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AN ASSESMENT OF THE
BRAZILIAN FISCAL BEHAVIOR

By Urbano Montero Martinez

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INTRODUCTION

In the past, economic development was treated as a long-term dynamic process that was characterized by the increase in per capita income.

Later on, more complex and all-encompassing surged that definitions considered other essential subjects related to the quality of life. In this new context they acquire the highlighted importance of the distribution of income, employment level, poverty and social imbalances. With this it started differentiating development and growth becoming then very difficult to apply unique measure that simultaneously contemplates changes in the product per inhabitant and the distribution of national income.

The modern development theory has been registering important and fast changes , and some peculiar aspects of them have captured attention of illustrious economists with wide international experience.

The first aspect refers to the accelerated rhythm of transformations in the international economy, altering dramatically the way of thinking on development notions and economic policies. Models of a closed economy which were conceived separately from the countries' economies have limited usefulness.

Today a national economy and its temporary development need to be analyzed in the international context of a globalized economy where the policies of other countries frequently influence domestic policies of development. In other words, the theory of development starts attributing great importance to the theories of international market and exchange rates as well as to the policies of foreign investment. The search of competitiveness has been the common ground of this new scenery.

INTERNATIONAL ECONOMY - OVERVIEW

In his classic work " The open society and its enemies (1966)", The Austrian Karl Popper tells us how sailing and trade gradually undermined the foundations of closed societies gradually and made it easy for the Greeks to create institutions of opened societies that became the cradle of Western civilization. The Peloponessian Wars , between Athens standing for democracy and markets and Sparta militarist and autarchical, represent even at that time the shock between two systems of political and economic organization in conflict which still persists 2,400 years later.

The technology of telecommunications and the globalization of financial flows and international trade dissolve the foundations of the old order today such as nationalism, statism and corporativism while accelerating in planetary scale the march to heading for the Great Open Society.

The globalization is a summary term for the growing integration of the economies in the world for trade, financial flow, transport facilities, technologies and communication. In general it promotes prosperity; the nations that opened up the borders to the international trade have achieved better figures than those that built protectionist walls. And although to put obstacles in the route of the liberalization of trade it is a self-defeating reaction, the anxiety is not just real, but also well based. Those that will promote the free market are very conscious of that.

We are testifying today the victory of markets - not the victory of capitalism. That distinction is critical. The capitalism, strictly defined, presupposes the existence of private property and the legitimacy of profits. But the existence of the private property doesn't guarantee the economic growth or the technological innovation. It can just guarantee the permanence in the power of an economic elite and a social aristocracy, through a system of private privileges and rooted commercial benefits. The market society unavoidably includes capitalism if, for that term, we understand the private property thoroughly spread out . But it goes beyond the capitalism. It implies opening to the competition, to the constant transformations and the menace that yesterday's winners can come to be the losers tomorrow, and vice-versa.

This is the process which has been dominated more and more in most countries. That doesn't mean the governments have abandoned its economic responsibilities. Seem historically, the faith in the " market " is simply the most recent expression of the dominant ideology in the last half of the 20th century. It is expected from the governments that guarantee the economic growth as a way to increase the life pattern of its citizens' well-being. As the decades past different political leaders in the world have followed different roads as communism, keynesianism, several lines of socialism and economies controlled to accomplish those goals.

What the governments recognized now is that other strategies failed or they were surpassed by more powerful tendencies. The most obvious of those tendencies is the dramatic fall of costs of the communications and the transportation, commercial expansion and the growth of the multinationals. The result of this is that more and more countries are at the mercy of global forces on which they can have very little influence or none at all The multinationals and the international investors are constantly evaluating the different countries to identify the best opportunities of investments or sales. The governments cannot, theoretically, control or protect their societies against those foreign forces. But if they exercise those powers in a very energetic or not very responsible way, imposing commercial restrictions to the investments or generating massive inflation, they will sacrifice the benefits of the global flows of capital and technology.

In a place that dilemma appears more clearly is Latin America. Since the beginning of the eighties, more and more countries adopted market " reforms ": commercial opening, privatization of industries, combating inflation. In all those countries, those new policies seek to revert decades of centralized control, under the influence of cartels or commercial and investment restrictive policies. But despite the changes made the results have been in most of the countries quite modest. In an article published in an American newspaper " Foreign Affairs ", economist Sebastian Edwards, University of California (LA), traced a detailed description of some of those disappointments.

a) Between 1991 and 1996, the GDP grew 3.1% -average- in Latin America and Caribbean, less than oriental Asia or than the index of 3.4%/year that the World Bank calculates to be necessary to reduce the poverty.

b) The foreign investments in Latin America continues insufficient. According to Edwards, they reached its pick in 1994, when they reached 1.4% of the GDP . Contrasting with that the foreign investments in the oriental countries has been more than 3% of the GDP every year since 1993.

c) The Latin-American countries have had less success in the export markets than the Asians. In 1980 Latin America and oriental Asia had equivalent commercial sectors -exports plus imports- around 30% of their GDP's. In 1995, oriental Asia surpassed the mark of the 50%, while Latin America continued about 30%.

As those figures suggest, the adoption of the " market " doesn't guarantee success. It is interesting to say that Latin America grew more quickly in the years 60 and 70, when most of the countries refused to open to trade and investment policies. - Between 1965 and 1980, the growth of Latin-American’s GDP reach the average of 6%, according to Edwards- Would the promise of the market be false? Actually not. During sixties and beginning of seventies Latin America benefitted from the fast growth of the developed world that guaranteed strong export markets. And at the end of the 70’s , its growth was sustained by gigantic loans from foreigner banks, these were imprudently used for consumption and that finished provoking the " crisis debt " in the eighties. Latin America had growth in the seventies but paid with growth stagnation in the eighties.

The important question is why Latin American countries continue behind in relation to equivalent countries in Asia. The reason is the skepticism of foreigners and national investors toward the continuity of reforms. They know the legacy from the past and ask themselves if it could be overcome easily and permanently. Edwards writes that scarce foreign investments result from the impression that the rules of long term investment continue unstable in Latin America. In the last few years some Latin countries - including Brazil - have been receiving a very large flow of foreign investments. What is in question is if this attitude could constantly change or could be sustained as it has already changed before.

All countries on the road to development - especially the Latin-American ones - has suffered the effects of a common dilemma. Almost unavoidably the " market " reforms exercise turbulent effect, because chase away industries and policies implanted a long time ago. In general the populations of Latin American countries have been tolerating those troubles recently due to the promises that changes would increase growth, employment and income. But if the foreseen benefits would not become true in short time, a public reaction could happen against the reforms, putting transformation process in danger.

That means that the theoretical economic advantages from the market will not work together without a favorable political climate. To enjoy the benefits from market, the countries need political consent in its favor , and they need to dispose to tolerate the imperfections from market. In Latin America, that consent is not strong. A political climate adapted is also important in a second sense. As the countries approach themselves economically, they need to improve their means of working together. The history of last half century has shown that cooperation has happened. In general, through organizations as WTO (World Trade Organization) , IMF (International Monetary Fund) and the World Bank. But the fact that had happened in the past doesn't guarantee that would happen in the future.

The procedures and the habits of transactions of flows of products, services, technology and investment capital are important but equally important is the atmosphere of confidence climate and necessary cooperation to work with the unexpected - such as the financial crises, that would adversely affect many countries. The major issue is if the economic integration pushed by the market would be the highest priority considering political capacity of countries, their cultures, histories and different interests to solve common problems. Half a century ago, the global economy could be described, wisely, as being composed by United States and Europe, with Latin America, Asia and Africa playing small parts. Today, that no longer is true, and one of the great doubts in relation to the 21st century is if the increasing economic interdependence could coexist with nationalism.

INSERTION IN THE GLOBAL MARKET

Decades of protectionism in Latin American countries allowed the industrialization, but, simultaneously they did not create an innovative managerial class and provoke a technological delay in a variety of sectors. Thus it doesn't seem reasonable to persist in those policies. It is vital for those countries to find a new insertion role in the new global logic.

A delicate problem of economic opening is that which involves among others relative restrictions to the domestic employment level and foreign accounts. The equilibrium of trade balance at a certain exchange rate involves the level of prices productivity and tariffs. The abrupt drop of tariffs without an equivalent jump in productivity can bring consequences to the trade balance - and employment - that demand an exchange devaluation. Thus the speed and the range of an economic opening process determine the subsequent costs and benefits. Otherwise perverse effects in the employment level, growth rate and the balance of payments will tend to happen. Progress in the systematic competitiveness and productivity level - that has been slow - are essential factors to reconcile opening and growth.

For a country like Brazil, with important industrial production and great domestic market, there are many reasons to contemplate. The direction of movement is not questioned. The opening to the world trade is an inevitable tendency. But the fragility of the employment structure, national industry and high internal costs as well as the Brazilian government's inefficiency demand an intelligent strategy that gauge simultaneously the quality and the speed of that opening.

The basic dynamics of Brazilian development begins without government's actions, especially such as the national program and elaborate investment project although this is not the case concerning the basic macroeconomic configuration. The government bureaucracies and the politicians have lost the missionary role that they assumed along decades. Progress and growth are obtained currently in the private area and in those circumstances the government needs to use exhibit a list of accomplishments that is not limited, and not even giving priority to the number of plans that it had begun. The priorities move from the instruments - programs, expenses - to the final objectives - social and economic indicators - . The real wage does not arise in function of salary policies, but it arises in function of growth and productivity generated from the private sector. It stops being a conquest of the government or parliament. The investment happens because the private sector trusts in the sustainability of a basic macroeconomic framework. It is no longer a consequence of a national project composed of megainvestments warped in cabinets. The government is not the primordial agent of process anymore and from those results a basic anguish from the politicians whose platform traditionally consists in a collection of expenses listed in a document of goals. In the past however the politician was committed to expenses that produced development in the ambit of a model where the State was the promoter of the mechanism. Today the " plan of government goals " is not so important anymore, and in that context the politicians' great challenge - and government's great challenge - are changing the terms of how government is evaluated and it is worth saying that this will redefine the rhetoric of the development process in such way that the basis of judgement of effectiveness will come from the State actions.

What is lacking in Brazil for it to proceed more quickly in globalized trade is known, it should continue reforming the State through privatization, adjusting budgetary imbalance, reforming the Social Security and furthermore Brazil needs a fiscal adjustment to increase its efficiency in the allocation of resources as well as becoming more consistent and solid in the long term.

It is a colossal challenge. But happily the transformations have already begun, impelled by the cultural rupture. The social support has growing with the economic stability and the State's reform.

Despite the challenge, there are reasons for optimism. Before even the restoration of investment levels, the productivity has grown by the reduction of business' costs and the increase of the efficiency of the economic system, allowing that the GDP and per capita income had begun to move again.

It is not unfortunately a sustained growth. The macroeconomic management is still failing. Without the fiscal reform, the monetary policy assumes excessive function in the control of the demand. The almost inevitable stop-and-go produces unnecessarily waves of expansion and contraction in the economic activity with high costs and risks of reestablishing a climate of uncertainties.

The sustained development depends on at least five pre-requisites : (Gustavo Franco - Public policy - 1996 - essays)

1) the recovery of high levels of saving and investment;

2) the elimination of cascading tax system , through tax reform;

3) the fiscal adjustment;

4) the reduction of the systematic costs, well known as Brazil Cost ; and

5) the creation of a compatible institutional basis according to the new development model.

FISCAL ADJUSTMENT

In the conduction of economic policies as in life absolute and definitive solutions do not exist. Every victory is partial every conquest could have a setback. Any solution as ingenious as it may be opens opportunity for the appearance of new problems - problems that we had ignored until they resurface or as usual they are a result of our choices. Maximum that we can expect is that challenges are progressively solved, setbacks avoided and problems happen in a positive direction instead of turning chronic and persistent.

More than the conquest for stable currency however the Real Plan allowed Brazil to find once again its macroeconomic reality. A reality that not only had been partially eclipsed by the distortion and mess from the inflationary atmosphere that we had lived in, but that has been in wide a extent created by the nature of the ongoing stabilization program. Having solved the great problem of chronic inflation, indispensable as a pre-requisite for everything, we faced a new challenge: to solve the problem without relapsing into the original problem - public deficit.

The fact is that two macroeconomics imbalances have strongly appeared from the implementation of the Real Plan. The first one is the need of financing the public sector. Although the expressive increase of fiscal load verified in the period with the collection breaking historical records and reaching the mark of 31.8% of the GDP , the Brazilian State passed from a consolidated operational surplus of 1.3% of the GDP in 1994 to a deficit of 4% to 4.5% of the GDP in 1997 and recently it has reached 8% of the GDP.

Among the main causes of the deterioration of the fiscal picture what stand out are: actual fall of inflation (tax revenue was better indexed than public expenditure); the increase of the financial cost (interest rates higher); and the strong expansion of public expenditures with civil servants, mainly concerning the retirement pension payroll . While the deficit of Social Security that assists about 17 million pensioners and retired people from private sector is R$ 6.9 billion and the deficit from Social Security in the public sector, that assists for 2.9 million retired people from Federal, State and Municipal governments have reached the annual horrendous figure of R$ 32.1 billion.

The second macroeconomic imbalance that appeared in an expressive way from the start of the Real Plan is the foreign sector. In a short space of time, from the adoption of the exchange anchor with the Real having more value related to the dollar, we passed from a deficit in the balance of payments of the 0.3% of the GDP in 1994 for a figure that should be close to 4.5% of the GDP, during the last year.

This shift reflects not only the growing deficit in the trade balance since 1995 as well as the increase of net expenditures with payment of services of factors (interests and profits) and non-factors (trips, freight and insurance). It is natural, in thesis, that an economy in development, as Brazilian has, absorbs savings from the rest of the world, financing its deficit in the balance of payments with the entrance of foreign capital in search of high interest rates.

What concerns us however Brazil has been receiving generous and growing doses of foreign savings in the last three years and the rate of gross formation of fixed capital staying inferior at 20% of the GDP and much smaller than it was in the seventies. In spite of the opportunity that we are receiving from the rest of the world, thanks to the renewed confidence in Brazil’s potential, our growth continues lower than expected.

The reason for this is the two deficits - the fiscal and the foreign are linked: the foreign savings that Brazil has attracted because of the Real Plan so far has not supplemented with the savings and domestic investment, as would be desirable, but it is replacing them and indirectly covering the hole of the public deficit. The compensation of those deficits is the future obligation that is being generated by their financing.

They are not worthless numbers. How long they can continue growing at a similar rate in the future, without spreading a deterioration of expectations and defensive behaviors in the financial market. It is impossible to say. Privatization truly brings a relief at the fiscal front and in foreign financing, but it only happens once, it has limited duration and it doesn't really solve basic problems. Burning that " card " without moving forward the solution of fiscal problems and the financing of the transition toward capitalized social security system, it means selling the silverware to give a banquet instead of repairing the hole. The rhythm of falling more the indebted in the FHC’s government has shown with clearly that we are buying time for price of gold.

The fact is that the public accounts instead of improving as promised by Brasilia’s authorities are getting worse. The accumulated nominal deficit from January to June (1998) reached 32.5 billion Real, equivalent to 7.27% of the GDP. In the same period in 1997 it was registered 3.85% of the GDP . The government's role is delicate. It is not enough to make correct decisions, they have to be believable. National debt grew in the last four years from 93 billion to almost 350 billion Real, having suffered an inflation due to the amount of bills at high interest. There comes a moment in the market what is financing the debt when mistrust arises pertaining to the government capacity to pay off. The basic reason of the investors' mistrust is, that the adjustment intended by the government, has not materialized. The Brazilians started paying more taxes, but the result of government expenditures has been lower than expected. A country target for " attacks " is which has shown more a vulnerable situation observed by the market as being unsustainable in a short term basis.

The problem is the destination that the country chose for the US$ 130 billion of foreign saving absorbed in the last four years which is the sum of the deficits in the balance of payment in that period. These savings are that the government imprudently used to finance deficits.

Professor Jorge Vianna Monteiro, from the Department of Economy of PUC-Rio, published an article in the Bulletin " Estratégia Macroeconomic ". In that article he discussed the conditions for a successful fiscal adjustment. Using a magnificent article from the economist Roberto Perotti (The Political Economy Fiscal of Consolidations, Scandinavian Journal Of Economics, 1998) which is a review if what is known, empirically , about fiscal adjustment procedures.

The conclusions of that article:

> 1) the experience of countries of the OECD suggests strongly that the fiscal adjustment produced by reduction of expenses are much more consistent than those obtained from tax raising;
>
> 2) there are evidences that when the adjustment is accomplished in a situation of great pressure -for example a wide relationship between public debt/GDP or big deficit- the adjustment may not have the dramatic recessive effects according to some macroeconomics theories.

Examining the experience from 20 countries of the OECD that have accumulated into 66 episodes of attempts of fiscal consolidation, the most succeed attempt could be reached when the adjustment of primary deficit is at least 1.5% of the GDP and after three years the relation between public debt/GDP decreases at least 5%, the Perotti’s results were the following :

> 1) From the 66 episodes of wide adjustment, 14 had been very successful because they had been supported in cutbacks of expenses, mainly in transfers of payments and the governments' payroll;
>
> 2) the bad ones: the adjustment made by increasing tax rates and cuts in investment expenses;

3) the difference among of these changes had been significant: in the well done adjustments the drop in expenses had reached 2.2% of the GDP , while the bad ones done had not reached the 0.5% of the GDP ;

4) in the well-done adjustment the transfer payments had dropped 0.5% of the GDP , and the payrolls 0.6% of the GDP , while in the bad ones they had been reduced by 0.1% and 0.4%, respectively;

5) in the well-done adjustment the increase of taxes had been just 0.4% of The GDP , while in the bad one it had reached 1.3%;

6) in the two types of adjustment , the good and the bad ones, the drop in the deficit had been very similar, 2.7% and 2.2%, respectively. This shows that the composition more than the size of the adjustment guarantees its success.

The recessive dimension of the adjustment is tied up to the magnitude of its effect of the reduction of the interest rate -that obviously depends on the exchange policy-, if it is significant the values of assets grow and the effect " wealth " may produce an increase in consumption.

These lessons are important for the Brazilian economic policies: a vigorous fiscal adjustment with cuts on expenditures without raising taxes can reduce the interests quickly and would be less recessive than it expected.

In December 1994, the recognized net debt of the public sector corresponded 28.1% of the GDP . At the end of 1997, it had reached 34.5% of the GDP. In December of 1998, it should have reached something close to 40% of the GDP. To control the explosive behavior and stabilize the relationship between the net debt of the public sector in relation to GDP are the central objectives of fiscal measures that the government has adopted recently.

Evaluating the effort required for fiscal adjustment toward achieving this goal, it is necessary to think about the variables that determine the evolution of the relationship between debt and the GDP along the course of time - Which is what the economists call debt dynamic. It is easy to notice that relationship will tend to grow as more quickly as the interest rate gets higher, as the rate of growth of the GDP gets smaller, as the current stock of debt gets higher and as the primary surplus of the public sector get smaller, which it is the difference between the government’s revenue and expenditures, excluding the payments of interests.

If it were possible to fix the value regardless each variable involved in the debt dynamic, it would be relatively easy to work with the challenge of stabilizing the net debt of the public sector in proportion to the GDP. And actually we could easily find someone who proposes what seems to be the most obvious solution: a combination of low interest rates and fast growth of the GDP. Unfortunately things are not so simple. And, when the debt of the public sector reaches relatively a higher level, the debt dynamic could become particularly adverse.

The lack of confidence that the Brazilian economy has faced establishes limitation to reduce interest rate. It may be discussed at great length which are the true roots of such mistrust. But, on borders of such a discussion, there is an obvious point of consensus. With the current interest rates it is difficult to stabilize the net debt of the public sector in proportion of the GDP . Perhaps it would be worthwhile to ask at what level the interest rate could be ideally reduced, if the government adopts " the correct macroeconomic policy ". Whatever is the conception that we have about what " correct macroeconomic policy" would be, it seems optimistic work with scenarios for the next four years that the average interest rates based on the net debt of the public sector should be around 12% a year. It is enough to realize that the rate can be observed in other Latin American economies that have been exhibiting macroeconomic fundamentals in a much more solid way than Brazilian economy.

If it were possible to maintain the interest rate at 12% for the next four years, how would the public debt develop as in proportion to the GDP? First of all, it is important to notice that, in 1999 this rate would imply payments at equivalent interests at 4.8% of the GDP. Unless such payments are largely covered by an expressive primary surplus, the debt will continue to have an explosive behavior. An exercise of simple simulation allows us to conclude: if the rate of growth of the GDP could be maintained at 3% a year and the primary result is zero during the whole period in analysis, the net debt would jump from 40% of the GDP in 1998 to almost 56% of the GDP in 2002. Furthermore it was possible to maintain an equivalent primary surplus at 1.5% of the GDP for the whole period, the net debt would rise from 40% of the GDP in 1998 to more than 49% of the GDP in 2002. But with a primary surplus of 3% of the GDP, the relation between the debt and the GDP would be practically stable, reaching not much than 42% in 2002.

Such exercises allow us to have a reasonable idea of the magnitude from primary surplus required to stabilize the net debt of the public sector in proportion the GDP. Divergences on what should be " the correct macroeconomic policy should not obscure the perception that even under optimism of plenty of hypotheses about the behavior of the interest rates, the stabilization of the relationship between public debt and the GDP should demand a substantial primary surplus.

TAX REFORM

The current Brazilian tax system is a distortion of what was adopted in the reform in 1967. It is a result of changes and casuistic additions that have been introduced during the eighties, according to the fiscal crisis and the process of chronic inflation that had become worse. Taxes in a cascading were introduced, higher tax rates, the creation of new taxes based on the same tax bases and tax based on a fictitious tax bases, for example, financial operations. The country got caught in a vicious circle: as to the distortion of the system became worse, tax evasion had went up, which demanded new regulations to maintain the tax load. Tax bases became narrowed and individuals and the private sector heavily burdened, the informal economy, which is the economy that is out of the range of tax collection, expanded greatly. The system became unpredictable, submissive to annual changes of regulations.

The unpredictability of the tax system adds an important element of uncertainty about investment decisions and portfolio allocation in general, it inhibits capital accumulation and reduces the maturity of the financial assets. This casuistry creates a situation of fiscal perversity, which means the system punishes individuals who cannot practice tax evasion and benefits those one who evade. Breaking in this way the ethical principles that manage the relationships among citizens and the State in a modern society. The proliferation of taxes based on the same tax bases or fictitious bases creates distortion in the allocation of resources within the economy, reducing the level of income and well-being for the same tax collection effort. The mechanisms of revenue transfer among government spheres has become intense after the Constitution of 1988, has created tensions and conflicts in the Brazilian Federation, in such way that they induced to the creation of States and Municipal , discouraging the effort of tax collection by government units which are beneficiaries increasing the fixed costs of public administration in the Country.

The Constitution of 1988 even though had defined the tax bases for several government spheres and mechanisms of partition of tax revenue, it does not specify clearly responsibilities among different levels of government, it does not explain who will provide what kind of public goods and service each level of government will offer.

Functions as basic education, basic health, etc. should be attributed to the Municipal; public goods with national character such as defense and foreign relationship should take place in the Federal , while for other functions should there be a division of responsibilities between the Federal and State governments. The Constitution of 1988 does not explain the decentralization of resources and liabilities among the three government spheres, but it promotes a significant transfer of resources for States and Municipalities without concomitant transfer of responsibilities of providing public goods.

Federal Constitutional transfers for States and Municipalities - % of Federal Revenue – 1996			
	Real - $	% of Total Revenue	% of Tax Revenue
Federal Revenue (A)	155,194,894	100	100
Tax (B)	62,310,307	40,14	40,14 B/A

Contributions – Unshared	92,884,587	59,86	59,86 C/A
Transfer from Federal (D)	24,695,950	15,91 D/A	**39,6 D/B**
To States (E)	9,396,221	6,05 E/A	15,07 E/B
To Municipalities (F)	10,307,694	6,64 F/A	16,5 F/B

Source: Secretary of National Treasury/FGV

From 1989 to 1993, approximately US$ 45 billion were transferred to States and Municipal through the FPE (State's Participatory Fund) and FPM (Municipal Participation Fund). Adding other constitutional transfers, the Federal body has transferred approximately 40% of its tax revenue to States and Municipalities. On the other hand the vertical decentralization of resources among government's bodies have not been accompanied with a new distribution of responsibilities, being one of many distortions of the Brazilian fiscal federalism. The Federal and State units continue to carry out functions typically local, that should be transferred to the Municipal. It should be emphasized additionally that the constitutional transfers have been justified with one objective, redistribution, which is the reducing of the regional inequality of the country without questioning; if it would be , indeed, the best way to reach such a goal

The regulation of the constitutional transfers is based on the following criteria

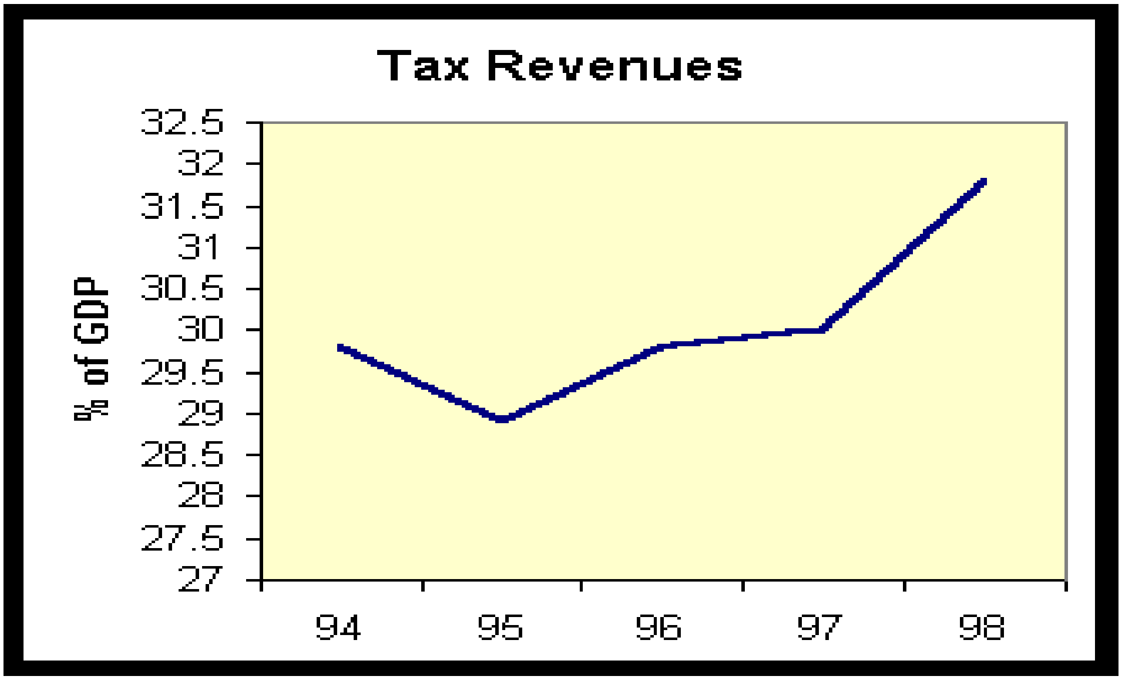
> a) For the FPE, 85% of resources from this fund is earmarked to States that belong to the North, Northeast and Center-West regions, and only 15% for the States in the South. A quota for each State varies positively according to its population and territorial extension and negatively according to the per capita income.
>
> (b) For the FPM, 10% of resources from this fund is earmarked to the States' Capitals; 3.6% goes to the Municipalities which have more than 156 thousand inhabitants (excluding the Capitals) and 86.4% for the others; there are 18 graduate levels of Municipalities that are not State's Capitals, and the distribution of resources is focused in those which have a smaller population.

These rules introduced an enormous distortion in the availability of resources among the three government spheres discouraging the exploration of their tax bases. Besides this, the big transfer of resources causes extreme distortion, and those State and Municipalities which have a smaller economic base and a smaller fiscal effort receive per capita resources more than another unit which explore efficiently its tax bases.

In relationship to FPE, the main distortion comes from the fact of privileging States with a smaller population and per capita income through the rigid fixation of 85% of Federal resources which it is transferred to the North, Northeast and Center-west regions. (See Table I Appendix)

CHARACTERISTICS OF THE CURRENT TAX SYSTEM

A recent forecast about the tax loads indicates that it has been maintaining around 30 to 32% of the GDP, however this is a high standard in comparison to other countries that have a similar stage of development. What differentiates Brazil from other countries with a similar tax load are: the reduced universe of taxpayers, high number of taxes and contributions, and bad distribution of tax liabilities and



Source : Ipea/Ministry of Finance/ Central Bank

expenditures among government spheres.

Figures that indicate the relation between the tax bases and its economic bases which the tax should be based on, are very low. Available data indicates the following: 37% to 41% for Income Tax, 36% and 45% in the case of IPI (Industrialized Product Tax) and ICMS (Circulation of Goods and Service Tax) and in just 14% in the case of ITR (Rural Property Tax). (IPEA, Fiscal Essays 1993).

Brazil has an active economic population of about 60 million people but there are only 6 million taxpayers for Individual Income Tax (IRPF). International comparisons indicate that while rich countries have larger taxation based on individuals (representing 80% of the total amount of the taxation), in Brazil it does not represent 50%.

Besides this, in comparison to other countries with a similar economy, it is verified that the collection of Income Tax is smaller in proportion to the GDP: 3.2% in Brazil, against 6% in other countries in development.

The value added tax (VAT), including ICMS (Circulation of Goods and Service Tax) and IPI (Industrialized Product Tax), although they at hear to the principles of tax policies, there is an important distortion. Having two VATs, a problem of double taxation appears, since there is an overlapping of tax bases and the inclusion of one within the base of the other.

The taxes based on property, IPTU (Urban Property Tax) and ITR (Rural Property Tax) and on services ISS (Service Tax) are clearly misapplied in Brazil, they contribute with just 0.3% of the GDP. The small revenue of IPTU and of ISS is related to high transfers payments from the Federal government, which reduces the incentive for Municipalities explore their own tax bases.

A creation of taxes and contributions and constant changes of their regulations, transformed the act of paying tax in a complex and expensive operation, decreasing the efficiency of inspection, and increasing costs within the private sector.

An elaboration of new taxes has been the maneuver used by the Federal government to by-pass the partition of tax revenues introduced in the Constitution of 1988. As it is known, the Federal government had an important loss of revenue in benefit for States and Municipalities, without a concomitant transfer of respective responsibilities. From the collection of IPI and IR, approximately 50% is being transferred for States and Municipalities. This led the Federal to use unshared taxes to elevate its revenue: COFINS (Social Contribution). This is a cascade tax that introduces an important distortion in the allocation of resources.

In an economy with a larger role in international trade, the tax distortion penalizes the exportation and domestic producers that compete with the importation. Taxes based on sales like COFINS, PIS, IOF are not possible of fiscal disbursement which could benefit exportation , reducing in this way the competitiveness of Brazilian products in the world market. The domestic product has a considerable disadvantage of cost about 10% to 15% due to the domestic taxes not compensated in exportation.

A country should move toward a tax structure that doesn't differ significantly to their main commercial partners and it could not place the domestic producer in a disadvantageous conditions within the ring of larger international competition.

A tax system with the characteristics described above puts an obstacle in the way an expansion of productive activities such as gaining productivity, growth of employment and improvement of income distribution. This gain is the only way to obtain a sustained growth for the average level of material wealth within the Brazilian population for a long period.

In summary, the Brazilian tax system could be described as following:

a) small tax bases, with nominal tax rates high and wide fluctuation;

b) excessive number of taxes and contributions, bringing elevated costs to the public and the private administration, and contributing decisively for a bad allocation of resources;

c) imbalances among the partition of tax revenue and responsibilities in government spheres.

The complexity of the system comes from the high number of taxes, fiscal incentives and differentiated tax treatment. In this environment cost of tax administration is high and has lower efficiency, in the same way the cost of the private sector is also substantial, motivating tax evasion. Besides, because of the differentiated tax treatment the system presents a low transparency with great discrepancy between nominal and effective tax rates. In the Brazilian tax system it is difficult to identify who pays and how much.

A distortion in the allocation of resources is a consequence of an existence of countless incentives (with doubtful efficiency to promote regional investments), altering the economic agents' behavior improperly and jeopardizing the country's growth.

An absence of equality comes from the excessive load of indirect taxation in the Brazilian tax system, from non intentional taxation of products from basic monthly food allowance for low income population and from a lack of integration in several taxation methods based on individuals income.

The quick diagnosis made above makes it clear that Brazil needs deep reforms in the national tax system, as a part of a wider fiscal reform, that it should seek to reformulate the Brazilian public sector, making it capable once more to play its fundamental part in providing a stable institutional and economic basis to resume the development of the country. Experience of a long period of economic and social stagnation, and a coexistence with a regime of high and unstable chronic inflation has been showing that marginal adjustment in the current structure of the public sector is useless. The actual structure has to be reformed with lucidity and courage, if we want to break the vicious cycle of incompetence.

The world growing economic and financial integration, have been stimulated by persistent reduction of protection levels and the opening of exchange regimes in almost every country. It has also been accompanied by an effort to equalize tax systems. Government goals in approaching their tax structure for the rest of the world are: reducing and to neutralizing, as far as possible, the taxation's difference between the local economy and world economy, which produces an important effect on the competitiveness and the allocation of resources among countries. The tendency of following this very established international pattern has been present in all cases of tax reform during the 70's and 80's, particularly among the developing countries.

Despite the great differences that still remain among tax systems, differences are reflected in development levels and cultural and historical characteristics of each country. The first and more general tax indicator is the participation of taxes in the GDP. For a group of industrial countries, a average tax load is around 35% of the GDP, for developing countries it is about 20% and for underdeveloped countries it is 14%. In the case of the Latin-American countries, classified by the World Bank as medium income, taxes represent 18% of the GDP. It seems clear, therefore, that this general indicator is associated to economic and social development levels.

Brazil has been maintaining a tax load around 31% of the GDP, locating beyond the Latin America medium pattern. Our tax structure is very close to the Latin-American average, with a great concentration in indirect taxes (sales and added value), and little emphasis in the direct taxes concerning income and property, and high participation of social responsibilities in the total amount of collection.

A large number of countries in development had accomplished, with much or little success, fiscal reform during the 70's and 80's, aimed to modernize their fiscal systems, approaching them to an international pattern established in the industrial countries. The motivations for tax reform are four: (vide World Bank, Lessons of Tax Reform, 1991)

a) reduce or eliminate chronic budgetary deficits, in order to make programs for structural adjustment in the public sector;

(b) reduce distortions produced by primitive tax systems, based on tax in cascade and tax based on international trade;

(c) eliminate imbalances in situations that where the system is highly regressive, causing tax evasion;

(d) improve system administration, by simplification of regulations and procedure as well as for increase productivity of inspection.

Tax System - Constitution of 1988

TAX	Tax Revenue			
	Federal	States	Municipalities	Social Security
Consumption	IPI	ICMS	ISS ICMS	
Income	IRPF	ITCMD		
Property	ITR	IPVA	IPTU ITR IPVA	
Gross Sales	PIS			COFINS
Capital	IRPJ			CSLL
Labor				CINSS
Economy Policy	IOF IE			

	II			

Acronyms are in the appendix

GENERAL CRITERIA OF TAX REFORM

Developing a tax system should involve three basic criteria. First, taxes exist to collect resources to finance programs and government services considered as useful for the community and which cannot be produced by the private sector or should be complementarily provided by the public sector. Therefore, before anything else, the function of a tax system is to collect from the citizens the necessary amount of resources for providing public functions.

Secondly, the system should be as neutral as possible, in the sense of interfering minimally in the allocation of resources that would prevail in the economy in the government absence. The only exception to this rule of neutrality resides in proven cases of externalities, that is to say, a pre-existent distortion that makes the prices of some goods and services not reflect faithfully the cost and marginal social benefits of their production and consumption. In those cases, corrective taxes are justified with respect to these outside factors. Every taxes applied now, generates distortion in the economy, that is to say , it is not neutral.

Thirdly, the tax system should preserve equity in tax treatment among individuals, social groups, sectors and regions. The concept of equity is not absolute and it has been developing as time passes, being the subject of controversies. A weak concept of equity says that everybody should pay tax proportional to their income, while the strong concept affirms that such a payment should be established according to more than a proportional scale to their the income. In the first case, we have a proportional tax system, in the second a progressive system. In practice, a difficulty of a implementation of a progressive system is the discouragement that it produces regarding work effort and capital accumulation, and larger induction to defraudment. All the countries have been leading toward reducing the progressivity of their taxes, especially from taxes based on personal income. It is recognized that the objective of the progressivity is better in the fiscal system as a whole, particularly directing programs and government's expenses toward people which have lower income.

EDUCATION AND DEVELOPMENT

Before the appearance of Capitalism societies were comparatively at level of stagnation. They were basically agricultural and they varied little along the years, except with the occurrence of good or bad crops and wars or epidemics.

Capitalism - through the market - had brought continuous technological changes and capital accumulation, altering in a radical way the structures of these societies.

Observing these changes, society tried to understand and consequently explain how society grows economically. Within a context which a growth process could be described better as being a transformation process, historical economists tried to develop theories about development scales, through which every economy of any society should necessarily pass.

Clark emphasized a domination of different sectors of the economy in different levels of its development and modernization. For Clark, development was a process of successive domination of primary production sector, agriculture, followed by secondary production sector, manufacture, and, finally, tertiary production sector, trade and service. In his analysis the economic growth begins in the period that extends between the domination of primary and secondary sectors.

Rostow based his theory of growth’s scales on historical observations of developed countries that according to the author have presented a considerable degree of uniformity in the development process. He identified five scales which every society should pass through along its economic growth and they are: traditional society, pre-requisites for growth, from growth to sustainable growth, maturity and the age of mass consumption. In

Rostow's analysis the economic development begins in some point located between the growth and the maturity of the society.

During the last four decades after the Second World War, growth has been seen as an important objective in the economic life. It does not matter if the country is rich or poor. The per capita national product of a country has been the conventional criteria to define development or underdevelopment . This criteria could be applied to the rate of growth of per capita income. Underdeveloped countries are usually defined as being those that have a smaller rate of growth of per capita income than developed ones.

Upto this point we have been using growth and development with the same meaning. Although, these meanings should be clearly differentiated.

For economic growth we should understand continuous growth of the national product in global or per capita terms. This criteria also implies a better efficiency of the productive system.

For economic development we should understand that beyond the changes of quantitative character of the levels of the national product, modifications alter a composition of a product and an allocation of resources for different sectors in the economy.

Economic development cannot be analyzed only through indicators like national product growth or national product per capita. Development concept takes these indicators plus indexes, which represent the quality of citizens' life.

One of the essential points of these indexes is the educational system, and Brazil will not enter in the first division of the world economy without modifying its system.

Before the waves of material progress provoked by industrial capitalism reached the majority part of the Brazilian population, a new threat could condemn individuals and companies again to a new exclusion. It is enough if they do not satisfy the requirements of a new order, paradoxically centered in the improvement of the human resources.

The twilight of the 21st century marks the definitive transition from the industrial society to the Great Open Society, the Society of Knowledge and Information. The dynamics of accumulation moved from quantity to quality of labor (education) and physical capital (technology). Natural resources lost importance to artificial factors, produced by the human intelligence.

Investing in the education of Brazilian's citizens is the critical factor of success to increase the rate of economic growth, to improve social conditions and reduce imbalances in income distribution. It can make it possible for Brazilian companies to be more competitive in the world economy and create new comparative advantages in face of the overpowering technological dynamics of 21st century. It can also improve institutional structure and Brazilian policies and, fundamentally, it will allow the individual to fulfill his potential.

But unfortunately Brazil has spent little with its students in elementary school. Brazil has been spending US$300/student/year with elementary school. United States has been spending more than US$4,000 student/year (UNESCO/96). We have spent less and badly. According to data from UNESCO/96, the efficiency degree in that area reaches 70% in Mexico, 100% in Europe, 98% to 100% among the Asian tigers and just 38% in Brazil. The average school attendance in Brazil is 3.8 years, but in Argentina is 8.7 and South Korea 11.

THE PARTITION OF TASKS AND GOVERNMENT RESPONSIBILITIES

The analysis of the public sector tries to study the approaches and mechanisms related to the government's intervention in the economy. The main variables which this intervention could affect are public expenses, taxes, regulation of private sector activities, public production and respective prices, the public debt and administration of monetary policies and exchange policies. Although the identification of the public sector's functions are not in consensus, the existence of a significant role for the public sector in a modern economy could be explained by the simple existence of nations. This simple presupposes a minimum of managerial activity and a well controlled finances through transfers imposed on the community or voluntary applications. The first ones correspond evidently to taxes.

The major issue of the partition of responsibilities among the Federal, State and Municipal spheres involves the range of benefits and costs of goods and services offered through by government. A specification of Federal responsibilities could be the national security activities such as justice, legislative function, regional development, foreign relations and international trade, energy and mineral resources, communication, agriculture, transport facilities, labor relations, monetary and fiscal policies, immigration, social security and a national statistical system.

Other functions for example education, health, social welfare, housing , culture, protection of the environment, etc., could be administered by the States and Municipal . The attribution of certain functions to State or Municipalities could depend on peculiarities that surround each one of these units.

In other words, the existence of externalities and indivisibility, certain activities could be developed at Municipal level in cities of medium or large size and at a State level in the case of smaller cities.

Distribution of Revenues and Expenditures - % of GDP-97				
	Federal	States	Municipalities	Total
Tax Revenue	20.81	9.55	1.44	31.8
Transfer	(3.40)	(0.39)	3.80	
Disposable Revenue	17.40	9.16	5.23	31.8
Total Expenditure	21.82	11.70	6.07	39.6
Potential Deficit	4.42	2.54	0.84	7.8

Source: Secretariat of National Treasury

CONCLUSION

The public administration has been submitted to a process of reform that looks forward to adjust its profile and capacities to an appearance of a new State that is born as an answer to the world's tendencies.

A reform of the State doesn't guarantee a reduction in the public expense significantly, but it improves the quality and the efficiency of its expenditure, as the bureaucracy stops being important and becomes an accessory in the production of goods and services for the society. Administrative flexibility allied with the control of results should transform the State in a smarter organization, with its decentralized action.

In this way, the State will be essentially a regulator and not an executor of those activities that remain under its responsibility, and they should be executed mainly in a decentralized way, with recruiting entities or private companies, or through strengthening local power and developing the non-state public utility sector.

The State is essential in the process of economic and social development, but not as a direct agent of the growth but as a partner, a catalytic element and promoter of this process (World Bank - The State in Changing World -

1997).

In this context, the predominant strategies to reform the public administration should be: debureaucracy , decentralization and transparency.

Debureaucracy means withdraw obstacles to implementation of flexible and responsible administration. Changing the State's decreeing to negotiating, becomes more strategic, replacing bureaucratic controls for effectiveness.

This means a change in the actual regulations, deregulating some sectors and elaborating new regulations in others. It is the dismantling of the State that manufactures, intervenes and sets up protectionist barriers.

An option for decentralized and indirect action , with a huge control of results and administrative flexibility tends to increase the productivity and the quality in the public services, but it depends on the existence of a developed and competitive market and a society that exercises the function of social control of the State.

Transparency is very important because it changes fundamentally bureaucratic controls to social controls. If the public administration becomes less bureaucratic and flexible, it is necessary to publicize more its actions to control the good use of public resources, moreover stimulating the competition among suppliers and society's participation in the decision-making-process, giving more legitimacy to State actions. The bad part of bureaucracy lives underground, in secret, but the transparency puts an end to this culture that favors this game of self interests.

With the progress of information technology, it will be possible to reconcile society's participation in the decision-making-process of the State with a professional and modern central administration.

To enlargen political participation, international context has never been so democratic. In 1974 only 39 countries (one in four) were independent democracies; now 117 countries (almost two in three) have chosen their leaders in open elections (World Bank - The State in Changing World - 1997).

The process of emptying power from the Central Power, either in the formation of hypernational union toward or decentralization to the local powers, takes the appearance of an organization that, despite being decentralized, is articulated and integrated.

This new configuration of the State facilitates a larger society participation in the policies formulation of government policies , in a definition of public expenditure and in legislative and judiciary processes. This is one of the ways to increase transparency and participation of the society in the decision-making-process using intensively information technology.

The main transformation of the State in the next century will be its form of organization for working, that will be characterized as decentralized, and in its decision-making-process will have a larger participation from the society. In this perspective the State turns direct from being producer of goods and services to being a promoter and regulator of economic and social development, with a more direct citizens' participation in its decisions.

The welfare State emergent in the 19^{th} and 20^{th} centuries enlargened its activities and started acting directly in the social area and intervening in the economic area. This State had started increasing expenses until the crisis in the eighties, when the public expenditure had reached superior participation close to 50% of the gross domestic product (GDP) in some countries.

This welfare State , bureaucratic, entered in crisis in the eighties, mainly due to its high operational cost. The promotion of social justice should be exercised with high rates of economic growth, which has not been happening in the last decades. The annual average of the world economic growth (World Bank Indicators - 1997) it dropped to half in the last years. From 4.2% in the fifties; 5.3% in the sixties; 3.6% in the seventies; 3.1% in the eighties to 2% from 1990 to 1995.

If in the thirties the world crisis was a consequence of problems in the market, in the eighties the crisis and the economic sluggishness had its main cause centered in the crisis of the State, due to the lack of effectiveness, high costs and the public debt.

Transformation of the Modern State is strongly influenced by three great world tendencies: globalization, progress of information technology and the emergence of the organized civil society.

This progress in relationship between State/Society, allied to the strengthening of civil society, should put an end to the monopoly of the State. It is interesting to notice that globalization and the emergence of an organized civil society appear to be parallel. It strengthens at the same time the formation of regional hypernational blocks and the decentralization to the local powers, the community and the individual, emptying the actual functions of the National State.

Decentralization with integration are the key words in this process. The central power will not disappear, but it will change its form of performance and influence, while the local power assumes a larger portion of managing the responsibility and executing public policies. The society will still continue demanding the existence of a State, but the society will increase its direct participation in the decision-making-process**.**

Decentralization with integration, direct participation with maintenance of national and local strategies, articulation, and intergovernmental articulation are the fundamental aspects in the construction of a streamlined, agile and democratic State. A State will become socially fair but also efficient in the allocation of its scarce resources.

Table I – States' Budgetary Revenues – 1997 – R$ - million

State	Tax Revenue	FPE	Total Budget	FPE/Budget-%
Acre	51,324	335,409	386,733	86.73
Alagoas	40,873	376,113	416,986	90.20
Amapa	54,867	334,527	389,394	85.91
Amazonas	273,582	1,234,841	1,508,423	81.86
Bahia	2,572,078	921,242	3,493,320	26.37
Ceara	1,254,253	719,340	1,973,593	36.45
Distrito Federal	905,145	67,670	972,815	6.96
Espirito Santo	1,660,941	147,066	1,808,007	8.13
Goias	1,587,604	278,749	1,866,353	14.94
Maranhao	396,737	707,702	1,104,439	64.08
Mato Grosso	956,826	226,276	1,183,102	19.13
Mato Grosso do Sul	674,508	130,595	805,103	16.22
Minas Gerais	5,641,644	436,738	6,078,382	7.19
Para	769,972	558,053	1,328,025	42.02
Paraiba	491,206	469,524	960,730	48.87

Parana	2,839,026	282,681	3,121,707	9.06
Pernambuco	1,611,009	676,524	2,287,533	29.57
Piaui	305,527	423,688	729,215	58.10
Rio Grande do Norte	458,903	409,619	868,522	47.16
Rio Grande do Sul	4,006,565	230,874	4,237,439	5.45
Rio de Janeiro	5,239,173	149,782	5,388,955	2.78
Rondonia	357,790	276,053	633,843	43.55
Roraima	53,342	243,218	296,560	82.01
Santa Catarina	2,033,340	125,477	2,158,817	5.81
Sao Paulo	23,519,064	98,044	23,617,108	0.42
Sergipe	366,729	407,403	774,132	52.63
Tocantins	156,182	425,512	581,694	73.15

Source: The National Treasury Secretariat

Acronym	**Description - Tax based on**
IPI	Industrialized Products
ICMS	Circulation of Goods and Services
ISS	Services
IRPF	Income Tax - Individual
ITCMD	State Tax
ITR	Rural Property
IPVA	Property of Automobiles
IPTU	Urban Property
PIS	Program of Social Integration
COFINS	Contribution for Social Security Fund
IRPJ	Income Tax – Companies
CSLL	Social Contribution based on Net Profit
CINSS	Contribution for Social Security
IOF	Financial Operations

II	Import
IE	Export
CPMF	Provisional Contribution based on Financial Transaction - check tax

Composition of the Tax Revenue among the levels of government – 97		
Tax	**R$ - million**	**% of total**
Federal	168,313	66.49
1. Tax	62,020	24.50
Income	36,560	14.44
IPI (VAT)	16,344	6.45
IOF	3,768	1.49
ITR	242	0.10
Foreign Trade	5,106	2.02
2. Contributions	103,120	40.74
Social Security	45,122	17.83
COFINS	18,401	7.27
PIS	7,257	2.87
CPMF	6,908	2.73
CSLL	7,228	2.86
FGTS	12,932	5.11
Civil Servants Security	2,583	1.02
Education Salary	2,689	1.06
Other Taxes	2,599	1.26
States	71,080	28.08
ICMS (VAT)	59,572	23.53
IPVA	3,841	1.52
ITCD	267	0.11
IRPF - Civil Servants	2,500	0.99

IRPF - Civil Servants	2,500	0.99
Social Security Contribution	3,300	1.30
Other Taxes	300	0.125
Municipalities	13,730	5.42
ISS	5,200	2.05
IPTU	4,200	1.66
ITBI	900	0.36
IRPF - Civil Servants	600	0.24
Social Security Contribution	450	0.18
Other Taxes	210	0.08

Source: National Treasury Secretariat

Country	**Government expenditures - % of total expenditure in Education - Central Government**		**Illiteracy**
	Elementary School	Universities	
Brazil	25	75	17
Chile	70	30	5
Mexico	38	51	9
Venezuela	31	45	8
South Korea	90	10	4
Thailand	81	12	4
Hong Kong	70	20	4

Source : World Bank - 96

Main items of the Budget from Federal, State and Municipal Governments									
Year	Payroll-Federal	Payroll-States/Munici	Transfer to State / Munic	Other Expend Federal	Social Security – Private Sector		Social Security – Civil Servants		Interest
					Revenue	Expend	Revenue	Expend	
1994	37,397	29,168	19,990	18,636	Na	37,840	Na	Na	29,635
1995	44,208	36,297	22,816	18,671	41,199	40,090	Na	Na	42,343

1996	44,902	37,418	23,091	22,487	45,134	44,783	Na	Na	31,560
1997	44,512	37,093	26,014	27,157	45,380	48,560	6,541	38,403	30,322
1998(1)	45,500	37,917	32,030	29,555	46,700	53,600	6,765	38,916	60,000

Source : BCB, FGV, Mare, Secretary of Finance.// (1) Forecast // Na – not available

Table II -

State	**Civil Servants – thousand**	**Payroll/Revenues %**
Acre	33	70
Alagoas	55	78
Amapa	4	30
Amazonas	75	31
Bahia	214	57
Ceara	114	58
Distrito Federal	148	76
Espirito Santo	62	82
Goias	150	70
Maranhao	92	58
Mato Grosso	46	58
Mato Grosso do Sul	52	70
Minas Gerais	478	80
Para	140	61
Paraiba	96	63
Parana	228	73
Pernambuco	165	70
Piaui	74	72
Rio Grande do Norte	374	79
Rio Grande do Sul	83	55
Rio de Janeiro	272	77
Rondonia	33	80
Roraima	4	45

Santa Catarina	120	66
Sao Paulo	800	64
Sergipe	50	70
Tocantins	37	42

Source: The National Treasury Secretariat

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