prescriptions matter because they outline the general structure of the polity and serve as a guarantee for the citizens and for the different levels of government as well. The formalism of this approach doesn’t consider important

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³ The Brazilian Constitution itself is entitled “Constitution of the Federative Republic of Brazil”. The Argentinean Constitution prescribes “The Argentine Nation adopts the federal republican representative form of government, as this Constitution establishes” (Art. 1) and also provides different official names to be indistinctly used for the designation of the state, between them. “Argentine Confederation” (art. 35). Despite the use of the term of *confederation*, the Constitution makers of 1853 used the term as a synonym for federation and not as a confederation as such.

informal rules that regulate the actual and effective functioning of federalism. It may occur that a formal constitutional provision does not apply in practice and traditions can create new non-formal rules that effectively influence the actual working of federalism. Sometimes, these informal rules become so relevant that despite the constitutional provision that establishes a federal structure, the actual practice of institutions may transform the polity into a unitary one.

A political (or governmental) approach to federalism does indeed consider informal rules: ‘By considering norms and traditions of power sharing as well as formal institutions (such as the existence of a bicameral legislature), the governmental approach has the potential to produce a ‘truer’ picture of the operation of a federation’ (Thorlakson 2003:2). These different approaches allow us to understand the real functioning of federalism as a government structure composed not only by formal but also informal institutions. Many practices and uses arise and, if maintained over time, become informal rules. Helmke and Levitsky have defined informal institutions as ‘socially shared rules, usually unwritten, that are created, communicated, and enforced outside of officially sanctioned channels’ (2004:727). These informal institutions actually modify the functioning and dynamic of the formal federal structure. A good example is the proliferation of federal transfers not contemplated in the constitutional text but created over time to fulfil specific issues and objectives.

Regarding the concept of federation (and its structural features), many authors have extensively defined it. In essence, federalism consists in a particular institutional arrangement with division of authority between two (or more) levels of government. Alexander Hamilton defined federation as ‘an assemblage of societies’ or an association of two or more states into one state’ (Hamilton, Jay, and Madison 2001:41). Defending the project of the 1987 North American constitution, he argued, ‘The proposed constitution, so far from implying an abolition of the state governments, makes them constituent parts of the national sovereignty, by allowing them a direct representation in the senate, and leaves in their possession certain exclusive, and very important, portions of the sovereign power. This fully corresponds, in every rational import of the terms, with the idea of a federal government’ (idem, 2001:41). According to Riker, federalism is ‘a political organization in which the activities of government are divided between regional governments and a central government in such a way that each kind of government has some activities on which it makes final decisions’ (1975:101).

The most distinguishing feature of a federation is that federal and constituent units have sovereign powers derived from the constitution and they are not subordinate to the other (Watts 1996)⁴. Indeed, according to Thorlakson, ‘it is the [constitutional] guarantee of autonomy for each level of government that distinguishes a federal system from a unitary state and from other types of relationships between states’ (2003: 5, also Beramendi 2007). The literature has identified some specific characteristics that identify a polity with a federation (Loewenstein 1957. Watts 1996. Swenden 2006. Thorlakson 2003. Galligan 2006, Beramendi 2007).

The recognition of power, functions and competencies imply that subnational units have some areas of action in which they have autonomy (or sovereignty) to act without the interference of any other power⁵. In order to guarantee this autonomy, their competencies must be provided by a constitution, as the supreme law and ‘the existence of a strong judicial review system’ (Beramendi 2007: 754).

⁴ The thesis of “the two sovereignties” has held by James Madison in *The Federalist Papers*, No. 39-51 and by Alexander Hamilton when he stated that a federation involves ‘the total or partial incorporation of a number of distinct sovereignties’ (No. 82. p. 426).

⁵ According to the economic literature of federalism, whether autonomy is constitutionally guaranteed or not it makes little difference to the economist views, “what matters is simply that decisions regarding levels of provisions of specified public services for a particular jurisdiction [...] reflect to a substantial extent the interests of the constituency of that jurisdiction” (Oates 1972:17).

Contrary to unitary or even the so-called quasi-federal or regional states, constitutional autonomy means that the subnational competences cannot be either modified nor eliminated by a unilateral decision from the central level of government – for instance, through the enactment of a national law. Consequently, the only way to modify or suppress one or more competences allocated to subnational governments is by means of a constitutional reform, a process that, in turn, would imply some kind of negotiated agreement between the two levels and the participation of subnational units in the process of reform. Although it is true that it is also possible to modify the constitutional contract through judicial review, in this case the court decision ultimately must conform to the Constitution. In addition, informal practices may change the means of constitutional prescriptions or even ignore judicial decisions, redefining the federal arrangement.

The recognition of power and competencies implies, in addition, that subnational units must have fiscal powers. i.e., sufficient and proper means to meet their responsibilities. Without a certain level of autonomy regarding the means by which subnational levels can meet their responsibilities and competences, some aspect of their autonomy could be affected. If a subnational government does not have enough resources to implement policies, a crucial aspect of subnational autonomy will be affected – in this case, the autonomy of policymaking. If this gap is filled by means of federal transfers, the local autonomy regarding the decision of how to spend could be limited.

The constitutional recognition of power and competencies to the subnational level of government is, therefore, a key element in order to analyse fiscal federalism. A constitution is an incomplete contract, however, and therefore, there may be room for opportunistic behaviours that could change, in practice, some constitutional provision regarding the distribution of competences. Any federal arrangement has an inherent weakness in the temptation to exploit the union for the own gain of constituent governments (Bednar 2009). In other words, both national and subnational government, may act in an opportunistic way to exploit each other.

Fiscal federalism has been defined as ‘the set of policies designed to increase the revenues or fiscal autonomy’ (Falleti 2005: 329), comprising the increasing of transfers from the central government, the creation of new subnational taxes or the delegation of tax authority. This is, however, a narrow concept of fiscal federalism since, for instance, it does not consider expenditures.

In addition to the problem that there is not a unique definition of fiscal decentralization, there is also the problem of how to measure it. Therefore, the problem is twofold: the first problem is theoretical, but it is still important in order to define the different aspects it encompasses. The second problem is an empirical one and is related to available data. We cannot approach the second issue without resolving the first one.

In order to measure fiscal decentralization, I have identified seven variables, which will be dealt with throughout this article: I will first discuss (1) constitutional allocation of competences and powers, to measure the size of subnational government within a federation. Secondly, (2) the constitutional allocation of revenue-raising capacity between levels of government in order to measure the formal or institutional decentralization of autonomy’s fiscal aspect and the scope of provincial taxation power. Thirdly, (3) the revenues directly raised by each level of government, excluding federal transfers in order to measure the degree of fiscal autonomy of subnational governments, considering, therefore, the effective exercise of such powers. Fourthly, (4) the mechanism of transfer of federal funds to subnational units to finance local expenditure. Considering provincial own-resources plus federal transfers we can have an index to measure the total amount of resources at the disposal of subnational governments.

The existence of federal transfers implies the insufficiency of local resources to afford their responsibilities – and consequently a lesser autonomy in what and how much to expend. It is necessary

therefore to consider the size and character of these transfers (conditional or unconditional, discretionary or non-discretionary) in order to measure the extent of dependency in administration of their competences and delivery of public services. Fifthly, the (5) total expenditure of each level of government combined is another useful index to measure the size of subnational administration of competences and public services. It is also complementary to the former (federal transfers) to measure the degree of dependency or autonomy with which levels of governments perform their responsibilities. In this respect, it is necessary to distinguish to what extent subnational units cover their expenses with their own resources or with federal transfers.

Variables (3), (4) and (5) led us to another index, the sixth variable, the (6) fiscal imbalance that measures the gap between the federal transfers and the total subnational spending. Finally, there is also another important aspect to consider in analysing local autonomy: (7) the borrowing capacity of federated units. While, on the one hand, borrowing capacity may increase fiscal autonomy of local governments⁶, on the other, it may imply an instrument of exploiting the federal level generating the so-called moral hazard problem – inherent to all federal structure. Taking into account these two extremes, we need to consider first the formal (constitutional and/or legal) limitations to subnational units' capacity to borrow, and the practical ability of them to borrow.

These seven aspects of fiscal federalism will be used as quantitative variables to measure the degree of subnational autonomy (expressed as a percentage). The first two variables are legal and measure the degree of institutional decentralization. Since constitutional prescriptions may not apply in practice, these two variables have to be considered carefully⁷. The remaining variables measure different aspect of decentralization and are elaborated with official data provided by the countries and international organizations' official databases (such as OECD, World Bank and IMF). The period selected encompasses mainly the years 2002-2012, due to the availability of information and data from both countries.

In the next sections, I will analyse these variables in the specific cases of Argentina and Brazil. Finally, the article ends with some conclusions drawn from the comparison of the two Latin-American federations.

⁶ “Provided their governments are not mired in debt, autonomy of constituent units is enhanced when they have direct and unhindered access to borrowed funds” (Watts 1966: 68).

⁷ Whether the constitution establishes that a competence is concurrent, this does not imply necessarily that in practice both levels of government implement and administrate this competence in an independent fashion. Intergovernmental coordination between levels of government (including municipalities) may distribute the different aspects of a single public policy between levels. For instance, as it occurs in most federations, when competence is allocated by the constitution to both levels, federal governments generally reserve to themselves the formulation for at least the minimum national standards of the policy, whereas subnational levels (states and municipalities, or both) remain in charge of its implementation. The same may occur with the constitutional allocation of fiscal and taxation powers. Besides that, it may occur – and it has happened indeed – that federal government may centralize (encroaching upon the jurisdictions of the states) or decentralize (shilling burdens away from the center) some competences in a way that in practice, only federal government or only the states manage the competence – despite the constitutional prescription that the competence falls within both jurisdictions. Both scenarios correspond to two different models of federations: the dual federalism and the joint federalism or federalism of concertation.

Table 1: Seven variables to measure decentralization

1.	Constitutional competences	Measures the size of subnational governments within a federation.
2.	Constitutional revenue-raising capacity	Measures the formal or institutional decentralization of autonomy's fiscal aspect and the scope of subnational taxation power.
3.	Own revenues	Measures the degree of fiscal autonomy, considering revenues raised by each level of government (excluding federal transfers) and, therefore, the effective exercise of such powers.
4.	Federal transfers	Includes the different mechanisms of transfers of federal funds to subnational units. In considering provincial own-revenues plus federal transfers it is possible to elaborate an index to measure the total amount of resources at the disposal of subnational governments.
5.	Power Expending	Measures how much subnational units expend on public services and in what kind of services, capturing the role subnational units play within the federation.
6.	Fiscal Imbalance	Measures the gap between federal transfers and the total subnational spending. It is built with variables (3), (4) and (5);
7.	Borrowing capacity	Measures the ability of subnational governments to access debt financing.
Source: author's own elaboration.		

CONSTITUTIONAL COMPETENCE ALLOCATION

Since its independence in 1822 until the adoption of the republican system, Brazil adopted different kinds of territorial organizations – all unitary with different nuances. The 1892 Constitution established a federal organization for the first time. After several amendments (almost all of them leading to a more decentralized system), in 1988 the current constitution establishing a highly decentralized federal system was enacted. The 1988 Constitution of the Federative Republic of Brazil (CFR) recognized four levels of government: the federal government, the states (26 states), the Federal District in which is located the capital of the country, Brasilia, and the municipalities.

The 1853 Constitution of the Argentine Nation (CAN) adopted a federal structure following 43 years of infightings between the federal and the unitary factions after its independence in 1810. The federation is currently composed of 23 provinces and an autonomous city (Buenos Aires, which is at the same time capital of the nation. Local governments (municipalities) have the status of autonomous⁸.

⁸ As established by the Article 18. "The political and administrative organization of the Federative Republic of Brazil comprises the Union, the states, the Federal District and the municipalities, all of them autonomous, as this Constitution provides". Without a specific clause like the one above, Argentinean constitution recognize the existence of provinces which are autonomous (Article 5 and 122), guarantee the autonomy of municipalities (Art. Paper 2020 - 01

Subnational units (“states” in Brazil and “provinces” in Argentina) are endowed with a wealth of authority, making both federations highly decentralized politically. Both constitutions reserve residual power upon the subnational units (Art. 25, par 1. CFR: art. 121 CAN). In order to simplify this complex matter, it is useful to classify the competencies as federal, state/provincial, shared and concurrent. Federal competences are those competences assigned exclusively to the federal government, whereas state/provincial competencies refer to authorities assigned exclusively to state governments. Shared competencies are those that require the consent of the two level of governments to be implemented. Finally, concurrent competencies are those that may be exercised independently and simultaneously by any level of government – but not necessarily in a coordinated manner.

The system of distribution of competences used by the Brazilian constitution consists in an enumeration of the Union’s competences (Art. 21) and of concurrent competences with the states (Articles 23 and 24 – legislative competences). Brazilian federalism can be classified as a devolutive federalism, in the sense that it was the central government – through a constitution – which recognized autonomy and therefore a set of competencies and authorities to the federated states (similar to Belgium, Australia and Canada). Conversely, Argentine federalism is an integrative one (See Hernández 2011), because provinces created – through a constitution – a central government and delegated to it a set of competencies and authorities (similar to the cases of USA, Switzerland and Germany). Normally, a devolutive federalism entails an allocation of residual power to central governments. Nonetheless, Brazilian constitution attributes most powers to the states when it establishes that ‘all powers that this Constitution does not prohibit the states from exercising shall be conferred upon them’ (Art. 25, par 1, CFR). According to this principle, the constitution endows to the central government with enumerated and limited competences (the same is true for municipalities).

Argentine federation has the same method of distribution of power: ‘The provinces reserve to themselves all the powers not delegated to the Federal Government by this Constitution, as well as those powers expressly reserved to themselves by special pacts at the time of their incorporation’ (Art. 121). Consequently, federal government’s competencies are enumerated (expressly or implicitly) in the constitutional text.

It is also necessary to distinguish between the legislative and administrative power – two different aspects within one single competence. According to this, there are two models of federal state design. A dual federalism in which the constitution allocates both legislative and administrative power in a single policy field to one of the two (or more) level of governments. Contrarily, a joint federalism utilizes a functional division of powers conferring the legislative power to one level of government (normally the federal level) and the administrative power to the other (the states). These two aspects refer to the questions: who decides to do what? And who implements it? Following Deil Wright (1982), dual federalism resembles a layer cake, since it has clearly demarcated spheres of competencies and authorities, while the second model resembles a marble cake, in which spheres are overlapped and intermingled.

Argentina and Brazil tend to allocate both powers (legislative and administrative) in the same policy area to a single level of government, but also there is a great range of concurrent competences i.e., competences allocated to the two levels of government to the same extent. In social policy areas, both federations tend to allocate them to both levels of government⁹. A Brazilian constitution enumerates them in a long list (Art. 23 and 24, CFR), whereas the Argentine constitution is more concise (Art. 125).

123) and creates an autonomous city, the city of Buenos Aires, an special district with particular characteristics – similar in all most sense to the provinces (Art. 129).

⁹ ‘The 1988 constituents chose the format of concurrent powers for most of Brazilian social policies’ (Arretche 2004:20).

Subnational entities are constitutionally authorized to implement programs in health, education, welfare, housing, sanitation policies, and environment (Arretche 2003, 2004; Almeida 1995; Samuels and Mainwaring 2004; Ter-Minassian 1997; Souza 2001, 2005). In fact, most of the consolidated public spending in these areas corresponds to subnational levels. However, the evolution of the decentralization processes that occurred in both countries resulted in subnational governments being in charge of implementation, whereas the federal governments reserved the role of coordinators and setting the general guidelines in those policies. Both constitutions reserve to the federal level traditional functions: defense, foreign affairs, army, economy (control of the money supply and of the financial system), etc.

The 1988 Brazilian constitution “assigns relatively few functions exclusively to each level of government for the vast majority of public expenditures, however, the constitution envisages concurrent responsibilities, to be further specified by a federal law – which so far has not been proposed” (Ter-Minassian 1997:441-2). Argentine federal design allocates to both levels of government most of the competences as concurrent (Art. 75, 18 and Art. 125)¹⁰.

This federal design is similar to the German, Australian and Swiss federations, where “concurrent powers are used extensively” (Thorlakson 2003:9). Those federations have as a common feature that they have relatively few policy fields falling under exclusive state competence. In this respect, all these countries are institutionally more decentralized than other developed federations such as the United States of America or Austria, where constitutions provide fewer concurrent competencies (Thorlakson 2003 and Watts 1999).

TABLE 2: Constitutional Allocation of Competences

	Brazil		Argentina	
Federal	11	61%	8	14%
Concurrent	7	39%	10	56%
	18	100%	18	100%

Source: Own elaboration

Table 2 intends to show the degree of policy decentralization constitutionally provided, taking into account 18 significant and traditional competences. Although this information involves a fair amount of discretion, since “constitutional allocation may mask the underlying reality of power allocation in the state” (Thorlakson 2003:11), it is still useful to highlight the degree of institutional decentralization. This sample shows that the Argentine constitution provides an institutionally more decentralized federation from that envisaged by the Brazilian constitution: 56 percent of 18 competences are concurrent in Argentine federation, compared to 39 percent in Brazil.

Both constitutions also provide another type of competences, those that I have called “shared” competences. In both countries, constitutions provide, as a shared competence, the merge, subdivision or dismember of states, requiring the consent of subnational units involved. Argentina also provides two

¹⁰ The Argentine Supreme Court has stated that, in principle, all competences are concurrent.

other shared competences: the establishment of the federal capital (Art. 3)¹¹ and the enactment of co-participation regimes (Art. 75.2).

Participation of subnational levels in other policy areas were further increased through later decentralization processes. In Argentina, this took place in the beginning of 1990 (during Menem first tenure) and made possible the total transfer of health and education policies to the provinces, while the national government maintained competence over the enactment of minimum nationwide standards¹².

In Brazil, the decentralization process began in 1980 and culminated in the enactment of the constitution in 1988. However, the process of decentralization was quite disorderly and, due to the wide regional inequalities and asymmetries, local governments and poor states relied heavily on transfers from the federal government to provide services and meet their obligations. This fact “resulted in a resurgence of the role of the federal government in defining roles and restricting the use of a public funds during the mid- to late 1990s under the Cardoso government – a trend that has continued to date” (Pierce 2013). Argentina experienced a similar phenomenon¹³.

In both countries, subnational governments are responsible for policy implementation, and the federal governments retain the role of coordinating and financing those policies, especially in health and education. In general, social policy areas are financed through specific federal transfers in both Argentina and Brazil, although in the later case the constitution itself lays down specific funds for specific issues¹⁴.

CONSTITUTIONAL ALLOCATION OF REVENUE-RAISING CAPACITY

As mentioned before, an important element of autonomy is the capacity of subnational governments to afford their competencies. Therefore, fiscal decentralization is analyzed taking into account the revenue-raising capacity of federal government vis-à-vis subnational governments and the level of expenditures of each level of government in different policy areas; while the revenue-raising capacity is used as a variable to measure the fiscal autonomy, i.e., “the power derived from control over the allocation of resources”, the degree of expenditures “captures the scope of decision-making authority and control over policy implementation” (Thorlakson 2003:12).

The constitutional allocation of revenue-raising capacity measures the formal or institutional decentralization of autonomy’s fiscal aspect and the scope of provincial taxation power. A proper capacity for levying taxes is vital to guarantee local autonomy. A constitution may allocate a large

¹¹ In Brazil, the capital is established by the constitution.

¹² During the de facto government in 1970 took place the first major antecedent in decentralization, culminating in 1990.

¹³ As Richard BIRD has noted, ‘Federal spending power, like spending mandates on sub-national governments, can be seen as what Breton (2006, 94) calls an “instrument of occupation” - that is, a way in which governments at one level may effectively occupy the policy domain of governments at a different jurisdictional level. The most common way in which federal governments employ their “spreading power” is through an earmarked grant (sometimes called a categorical or specific-purpose grant), defined as any grant for which the amount received is conditional in some way on the spending decisions of the recipient government’ (2009:). This federal encroachment also occurs in developed federations, such as Canada, Australia, Germany, Switzerland and USA (see BIRD 2009).

¹⁴ The FUNDEF created by the 14th constitutional amendment of 1996 to finance education policies, or the 29th constitutional amendment of 2000 allocating a percentage (12 percent for states and 15 percent for municipalities) to be invested in health policies (Soares and Pereira Neiva 2011:99).

number of competencies and authorities to local levels, however if they do not have sufficient resources at their disposal, their autonomy may in fact disappear.

TABLE 3: Current Taxes Levied by Level of Govt.

Taxes	Argentina		Brazil	
	No.	%	No.	%
Federal	31	89	17	71
State/Provincial	4	11	6	26
	35	100	23	100

Source: Ministry of Economy and Public Finance of Argentina Databases and Ministry of Finance of Brazil (2002)

The Argentine constitution adopts a current tax system regarding internal taxes. According to the constitution, provinces are endowed with the power to levy direct and indirect taxes. Taxing power over indirect taxes (the Value Added Tax among the most important) is concurrent with the federal government (Art. 75.2), whereas the federal taxing power over direct taxes (income tax, property tax) is only exceptional. According to Art. 75.2 the federal government is authorized to levy direct taxes for a specified term and proportionally equal throughout the national territory only when the defence, common security and general welfare of the State so require it. In spite of this constitutional mandate, the federal government has created and collected direct taxes in a permanently and continuously fashion since 1930. Art. 75.1 allocate as a federal government's exclusive power the power to lay import and export duties, a power forbidden to provinces (Art. 126).

The Brazilian constitution is more detailed. Art. 152 establishes that the states and the Federal District shall have the competence to institute taxes on: (a) transfer by death and donation of any property or rights; (b) transactions relating to the circulation of goods and to the rendering of interstate and inter-municipal transportation services and services of communication (even when such transactions and renderings begin abroad); (c) ownership of automotive vehicles. The Federal Senate has the competence to establish the maximum rates and other specific characteristics.

The Federal government has the exclusive competence to institute social contributions regarding intervention in the economic order and the interest of categories of employees or employers (Art. 149). It also may institute taxes on: (a) importation of foreign products; (b) exportation to other countries of national or nationalized products; (c) income and earnings of any nature; (d) industrialized products; (e) credit, foreign exchange and insurance transactions, or transactions relating to bonds or securities; (f) rural property; (g) large fortunes, under the terms of a supplementary law (Art. 153).

In both countries, different systems are applied to regulate subnational legislative taxation power over the taxes attributed by the constitution. The legislation of Brazilian states must therefore be in accordance with a national complementary law (the national tax code) in several situations established by Art. 146, in order to render the collection of these taxes compatible with each other. In addition, the constitution itself establishes several limitations to the legislative power to institute state and local taxes. Such limitations do not exist in the Argentine national constitution: federal and provincial legislative fiscal powers are equal in measure and significance.

SUBNATIONAL OWN-RESOURCES

In this section, I consider the total amount of resources levied by subnational government, without considering federal transfers. The practical exercise of fiscal power may be different as provided by the constitutional text.

TABLE 4: Subnational Own-Resources as percentage of subnational and federal total resources before transfers 2002-2012

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	AV G
Argentina	20%	19%	17%	17%	18%	17%	17%	19%	18%	19%	19%	18%
Brazil	26%	26%	26%	25%	25%	25%	25%	25%	26%	25%	25%	25%

Source: Compilation base don DNCFP, Argentina Ministry of Economy, Brazil Ministry of Finance and OECD Statistical Database.

The Brazilian federation is highly decentralized. As it shows in Table 4, subnational governments collect on average between 2002 and 2012, 25 percent of total tax collection (considering the other two levels of government, federal and local). Argentina fiscal federalism, in turn, is more centralized giving the low participation of provinces in the overall tax collection structure (and the almost insignificant participation of local governments). Local government in Brazil represents 5.32 percent, whereas Argentine local government represents only 0.20 percent (Altavilla 2015) over the same period. The 1988 Brazilian constitution favoured decentralization of fiscal revenues, a trend that was maintained during the last decades. According to Ter-Minassian, state governments increased their share of tax collection from 26.7 percent of GDP in 1991 to 28.7 percent in 1995 (1997:439). The OECD Statistic Database shows a share around 30 percent of GDP for states governments in tax collection which decreased to 26 percent in 1993, a percentage that remained almost unchanged until 2013.

Fiscal decentralization in Brazil began to increase from 1983 to 1988 due to – among other factors – the increase in intergovernmental transfers and the fragility of federal taxes in a high inflation environment. Decentralization continued through the enactment of the 1988 Constitution (Mora and Varsano 2001). Considering a longer period, subnational governments in Brazil have collected 26 percent of total tax (as percentage of GDP) on average between 1990 and 2013. Argentine subnational governments have collected an average of 16 percent, between 1990 and 2013. In the decade, shown in Table 4, provinces in Argentina recollected 18 percent, on average between 2002 and 2012, and Brazilian states 25 percent.

Unlike the constitutional provisions, Argentine provinces actually levy a few taxes as exclusive competence (only four taxes). This is possible through specific agreements and intergovernmental coordination.

In short, the current and practical assignment of revenues in both countries is as follows: in Brazil, the federal government is responsible to levy (a) personal and corporate income taxes; (b) a selective type of VAT (IPI); (c) a tax on rural property; (d) different social security contributions; (e) foreign trade taxes and (f) certain taxes on financial operations. Taxes a, b and c are shared with states and municipalities. States collect and administer (a) the ICMS, which is another type of VAT more broad based than the federal IPI; (b) tax on motor vehicles and (c) estate and gift taxes. The municipalities are in charge of collecting: (a) tax on services (ISS); (b) a tax on services of immovable properties and (c) tax on urban real estate property (Ter-Minassian 1997).

In Argentina, the federal government collects (a) income tax (b) VAT (c) Excise taxes (d) import and export duties (e) liquid fuel and energy taxes (f) gross assets tax (g) personal assets tax (h) social security taxes. Provinces collect (a) automobile taxes (b) tax on immovable property (c) stamp duty and (d) gross receipts tax (Schwartz and Liuksila 1997). Municipalities only collect, in practice, charges and administrative fees. This is mainly a consequence of coordination between federal and provincial governments on fiscal authority distribution (Altavilla 2015). In general, the federal government collects all taxes (which are subject to revenue sharing with provinces), except those four taxes which are currently collected by provinces.

Tax Structure

In 2010, Argentina and Brazil had the highest tax revenues on GDP in Latin America, ranking first and second respectively, with an average well above the regions – 19.4 percent. With a level of tax revenues over 30 percent of GDP¹⁵, both countries reached similar levels of the OECD countries – and even surpassing countries such as Australia, Canada, Japan, New Zealand, Spain, Switzerland and the United States of America (Revenue Statistic from Latin America – 1990-2010).

Within the tax structure of each country, the prevalence of indirect taxes can be observed. Consumption taxes in Argentina accounted for 55 percent and in Brazil 41 percent of total tax collection in 2001 a trend maintained in the last decade.

In Argentina, three specific taxes have more prominence in the tax structure: social security contributions, income tax and VAT (Value Added Tax). Together, these three taxes represent more than 25 percent of the GDP (Ministry of Economy and Public Finances, 2012).

In Brazil, the percentage of indirect taxation is relatively high in comparison to OECD countries. In particular, the specific taxes of VAT (ICMS), collected at the subnational state level and excises and taxes on international trade and social security contributions. These latter taxes made up a significant proportion of total tax revenues in Brazil over the last two decades, reaching levels closer to those in the OECD (Revenue Statistics in Latin America 1990-2010 – Brazil Country Note Final).

TABLE 5: All tax revenues as percent of GDP (2013)

	Argentin a	Brazil	LA	OECD
Income & profits	5,6%	7,4%	5,5%	11,4%
Social Security	7,1%	9,2%	3,8%	9,0%
Payroll	0,0%	0,7%	0,2%	0,4%
Property	2,9%	2,0%	0,8%	1,8%
Goods & Services	15,5%	15,2%	10,6%	10,8%
Other	0,2%	1,2%	0,3%	2,0%
	31,3%	26,5%	21,2%	35,4%

* For OECD countries, 2012

Source: OECD Statistics Database.

¹⁵ In Argentina, the total tax revenue represents 31.3 percent of its GDP, whereas Brazil 35.7 percent (see Table 5).
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FEDERAL TRANSFERS: INTERGOVERNMENTAL COORDINATION OF FEDERAL AND SUBNATIONAL TAXATION POWERS.

Tables 3 and 4 do not show the total revenues available at the subnational level. In any federation, as the fiscal structure and intergovernmental relations get more complex, a series of different mechanisms for intergovernmental transfers – usually called federal grants – begin to develop in order to balance fiscal autonomy with policy decentralization.

There are different kinds of federal transfers. There are discretionary and non-discretionary grants, and on the other hand, there are earmarked and non-earmarked transfers. In order to measure subnational fiscal autonomy classification is necessary as earmarked funds affect the expenditure autonomy of subnational governments whereas non-earmarked ones do not. On the other hand, the level of discretion of federal government to allocate resources to the subnational government affects the behaviour of these units.

Automatic transfers refer to non-earmarked and non-discretionary grants, but this kind of transfer may still affect subnational fiscal autonomy, generating space for federal opportunistic behaviours. For instance, federal governments may modify aspects of a tax generating funds transferred to states in order to decrease revenues transferred to subnational units.

In Argentina, since indirect taxes are concurrent, there is no constitutional prohibition to double taxation and this in fact existed in the fiscal structure from 1890 to 1935. With regard to direct taxes, there was a tax overlap from 1930 and 1935 resulting in double taxation for indirect and direct taxes.

To avoid the pernicious effect generated by double taxation, federal and provincial governments agreed to a new system of coordination of taxation powers and distribution of tax collection. In 1930 the first co-participation regime was born, a revenue-shared system that confers the power to create and collect taxes only to the federal government and distribute incomes to provinces. Distribution occurs in two stages: a first one, between the federal government and all the provinces (primary distribution) and a second one between provinces (secondary distribution). Co-participation regime still exists, although with numerous modifications and substitutions.

In 1988, the last and current co-participation regime law was enacted (law no. 23.548). Following the same basic structure as the previous regimes, this law established some changes. It significantly increased the size of the Federal Tax Sharing System's fund, incorporating all internal federal taxes (direct and indirect), created or to be created in the future, and substantially increased the provincial share in the distribution to 54.6 percent of total tax collection with 42.34 percent to the federal government¹⁶. These provisions clearly favoured the provinces, however, provinces are forbidden from creating equivalent taxes to those co-participated¹⁷. This is the main reason why provinces maintain a very narrow margin in exercising their taxing power (see Tables 3 and 4). The percentages established for the secondary distribution have remained unaltered since 1988, since governors prefer establishing fixed proportions for determining the share for every province. Governors fear opportunistic behaviour of the federal government and therefore they agreed on fixed percentages.

From a constitutional perspective, it is necessary to clarify that all taxes composing the Federal Tax Sharing System's fund belong in an equal measure to the federal states as well as the provinces. Hence,

¹⁶ The remaining 2 percent is bound to a special fund to four provinces and 1 percent to the National Treasury Contributions (ATNs), a transfer with high level of presidential discretion.

¹⁷ With the only exception of (a) automobile taxes; (b) Tax on Immovable Property; (c) Stamp Duty; and (d) Gross Receipts Tax. These four taxes remain as provincial taxes.

co-participated transfers cannot have a specific expenditure allocation determined by the federal government. It is therefore a non-discretionary and non-earmarked transfer. This did not, however, prevent opportunist behaviour from the national government. In 1994, the constitutional reform incorporated the co-participation regime as a mechanism of coordinating fiscal powers, and expressly established that direct and indirect taxes are concurrent¹⁸.

There is one other constitutional provision referring to intergovernmental transfers. Art. 75.9 authorizes Congress ‘To grant subsidies from the National Treasury to those provinces the incomes of which, according to their budgets, do not cover their ordinary expenses.’ These grants are funds created with federal own-source revenues and might be earmarked or non-earmarked and discretionary or non-discretionary; a decision which ultimately depends on the federal government.

Since its enactment, the co-participation regime has been the main federal revenue transfer mechanism to provinces. Nonetheless, in the last decade other federal transfers have gained significance. With these federal transfers Argentina provinces increased the total revenues at their disposal by up to 4 percent annually since 2012¹⁹ and a total of 46 percent on average during the period under analysis. According to Schwartz and Liuksila, between 1991 and 1995, there were similar percentages in the last decade (1997:390).

The evolution of fiscal intergovernmental relations shows an increase in federal transfers, and simultaneously a decrease in the total amounts of co-participation regime²⁰. While in the beginning of the 80s, two thirds of federal transfers came from the RCFI (Schwartz and Liuksila 1997:401), in the last decade, amounts of RCFI represent an average of 68 percent of total federal transfers from 2002 and 2012. The remaining 32 percent is from other specific federal funds.

TABLE 6: Argentina. Evolution of Co-participation and Others Discretionary and Non-Discretionary Federal Transfers. 2002-2012

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	AV G
RCFI	64%	65%	70%	72%	71%	72%	70%	65%	62%	73%	64%	68%
Others	36%	35%	30%	28%	29%	28%	30%	35%	38%	27%	36%	32%

Source: Compilation based on DNCFP, Ministry of Economy of Argentina and OECD Statistical Database.

These mechanisms of federal-provincial transfers are necessary since revenue collection remains fairly centralized while functions are decentralized (Schwartz and Liuksila 1997:398). If we consider the increase of federal transfers, and the fact that 17 of 19 federal transfers are earmarked, we can conclude that provinces have lost some degree of autonomy. Non-earmarked funds represent 82 percent of total

¹⁸ Art. 75.2, second paragraph, establishes that “An agreement-law based on understandings between the Nation and the provinces shall establish systems of joint participation for these taxes, guaranteeing the automatic remittance of funds.” In addition, the Sixth temporary provision established that “A system of joint participation according to Art. 75.2 [...] shall be stated *before the end of the year 1996*”. This mandatory constitutional provision has not been implemented yet.

¹⁹ Data from 2012. Compilation based on National Direction of Fiscal Coordination with Provinces, Ministry of Economy of Argentina, databases.

²⁰ Within these federal transfers, the most important are: Education Transference Funds, Infrastructure Fund, Provincial Road Fund, F.E.D.E.I. (Special Interior Electric Development Fund/Fondo Especial para el Desarrollo Eléctrico del Interior), F.O.N.A.V.I (National Housing Fund), ATN (National Treasury Contributions), the Basic Social Infrastructure Fund and the most recent fund, the Federal Solidarity Fund (composed with 30 percent of export duties collected from soybean exportation).

amounts transferred between 2002 and 2012 (considering the co-participation regime, which is a non-earmarked or unconditional fund) with only 18 percent funds transferred conditionally.

On the other hand, only 2 of 19 federal transfers are discretionary – i.e., amounts of money freely allocated by federal government. Discretionary transfers represent only 3 percent of total amounts transferred between 2002 and 2012, whereas non-discretionary federal transfers represent 97 percent (66 percent for co-participation regime).

Adding fiscal transfers to their own resources, provinces increased their share of total resources to nearly 50 percent, with an average of 45 percent of total country revenues between 2002 and 2012.

As Table 7 shows, provincial budgets are composed of 39 percent from own resources, 41 percent from federal co-participation regime and 19 percent from different federal transfers, on average. This figure, however, does not take into account the horizontal asymmetries between provinces.

TABLE 7: Argentine Provinces' Own-Resources. Co-participation Regime and Federal Transfers. 2002-2012.

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	AV G
Own-Res.	44%	41%	38%	38%	38%	38%	39%	40%	38%	39%	40%	39%
RCFI	36%	38%	44%	44%	45%	45%	43%	39%	38%	44%	39%	41%
Fed. Tranf.	20%	21%	17%	18%	17%	17%	18%	21%	24%	17%	21%	19%
		100		100	100	100	100	100	100	100	100	100
TOTAL	100%	%	99%	%	%	%	%	%	%	%	%	%

Source: Compilation based on DNCFP, Argentina Ministry of Economy.

In Brazil, federal transfers are of two types: constitutionally mandated transfers and discretionary transfers. The first type are transfers provided by the constitution, composed of taxes collected by the federal government and subsequently transferred to the states, the federal district and/or the municipalities.

Regarding the constitutionally mandated transfers, the Brazilian constitution²¹ defines a system of “unconditional” transfers²² between the union, the states and the local governments. With reference exclusively to the states, the constitution establishes that the federal government shall distribute percentages of some taxes expressly provided in Art. 157 and 159. In addition to these constitutional transfers, specific laws may determine specific fund transfers to states and municipalities, as in the case of FEX (Financial Aid for Export Promotion / Auxilio Financeiro para Fomento das Exportações) and extraordinary transfer to municipalities by way of Financial Support to Municipalities in 2009 carried out by the national treasury. The most important of all constitutional transfers is FPE (Participation Fund of

²¹ Title VI, “Taxation and Budget”, Section VI “Tax Revenue Sharing” (Arts. 157 through 162).

²² These funds are unconditional according to Art. 160 prescription: ‘It is forbidden to withhold or to make any restriction to the remittance and use of the funds assigned in this section to the states, to the Federal District and to the municipalities, including any tax additions and increases’.

the States – Fundo de Participação dos Estados), which represented 90 percent of TC total amounts transferred in 2014 (87 percent between 1991 and 2014)²³.

TABLE 8: Brazil. Distribution of Federal Transfers. 2014

	Year	2014
FPE	1991	89,57%
IPI	1991	6,00%
IOF	1991	0,00%
LC 87/96	1996	1,81%
FEX	2004	2,26%
CIDE	2004	0,13%
AFE	2010	-
TCP	2012	0,23%
CPR	2012	-

Note: AFE and CPR were federal funds with a single disbursement in 2010 and 2012, respectively.

Source: Compilation based on Ministry of Finance of Brazil databases,
<http://www.tesouro.fazenda.gov.br/>.

The second group is the so-called Voluntary Transfers of Union – TVU (in the Portuguese acronym of “transferências voluntárias da união”), discretionary transfers from the federal government to the states. These “federal discretionary transfers are within the competence of federal government, more specifically of the national Executive branch, which has full freedom to set amounts and geographic destinations for these discretionary funds, in addition to the public policies that are to be benefited” (Soares and Pereira Neiva 2011:95).

In the last seventeen years, discretionary transfers (TV) played a prominent role in federal transfers, being overtaken by constitutional transfers only in the last year of the considered period, 2014. Taking the 1997-2014 period into account, we can observe a breaking point in 2007-2008, when Constitutional Transfers increase from 24 to 42 percent, and grow to reach 57 percent of total resources transferred to states in 2014, whereas Voluntary Transfers had reached 92 percent in 2001. Despite this evolution, in the period under consideration in this article (2002-2012), TV represented 71 percent of federal transfers.

TABLE 9: Brazil. Comparative Evolution of TC and TV to States and Federal District. 2002-2012

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	AV G
T												71
V	87%	88%	87%	84%	81%	76%	58%	58%	62%	41%	60%	%
TC	13%	12%	13%	16%	19%	24%	42%	38%	59%	40%	40%	%

Source: Compilation based on Ministry of Finance of Brazil databases.
<Http://www.tesouro.fazenda.gov.br/>.

²³ According to an own Compilation based on Ministry of Finance of Brazil databases,
<http://www.tesouro.fazenda.gov.br/>

TC in Brazil are similar to RCFI in Argentina, since both federal transfers are non-discretionary and non-conditional transfers. TC represented between 42 and 59 percent of total federal transfers to states in the last years; RCFI in the same period represented 68 percent.

With this federal transfer structure, Brazilian states' budgets are composed of 59 percent own-resources and 41 percent federal (constitutional and voluntary) transfers. Despite the strong presence of federal transfers in intergovernmental fiscal relations, subnational states have an important percentage of their budgets composed of own resources, increasing their fiscal autonomy. The percentages of States' own resources progressively increased from 41 percent in 2002 to 73 percent in 2012.

TABLE 10: Brazil. Federal transfers as percent of total states' Own-Resources and Federal Transfers. 2002-2012.

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	AV G
Own-Res.	41%	41%	44%	47%	51%	57%	69%	72%	71%	78%	73%	59%
Fed. Transf.	59%	59%	56%	53%	49%	43%	31%	28%	29%	22%	27%	41%

Source: Compilation based on Brazil Ministry of Economy and OECD Statistic Database.

Federal transfers increase the total amount of resources available to subnational units; however, they increase the extent of dependence of subnational governments in the administration of competences and public services.

Federal transfers in both countries represent an important percentage of provincial resources. However, Argentine provinces are more dependent on these funds (60 percent – Table 7) than Brazilian states that have more autonomy regarding federal funds (41 percent – Table 10). The positive side of this is the increase of subnational units' resources. Brazilian states represent 46 percent of the country's total resources (52 percent for the federal governments) in the period under analysis. In 2012 subnational governments in Argentina represent 48 percent (own resources plus federal transfers), whereas Brazilian states decreased their resources up to 34 percent in the same year.

TABLE 11: Subnational Resources as percent of subnational and federal total resources *after* transfers. 2002-2012

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	AV G
Argentina	45%	45%	45%	46%	46%	46%	44%	47%	47%	48%	48%	46%
Brazil	62%	63%	59%	53%	49%	43%	37%	36%	36%	32%	34%	46%

Source: Own elaboration based on DNCFP, Argentina Ministry of Economy, Brazil Ministry of Finance and OECD Statistical Database.

While in Argentina earmarked funds are numerous, they do not represent the largest portion of federal funds. These are the non-earmarked funds, which increase the autonomy to expend but, at the same time, creates a problem regarding coordination and equality among provinces. In Brazil federal funds are less important than in Argentina, since states' own resources are higher, with a higher tax autonomy and spending autonomy.

POWER EXPENDING BETWEEN DIFFERENT LEVEL OF GOVERNMENT: THE SUBNATIONAL EXPENDITURE.

So far, we have considered the resources available to subnational units. To have a full picture about the fiscal aspect of federalism in Argentina and Brazil, it is necessary to bring into the analysis the level of public expenditure of subnational units. Federated units may have important resources at their disposal, nonetheless if they have many competences to fund and if their own resources and federal transfers are not enough to cover them, their self-financing capacity would be compromised and their fiscal autonomy as well.

From this perspective, public expenditure can be approached in two different ways. On the one hand, a high level of spending on programs and public services may provide a positive political influence. On the other hand, a large amount of expenditure without an adequate amount of resources may imply a great level of dependence on federal government's resources. In other words, the level of expenditure measures the government's "capacity to act" (Thorlakson 2003).

The level of subnational public expenditure is a useful index to measure the size of subnational administration of competences and public services and it is complementary to the former index (transfers of federal funds index) to measure the degree of dependency or autonomy with which levels of governments perform their responsibilities.

Due to the increase of new and further competences assigned to subnational units (as mentioned before), their share of public expenditure significantly increased in the last decades. As seen before, both national constitutions adopt a welfare state model for both the national and subnational states, with most of these welfare competences concurrent. However, through important processes of decentralization, subnational governments address the most sensible and critical competences and services. Police officers, teachers, bureaucrats and physicians depend on local government actions. Provinces not only pay their wages but also the infrastructure and supplies necessities to perform these activities (Gervasoni 2010, 2011). In many cases, subnational states are the engines moving local economy. This is an important fact, since in both federations horizontal asymmetries are high.

What we have to consider next is (a) how much provinces or states expend (b) for what do they expend, considering the most important competences they can afford (c) to what extent they cover their expenses and (d) the need to resort to (internal and/or external) debt. Points c and d will be analysed in the following sections.

Public Spending Decentralization: How much do subnational governments expend?

Decentralization of public spending is a worldwide trend, even in unitary countries (Rodden 2004). Argentina and Brazil are not the exception. In Argentina, the most important turning point in the evolution of public expending between levels of governments occurred at the beginning of the 1990s, when federal government decentralized some competences – in particular, education and public health. Provinces increased their public share of expenditure from 25 percent in 1986 to 38 percent in 1994 (World Bank 1996:5) just after the decentralization process occurred.

This trend continued over the following decades. Subnational units share was 40 percent on average between 1994 and 2009. In 2006 provinces reached the highest share of public expenditure (43 percent), however, since then the percentage began to decrease to 40 percent in 2007, 39 in 2008 and 38 in 2009 (see Table 12). This downward tendency corresponds to a change in state model since Kirchner took office in 2003, moving from a neoliberal state (introduced by the Menem administration in the 90s) to a more interventionist state. Central government recentralized some competences like housing and

renationalized the social security system. These percentages align Argentina with other decentralized federations, such as Germany (38) and Switzerland (39) (Swenden 2006:109).

In Brazil, fiscal federalism shows two phases: from 1980 to 1994, where a decentralization process occurred and a second phase from 1994 on, where intergovernmental relations experienced a recentralization process (Soares and Pereira Neiva 2011:97). The first period is characterized by an increase in the share of tax resources and a decentralization of public expenditures in favour of the state and local governments. This process, however, was carried out in an uncoordinated way, characterized by a lack of constitutional and/or institutional mechanisms for cooperation and fiscal accountability (Soares and Pereira Neiva 2011).

The share of public expenditure of states governments began to increase sharply. While in the beginning of the 1980s, state public expenditure share represented 22 percent of the total consolidated public expenditure (considering federal and local levels of government) in 1988 the share began to systematically increase from 27 percent (Soares and Pereira Neiva 2011) to 45 percent in 2003 and 59 percent in 2012, with an average of 47 percent between 1997 and 2012 and 46 percent in the period 2002-2012²⁴. These values place Brazil among the most decentralized federations in the world.

TABLE 12: Subnational Expenditure as percent of Total Country Expenditure

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	AV G
Argentina	40%	39%	42%	42%	43%	40%	39%	38%	37%	37%	36%	39%
Brazil	46%	45%	44%	44%	43%	42%	45%	44%	42%	51%	59%	46%

Source: Brazil 1980-1993 Soares and Pereira Neiva 2011, 2003-on, Brazil Ministry of Finance; Argentina Ministry of Economy.

The year 2006 is a breaking point for both federations: Provinces and states reached a 43 percent share of public consolidated expenditure. In Argentina this percentage was the highest percentage of public consolidated expenditure, and has since decreased while the Brazilian states, instead, continued to increase their share up to a high of 59 percent in 2012²⁵.

Subnational Expenditure by Function and finality: What subnational governments actually spend their money on

As we have seen before, most of the competences allocated by the constitution are concurrent between federal and subnational levels. On the one hand, constitutions assign to the federal levels the most traditional competences (defence, foreign affairs, army, economy, etc.). On the other hand, both constitutions proclaim a large amount of competences as concurrent. These competences revolve around the idea of a welfare state model – defined as “the complex of policies that, in one form or other, all rich democracies have adopted to ameliorate destitution and provide valued social goods and services.” (Hacker 2006:385).

The competencies that encompass this model of state focus on social policy areas, typically health, education, social security, housing, sanitation policies and the newest ones, such as environment and consumer protection. Through different process of decentralization, the federal levels delegated the

²⁴ According to an own compilation based on Ministry of Finance of Brazil databases.

²⁵ Unfortunately, data from 2010 and 2012 is not available for Argentina.

administration and implementation of these policies, while reserving the financing and establishment of general and nationwide minimum standards. This logically increased subnational share of consolidated public expenditure.

In Argentina, the rise of subnational expenditure was inversely proportional to the decrease of federal spending on the same areas:

TABLE 13: Argentina. Share of Public Expenditure by Function between levels of Government

Sector	Federal		Provincial		Local		Total
	1986	1994	1986	1994	1986	1994	
Basic Education	33.7	0.4	63.7	96.5	2.6	3.2	100
Higher Education	83.9	78	16.1	22	-	-	100
Health Care	14.8	12.7	75.3	73.7	10	13.6	100
Sanitation	32.4	7.9	67.6	92.1	-	-	100
Housing	13.5	6.5	75.4	69.6	11.1	23.9	100
Social Welfare	65.9	16.2	34.1	83.8	-	-	100
Urban Services	-	-	3.6	6.7	96.4	93.3	100
Total	70.7	54.2	25	38.5	4.3	7.4	100

Source: World Bank, 1996a:5

The areas in which provinces most increased their expending were basic education (32.8 percent more), sanitation (24.5) and social welfare (49.7). These same areas represent 56 percent of the provincial budget. Other services also increased, but to a lesser degree higher education (5.9 percent) and urban services (3.1).

In housing policy, the federal government contributed to finance home construction programs, which are implemented and developed by the provinces – in addition to other existing provincial programs. The financing is made through a federal transfer fund named FONAVI (the Spanish acronym of “Fondo Nacional de la Vivienda”). In education, provinces are unilaterally responsible for implementation and administration of primary and secondary education, whereas the federal government reserves for itself university education. Federal government contributes to the financing of those policies through three specific federal funds. Education Transference Funds (Fondo de Transferencia de Servicios Educativos. Law 24.049/1991). Education Fund (Fondo Educativo. Law 23.906/1991) and Education Financing Law 26.075, which provides a program to increase public investment in education. In addition, Law 26.206 provides the nationwide minimum standards of educational programs and main objectives to be reached by provinces. Among these main objectives, Law 26.206 establishes the ability of provinces to increase their expenditure in education up to 6 percent of their GDP.

In health care policy, at the same time, the federal government fully decentralized the administration of all hospitals and assistance services: 20 hospitals with 9,200 employees and 22 families and young institutes with 1,700 employees (Tommasi 2002:69). This transfer represented an expenditure of AR\$ 110,7 million – 17 percent of the National Administration Budget destined to health (Cetrángolo and Gatto 2002:19).

The federal government manages the Social Security System (pensions, retirement and other social assistances). In the 90s, the federal government recentralized all social security systems administered by provinces, leaving to them only those concerned with provincial public employees and liberal professionals. As the provincial Social Security System was one of the many factors leading to deficits

and local economic breakdown, both levels of government agreed to pass this system to the national sphere and in turn, privatized the system.

As many provinces resisted delivering the total system, the federal government created a Special Fund over the VAT collection (Law N° 23.966/1991). Ten percent of VAT collection is targeted to finance the Provincial Social Security Fund, distributed among provinces according to an index consisting of the number of beneficiaries of the Provincial Social Security Fund.

The processes of decentralization of education and health care were made through national laws (No. 24.061 and 24.049, both from 1991) without prior consultation or negotiation with the provinces. The decentralization was imposed on subnational units, generating important intergovernmental conflicts. As many authors have maintained, decentralization had the implicit aim to balance the national budget (Falleti 2001) and the consequence was a decentralization of responsibilities and a recentralization of revenues. Two years later, provinces increased their public expenditure share of education to 96.5 percent and of health care to 73.7.

In Brazil, the 1988 constitution established most of these policy areas as concurrent. The Brazilian federal design authorizes subnational states to invest in health, education, welfare, housing and sanitation, but this authorization does not imply a constitutional mandate, so “no federal entity was constitutionally obligated to implement programmes in those areas” (Arretche 2004:22). Unlike the Argentine case, the 1988 Constitution decentralized revenues, but not the functions (Almeida, 1995. Arretche 2004).

In practice, however, subnational governments are responsible for implementing and administering those policies. In public education, the federal government is responsible for financing and coordinating the policies, while subnational governments administer and implement them. States are dependent on federal transfers to afford public health expenditures and the federal government establishes the policies and governmental action in this area. With federal coordination, the network and the delivery of outpatient services has basically become municipal (Arretche 2004)²⁶.

Educational policy is allocated by the constitution to the three levels of governments (and is, therefore, a concurrent competence) but in practice, is managed by states and municipalities – who decide the main policies. Regarding the financing aspect, the constitution mandates that states and municipalities invest 25 percent of their own resources to education. Consequently, the federal government plays a secondary role in financing education policies. In 1996, a constitutional amendment introduced the FUNDEB, a special fund consisting of 15 percent of state own-resources earmarked to education. The same constitutional amendment established that the federal level should help finance states that do not cover the minimum national standard of education expenditures.

In housing policies, states and municipalities are responsible for implementing and administering the programs – especially those programs designed to provide housing to low – income people. Funding comes from the federal level through a special fund (Fundo de Garantia per Tempo de Serviço – FGTS), which is administered mostly by municipalities. However, states retain the capacity to decide on the distribution of these resources through state commissions whose members are nominated by state governments. As in the case of health policy, the federal level is responsible for formulation and financing of housing national policy.

The participation of states and municipalities in public spending for in these three policies (education, housing and health) are similar:

²⁶ The radical decentralization of health services was, however, a main pursued by the 1988 Constitution and culminated in the enactment of the Organic law of Health (1990) which allocate competence on decision – making, resources and functions on this area to municipalities (ALMEIDA 1995).

TABLE 14: Brazil. Share of State and Local Public Expenditure by Function between 1996 and 2000 as percentage of GDP

	States		Local		Total	
	1996	2000	1996	2000	1996	2000
Housing & Urban Services	0.2	0.2	1	0.8	1.1	1
Health and Sanitation	0.9	1.1	1.1	1.5	2.0	2.6
Education and Culture	2.1	2.6	1.	1.9	3.5	4.4
Total	3.2	7.4	3.5	4.2	6.6	8.0

Source: Rezende and Afonso 2002:18.

As in many countries of Latin America, decentralization of public spending on health and education is pronounced in Argentina and Brazil. In Argentina, subnational governments cover 50 percent of total government expenditure in health and 80 percent in education, whereas Brazilian subnational governments cover 50 and 70 percent, respectively. These expenditures represent 38 percent of total subnational expenditures for both countries – with identical percentages in each area: 15 percent on health and 23 in education (Jiménez and Ter-Minassian 2012)²⁷.

VERTICAL FISCAL IMBALANCE

The vertical Fiscal Imbalance index helps us answer the question: To what extent do subnational levels cover their expenses? So far, we have considered the amount and purpose of subnational public spending. When we ask to what extent subnational government cover their expenses, we are referring to an important issue within fiscal federalism: the fiscal imbalance. Fiscal imbalance arises when subnational governments do not have enough resources to cover their expenditure need (Swenden 2006).

Fiscal imbalance can be vertical or horizontal. Horizontal fiscal imbalance appears when the ability to cover public expenses differs between subnational units. This may occur when regional taxes are unequally spread or when per capita revenues and expenditures vary strongly from one unit to another (Swenden 2006). There are, of course, other factors contributing to horizontal imbalance, such as the geographic characteristics of subnational units, population, etc.

Fiscal imbalance is vertical when subnational insufficiency exists relative to the federal level. In this article, I focus on vertical fiscal imbalance (VFI) only. I have taken the average of subnational own-resources plus federal Transfers as a percentage of total country revenue and the percentage of subnational public expenditure as a percentage of total country public expenditure, using average data from 2002 to 2012. The VFI index is determined by the ratio of total revenues and public expenditure using the available official data from Countries' Ministry of Economy and OECD databases. According to Sweden, if the ratio obtained is lower than 1.0, then subnational units do not cover their expenses with their own resources (i.e., locally raised taxes). Conversely, if the ratio exceeds 1.0 then subnational governments receive more money than they expend (2006:142). A ratio of 1.0 indicates a perfect vertical balance.

²⁷ For both cases, authors include states and municipalities.
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TABLE 15: Vertical Fiscal Imbalance in Argentina and Brazil (2002-2012)

	Argentina	Brazil
Expenditure	40	44
Revenues	18	25
VFI	0.45	0.56

Source: Own elaboration based on data supplied by countries' Ministry of Economy and OECD database

Table 15 shows the Vertical Fiscal Imbalance index obtained for both countries. VFI is higher in Argentina than Brazil, meaning that provinces in Argentina are responsible for a high percentage of consolidated public expenditure but at the same time, they have an insufficient allocation of own resources. Brazilian states are closer to fiscal balance (0.56), with an index similar to Germany (0.75).

Brazil has a VFI of 0.56 meaning that states are responsible for a higher percentage of consolidated public expenditure. In Argentina VFI is lower than Brazil, because subnational participation in the consolidated public expenditure is also low. In any case, VFI is a useful index to confirm the dependence of subnational governments on federal transfers to afford their responsibilities. Our findings confirm the general trend, that VFI is common in most countries.

It is interesting if we measure fiscal imbalance after transfers. In this case, Argentine provinces exhibit a VFI index of 1.16, and Brazilian states 1.0, a perfect fiscal balance.

PUBLIC DEBT, BORROWING CAPACITY AND OTHER FORMS TO FINANCE POLICIES

Borrowing capacity may increase fiscal autonomy of local governments, however, it may provide an instrument to exploit the federal level. This behaviour is described by the so-called moral hazard problem, which is inherent to any federal structure. We need to consider the formal (constitutional and/or legal) limitations to subnational units' capacity to borrow, and the practical ability of constituent units to borrow.

As Rodden emphasizes, "central governments might attempt to restrict the fiscal autonomy of subnational governments not only through conditional grants and regulations governing local taxation, but also through formal limitations on subnational borrowing (2004:486). In Argentina and Brazil, legal limitations on borrowing capacity were implemented by federal governments in order to maintain some level of fiscal discipline. With responsibilities for more competences subnational governments began to appeal to borrowing. As decentralization has been an international trend, subnational public debt and deficit emerge as a (non-desirable) worldwide trend. These new phenomena have begun to draw the attention of scholars, who have alerted us to the danger of decentralization (Prud'homme 1995, Rodden 2002).

Subnational public debt seems to be a consequence of decentralization. Since 1980, when decentralization processes had not occurred, the average subnational deficit was only 0.42 percent of GDP in sixty-three countries (Rodden 2002). However, federal countries are at the top of the rating; Rodden accounts that in eleven formal federations the average subnational deficits exceeded 1 percent of GDP and accounted for nearly 20 percent of total government deficit (2002:671). Argentina and Brazil are two

paradigmatic cases “the aggregate subnational deficit routinely surpasses that of the central government and exceeds 2.5 percent of GDP” (Rodden 2002:671).

Argentina and Brazil are good examples of the risks a lack of limits and controls on subnational borrowing may imply. World Bank reports had already alerted in the early 1990’s that national economic meltdown was caused mainly by subnational fiscal indiscipline (World Bank 1993, 1996).

Borrowing capacity - i.e., the ability to access credit market or other sources of deficit finance independently” (Rodden 2004:486) – is another important component of subnational fiscal autonomy. However, a limitless capacity to access credits and debts may be a serious cause of economic and fiscal instability at the national level (a consequence of the well-known “flypaper effect”).

According to Rodden’s index²⁸, Brazil and Argentina ranks first and second with 4.0 and 4.5 respectively, on a scale of 1 to 5 in a sample of 39 countries, whereas others federations exhibit 2.5 (Australia and Germany), 2.7 (Canada) and 3.0 (Switzerland and USA) (Rodden 2004:483).

A broad ability to borrow and a lack of fiscal constraints, make it possible for subnational units to resort to many kinds of alternative financial sources. Aside from federal resources (co-participation regime, federal transfers and loans, etc.), provinces finance their deficits through three main sources: (a) borrow from suppliers and contractors (via arrears and delays in payments); (b) loans from provincial banks (which in turn were financed by rediscounts from the Central Bank); and (c) loans from national public banks – which account for more than 20 percent of their financial needs).

In the 1980s, the average annual primary deficits of Argentine provinces (excluding discretionary grants of the National Treasury – ATN) stood at nearly 1.7 percent of GDP, contributing on average approximately 40 percent to the fiscal primary deficit. In the 1990s, the total deficit of provincial governments was also high, rising to US\$1.6 billion. The provinces remained financially distressed after 1986 and were unable to recover until the second semester of 1994. Between 1982 and 1985, the annual financing requirements of provinces averaged only US\$800 million. Between 1986 and 1990, this need doubled to an annual average of US\$1.6 billion. Preliminary data for 1992 shows provincial government deficits amounted to about US\$400 million (World Bank 1993:125).

In conclusion, “the availability of these resources and sources of financing created the perverse incentive to spend without raising revenues. For these reasons, provincial governments have been primary contributors to the consolidated public sector deficit since 1986” (World Bank 1993:124).

The rise of subnational expenditure in the early 90s exacerbated this behavior. This trend continued over the following decades: in 1999 after the Tequila shock (1995) and the devaluation of Brazilian currency (1997), provinces increased their deficit and indebtedness (Tommasi et al. 2001). In 1995 provincial public debt represented 54 percent of total revenues. By 1999, Federal governments refinanced provincial debt on a ten-year term. In 2001, the country experienced a severe economic crisis. While the federal government refinanced the provincial debt and implemented an adjustment of 4 percent of GDP, provinces continued to increase their public expenditure.

At the end of the decade, the situation was similar. The public debt increased from 30 million in 2001 to US\$ 95,400 million in 2008. A bailout from the federal government was, once again, the solution. Through a presidential decree, federal governments compromised to refinance provincial public debt on a thirty-year term.

²⁸ This index considers debt authorization requirements, numerical limits, restrictions on the use of debts imposed by central government, and the ability to borrow through Banks and public enterprises owned by subnational government.

The Brazilian experience was quite similar. In the 1970s, state borrowing increased sharply and in the next decade, with a deepening recession, states experienced a widespread default in 1989 and 1993. The federal government rescheduled states' public debt on a twenty-year period, after lengthy negotiations. In the mid-1990s, states expenditure began to rise again, especially in 1995 when states increased the salary of public employees. Brazilian state behaviour was similar to Argentine provinces. To finance themselves, Brazilian states resorted to payment of suppliers and employees, in arrears short-term borrowing from commercial banks and guarantees for bank borrowing by contractors for state infrastructure projects. States' public debt increased from 2.5 percent of GDP in 1991 to 5.4 percent in 1996. The federal government had to intervene once again, shifting most of the states' debt into federal bonds (Ter-Minassian 1997:451-2).

Rodden (2002) develops two hypotheses that could explain subnational fiscally unruly behaviour. First, if subnational units have access to credit, higher levels of dependence on intergovernmental grants will be associated with larger subnational deficits. Second, this commitment problem should be most pronounced in federal systems, especially when the states are directly and disproportionately represented in the upper legislative chamber (2002:671). Both hypotheses are present in the Argentine and Brazilian cases.

CONCLUDING REMARKS

Based on the analysis of these seven variables it is possible to have a broad idea on the degree of fiscal decentralization in these two traditional Latin-American federations.

Regarding variable 1, both federations constitutionally recognize a large number of competences as concurrent among both levels (or three levels, if we consider municipalities in the analysis), and the bulk of those policies are social in nature. This reveals two things: constituent convention desired a cooperative – rather than a dual – federalism and they wanted to create a subnational-based welfare state. Regarding variable 2, the Argentine constitution is vaguer in defining the fiscal powers of both levels and ultimately, that gap was filled by intergovernmental agreements that result in a centralization of fiscal resources. The Brazilian constitution is more precise and delegates a significant number of taxes to subnational units: 26 percent of Brazilian taxes are subnational, compared to 11 percent in Argentina (Table 3).

When it comes to own resources, Brazil is again more decentralized. Both federations have maintained a regular percentage over the decade, Argentina between 19 percent and 20 percent in the period 2002-2012 and Brazil between 25 percent and 26 percent in the same years (Table 4). As a consequence of that, federal transfers play a more important role in Argentina than in Brazil. Federal transfers have increased in size and importance during the last decade.

Argentine provinces rely more on federal transfers, which cover 59 percent of provincial budgets (Table 7). Brazilian states cover 39 percent of their budgets with central transfers (Table 13). When we add federal transfers, both federations increase the total amount of resources at the subnational units' disposal.

With respect to power the most important variable in measuring subnational autonomy, it is clearly observable that state levels of government have increased their participation in public spending due to the increased allocation of constitutionally recognized powers. In Brazil 46 percent of the total country expenditure is subnational, while in Argentina it is 39 percent (Table 12). In both cases, however, most of the subnational expenditure is destined for social policies and in both cases, those policies are basically the same: housing, health and education (Tables 13 and 14). It should be noted, however, that spending autonomy is higher in Argentina, since provinces have greater flexibility in deciding to expend their money due to the fact that most of the transferred resources are non-discretionary and non-earmarked,

while in Brazil most federal transfers are for a specific purpose. The VFI is consequently higher in Brazil (0.56) than in Argentina (0.45). Finally, borrowing capacity has moved higher in both countries, which represents a risk for the federation given the possibility of the “flypaper effect”.

The main conclusion of the comparison between these two Latin American federal countries, the main aim of this research is that both federations show a reasonable degree of decentralization. This decentralization was started by the constitutions and extended subsequent agreements and national legislations and sought to put in the hands of subnational governments the administration of social policies but reserving to themselves a role of fixing minimum standards and financing. Federal governments retain important tools in the fiscal relationship, especially in determining the tax legislation.

Constitutional mandates do not necessarily coincide with reality. If constitutionally guaranteed autonomy is the most important difference between a unitary and a federal setting, a simple constitutional declaration will not be enough.

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