

FISCAL DECENTRALIZATION AFTER SYSTEMIC CRISES: AN ANALYSIS OF THE BRAZILIAN EXPERIENCE

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ABSTRACT

Systemic crises are often conducive to institutional changes that can affect, among others, the dynamics of fiscal decentralization in federal countries. In this case study on the recent Brazilian experience with two crises (the 2015-2016 economic crisis and the COVID-19 pandemic), I argue that systemic crises create an opportunity for endogenous centralizing forces to gain traction and push for institutional changes that reshape the dynamics of fiscal decentralization. To support this argument, I analyze the institutional contours of the Brazilian fiscal federalism and show how centralizing forces harness institutional ambiguities to instill transformations that affect fiscal decentralization and intergovernmental fiscal relations in the long run. This paper aims to contribute to research and policy-oriented discussions about the future of management of subnational finances with a focus on fiscal decentralization and intergovernmental fiscal relations.

Keywords: fiscal decentralization; fiscal federalism; intergovernmental fiscal relations; systemic crisis; tax reform.

I. INTRODUCTION

The aftermath of the 2008 crisis and the COVID-19 pandemic induced institutional changes that affected the dynamics of fiscal competition and decentralization in the Brazilian federation. While the 2008 financial crisis did not pose immediate shocks to the Brazilian economy, the country went through its worst economic recession between 2015 and 2016. This economic downturn prompted the creation of a Fiscal Recovery Regime that aimed to restructure the states' finances with the federal government's support. To join the program, states were required not to grant tax subsidies that could diminish their tax revenues, among other measures that limited their fiscal autonomy. During the COVID-19 pandemic, the federal government absorbed most economic shocks. However, a federal proposal to bring fuel prices down (whose spike was mainly attributed to the pandemic) through cuts in state taxes sparked new frictions between the federal government and the states. Moreover, the National Congress is wrapped around the promotion of a comprehensive national tax reform. Currently, three proposals to reform the Brazilian tax system seek to introduce significant changes in the fiscal architecture, either through a standard levy across all states or by replacing the tax on the circulation of goods and services (ICMS) – a state tax that is the primary source of revenue for most subnational governments – with a unified duty modeled on value-added taxes.

Against this background, a core question emerges: how do systemic crises affect fiscal de/centralization in federations? Through a case study of the Brazilian experience, in this paper I analyze the institutional dynamics of fiscal decentralization following periods of systemic fiscal crisis. The main argument is that systemic crises create an opportunity for endogenous centralizing forces to gain traction and push for institutional changes that reshape the dynamics of fiscal decentralization. I employ an institutionalist approach to explain how such centralizing forces persist and instill enduring effects onto the fiscal landscape through a process of policy displacement. This study aims to contribute to research and policy-oriented discussions about the future of management of subnational finances with a focus on fiscal decentralization and intergovernmental fiscal relations.

The paper is structured as follows. Section 2 provides a theoretical discussion about the interplay between fiscal decentralization and systemic crises, focusing on how the latter prompts institutional changes to the former. Section 3 presents an overview of the Brazilian fiscal architecture, focusing on its main sources of vertical and horizontal tensions. Section 4 delves into the 2015-2016 recession, showing how responses to its effects on subnational finances led to the creation of new instruments that allowed the federal government to curb fiscal decentralization and the fiscal autonomy of states that adhere to the Fiscal Recovery Regime. Section 5 explores how the federal government's responses to the COVID-19 crisis was fueled by conflicts with the states and analyzes prospective reforms poised to re-take center stage as the space occupied by the pandemic in the policy agenda wanes. Finally, the concluding section summarizes the paper's main arguments and points to new directions for future research on the relationship between fiscal decentralization and systemic fiscal crises.

II. FISCAL DECENTRALIZATION, SYSTEMIC CRISES, AND INSTITUTIONAL CHANGE: A THEORETICAL PERSPECTIVE

Do systemic crises induce changes in the institutional tenets of fiscal decentralization? The COVID-19 pandemic has renewed the interest in many facets of crisis and emergency management in federations (Downey & Myers, 2020; Hegele & Schnabel, 2021). To a lesser extent, it has inspired research on the implications of this critical event to the architecture and functioning of fiscal federalism, with most of the focus on

the United States (Clemens et al., 2021; López-Santana and Rocco, 2021; Rocco et al., 2020), even though some notable exceptions include Béland et al. (2020) and Hanniman (2020) works on Canada. Before the COVID-19 pandemic, some works addressed the consequences of economic crises to the dynamics of de/centralization in federations either from a theoretical (Dardanelli et al., 2019) or empirical perspective (Fenna, 2019). In the context of the fiscal crisis that struck many countries in the European Union, Muro (2015) showed how such critical context helped explain the trend towards re-centralization in Spain. In this piece, Muro (2015, p. 28) hypothesized that “[c]entral governments control sub-state levels of expenditure more intensively during periods of economic crisis”. While this hypothesis holds true for the Brazilian experience with the 2015-16 and COVID-19 crises, re-centralization was felt not only on the expenditures side. In both scenarios, the federal government put forward measures that directly affected the autonomy of sub-national governments over their revenues.

In a way, the limited scholarly attention to the consequences of crises on fiscal federalism and, more specifically, fiscal decentralization comes as a surprise, given that such circumstances are usually intertwined with economic shocks that trigger changes to the dynamics and balance of power in intergovernmental fiscal relations. In this paper, my focus lies on systemic fiscal crises. The working definition of systemic crises that I adopt posits that they are external events that affect stability by triggering shocks that affect all levels of government for a reasonable period. Therefore, isolated and transient critical events are excluded from its scope since they may not elicit significant institutional changes that yield effects in the long run, which is the focus of the present work.

Fiscal decentralization refers to assigning revenue and expenditure responsibilities from the central government to subnational and local tiers. It is a central issue in the broader realm of fiscal federalism, whose strong roots in public economics emphasize the positive economic effects of fiscal decentralization, despite some dissenting views (Prud’Homme, 1995). Numerous works in the past few decades have drawn attention to the linkages between fiscal decentralization, economic growth, and enhanced public governance and policy outcomes (Cavaliere and Ferrante, 2016; Faguet, 2014; Martínez-Vázquez and McNab, 2003), generally assuming that decentralization leads to more efficient outcomes than centralization. Measuring fiscal decentralization in federations is not a straightforward process, though. Measurement difficulties arise because fiscal decentralization is a multifaceted phenomenon that cannot be directly observed and gauged. Over the years, academics and policymakers have developed a series of indicators that act as *proxies* of fiscal decentralization. (Ebel and Yilmaz, 2002), normally encompassing variables along four main dimensions: 1) decision-making powers, 2) revenues, 3) expenditures, and 4) the structure of public accounts, including the composition of debts, deficits, and the share of intergovernmental transfers in revenue and spending.

Aside from these economic approaches, political scientists have also studied fiscal decentralization, especially with regard to the political conditions that enable it to emerge and endure (Garman et al., 2001). For instance, the literature stresses the political appetite from subnational and local governments for both administrative and fiscal autonomy as of the 1980s in Latin America, when the countries in the region that had undergone authoritarian regimes started their re-democratization processes (Montero and Samuels, 2004; Willis et al., 1999). However, less attention has been paid to situations where decentralized regimes suffer drawbacks, especially in contexts of crisis.

The vast literature on institutional change provides some relevant insights to understanding the drivers and consequences of the relationships between crises and fiscal decentralization. The concept of critical juncture has been a cornerstone in explanations of institutional change, especially in the historical institutionalism stream (Capoccia

and Keleman, 2007). Against a background of predominant stability and inertia, critical junctures constitute an opportunity for policy actors to push for institutional changes. In the context of crises, this means that they “can bring abrupt institutional change, as they present leaders with an opportunity to enact new plans and realize new ideas by embedding them in the institutions they establish” (Hogan, 2006, p. 657).

Nevertheless, not all institutional changes directly result from sharp transformations following major external events. Incremental policy changes that build upon rules, ideas, power relations, and other antecedent conditions *endogenous* to institutions can be more frequent and even more consequential than abrupt changes resulting from external shocks. Among the categories of gradual policy change proposed by Mahoney and Thelen (2010), *policy displacement* emphasizes the interplay between endogenous conditions for institutional change and limited veto possibilities. Furthermore, in institutional settings marked by ambiguous rules – such as the Brazilian experience – actors pushing for change might find fertile ground to enact the measures they envisage.

In the remainder of the paper, I will show how the institutional changes that affected the fiscal decentralization in Brazil in contexts of crisis are not the outcome of swift transformations but rather the apex of historical ambiguities, institutional legacies, power dynamics, and gradual changes that built up over time. As such, critical events act more as catalyzers of change whose enabling conditions had already been underway than as their ultimate source. The following sections develop in length my argument that systemic crises create an opportunity for endogenous centralizing forces to gain traction and push for institutional changes that reshape the dynamics of fiscal decentralization. I further argue that the changes brought by systemic crises might favor centralization amidst the ambiguities permeating the relationship between centralization, decentralization, cooperation, and competition in the Brazilian federal system. I unpack these issues against the background of the recent Brazilian experience with two major crises: the 2015–2016 economic recession and the COVID-19 pandemic. To situate these crises within the Brazilian fiscal federalism landscape, the next section discusses its tenets and how the fiscal decentralization system is embedded in a complex institutional setting that nurtures tensions within and across levels of government.

III. BRAZILIAN FISCAL FEDERALISM: VERTICAL AND HORIZONTAL TENSIONS IN A COMPLEX FEDERATION

1. Antecedents: The 1988 Federal Constitution and a New Logic of Decentralization

Brazil is a three-tier federation with a high degree of regional inequalities that manifest along economic, social, and demographic dimensions. The contrasting realities across Brazilian states have consequences for fiscal federalism and intergovernmental fiscal relations, such as nurturing subnational tax policy competition. The disparate levels of economic development and fiscal revenues lead to a high degree of variation in the capabilities of subnational governments to provide high-quality public goods and services, invest in infrastructure, and fund educational and professional development initiatives – elements that usually bear considerable weight in business decisions about where to base operations within a country (Agrawal et al. 2015; Zodrow, 2010). Thus, to attract businesses and private sector investments, states often pursue aggressive tax policy strategies that have historically created tensions in horizontal and vertical relations – a phenomenon commonly dubbed *fiscal war*.

The enactment of the 1988 Federal Constitution was a turning point in the institutional trajectory of fiscal federalism in Brazil. It established a new federal pact and set out a

complex division of powers and competencies across the federal, state, and local governments that led to an unprecedented level of fiscal decentralization (Souza, 2016). However, as this paper shows, the Brazilian federation is characterized by the co-existence of centralizing and decentralizing devices that have historically shaped intergovernmental fiscal relations in the country.

The decades preceding the 1988 Federal Constitution were marked by a 21-year civil-military regime that undermined the autonomy of subnational governments amidst a centralizing and authoritarian ethos that dominated political life from 1964 to 1985 (Desposato, 2001). During that period, elections for governors, the heads of the Executive Power at the state level, were suppressed. Overall, the distribution of power throughout the Brazilian republican history¹ is often characterized as a pendulum that swings back and forth between centralization and decentralization (de Medeiros, 1994; Ward et al., 2010). Even though the alternation and instances of co-existence between these two forces are part and parcel of Brazilian institutions, between the 1930s and 1980s, periods of authoritarianism prevailed and undermined the political and fiscal autonomy of subnational governments, leaving a legacy of tensions in vertical intergovernmental relations.

Against this background, the 1988 Federal Constitution not only sought to consolidate democracy but also to institute a new federal pact predicated on decentralization and cooperation across levels of government. To achieve these goals, the Constitution created a series of mechanisms to secure the realization of elections at all levels of government, guarantee that subnational and local governments enjoy the autonomy they need to provide public goods and services and implement intergovernmental transfers to help fulfill the constitutional principle of reducing regional inequalities.

Through an extensive title dedicated to taxation and budget matters, the Federal Constitution set out the taxing powers of the federal, state, and municipal governments (Table 1). These provisions are regulated by several statutes containing specific rules, procedures, and exceptions^{2,3}. In general, the federal government has taxation powers over international trade, income, financial operations, and industrial goods. At the state level, the main source of tax revenue is the ICMS, the tax falling upon interstate and inter-municipal trade and transportation. State governments also have tax authority over the ownership of motor vehicles and the transmission of any goods and rights upon an individual's death. Municipalities, in turn, mainly rely on property and services taxes (ISS) on top of certain real estate transactions.

1. When Brazil, a former Portuguese colony, conquered its independence in 1822, it became a constitutional monarchy. Later on, in 1889, it assumed its current republican form. The first republican Constitution, dated from 1891, recognized the autonomy of the states in relation to the federal government.

2. According to a report prepared by the Brazilian Institute for Tax and Planning, between the enactment of the Federal Constitution in 1988 and September 30, 2021, more than 443,000 tax norms had been created in the country, with 30,837 norms in effect by September 30, 2021. The report (in Portuguese) is available at <https://static.poder360.com.br/2021/10/IBPT-ESTUDOQUANTIDADEDEENORMAS33ANOSDACONSTITUICAO.pdf>

3. Brazil is notable for the complexity of its tax system, which lies upon a myriad of legal and sub-legal regulations across all levels of government. Such complexity negatively affects compliance with tax obligations and contributes to harmful practices like tax evasion by individuals and businesses. The World Bank's data on time to prepare and pay taxes (measured in hours) indicates that Brazil ranks first among all countries: https://data.worldbank.org/indicator/IC.TAX.DURS?most_recent_value_desc=true

Table 1. Division of taxation powers in the Brazilian federation

Federal Taxes	State Taxes	Municipal Taxes
Import of foreign products	Transmission <i>causa mortis</i> of any goods and rights	Urban real estate and territorial property
Export of national or nationalized products to foreign countries	Operations relating to the circulation of merchandise and interstate and intercity transportation and communication services	Transmission <i>inter vivos</i> of real estate property by an onerous act
Income and earnings of any nature	Motor vehicles ownership	Services of any nature
Industrialized products		
Credit, exchange, and insurance operations, or those relating to bonds and securities		
Large fortunes		

Source: elaborated by the author

Although each level of government exercises its taxation powers within its competencies, not all revenues remain with the government that originally collected certain taxes. The Federal Constitution drew a distribution of tax revenues for some tax categories that takes place directly and indirectly. The direct distribution of tax revenues occurs when a political entity receives the concerned revenue directly from the government with the power to collect it. In turn, the indirect distribution is operationalized through participation and compensatory funds in which revenue is shared across beneficiaries following the criteria established by the governing legislation.

The distribution of tax revenues aims to ensure a reasonably predictable and stable level of transferred revenues for states and municipalities. Still, its underlying policy design has created some contradictions over time. First, it is important to note that not all revenues stemming from the taxation power exercised by the federal government are included in the sharing scheme. The Brazilian Federal Constitution provides for five categories of duties⁴ of which solely taxes are subject to tax revenue distribution. Against a backdrop of decline in the collection of tax revenues at the federal level that is not matched by a decrease in the proportion of resources that the federal government must transfer to subnational and local governments, the federal government has adopted a new strategy to raise its revenues without sharing additional resources with other levels of government. Hence, instead of raising tax rates – implying that states and municipalities would receive a share of such increases – the federal government has prioritized raises in social contributions, which are not subject to the distribution of revenues under constitutional rules.

Historically, the federal government's strategy to raise social contributions while granting benefits and exemptions involving federal taxes whose revenues are shared with subnational entities has led to conflicts with the states. As Rezende (2007, p.

4. The five categories are: taxes, fees, improvement contributions, general contributions, and mandatory loans.

78) argues, “conflicts come up whenever measures adopted by the federal government reduce revenues from the income and manufacturing taxes that form the basis of the present revenue-sharing system”. The model of intergovernmental transfers inscribed in the 1988 Federal Constitution is anchored in the so-called *participation funds*⁵. The participation funds are fed with the resources stemming from the share to which states are entitled. For some of the poorer states (*Acre, Amapá, Roraima, and Tocantins*), the resources distributed through these funds constitute the main source of revenue. Along with the general participation funds, special funds provide federal resources for specific policy areas, such as basic education.

The fiscal equalization system currently in place in Brazil does equip states with an adequate level of resources because “[t]he national model adopts absolute (static) population and household income indicators and does not provide for periodic reviews or relative (proportional) and dynamic (growth) aspects of states’ socioeconomic context” (Mendes, 2022, p. 1)⁶. Therefore, supply-side considerations (i.e., fiscal capacity) and the contrasting socioeconomic indicators are not considered in the most important mechanism to tackle horizontal inequality between states in the country. Consequently, the current fiscal equalization model contributes to perpetuating inequalities across states.

Despite these remarkable developments towards decentralization, the new institutional arrangements set forth by the 1988 Federal Constitution suffer from implementation gaps and co-exist with enduring centralizing forces that raise vertical and horizontal tensions. Along with other countries in Latin America, the Brazilian political system is characterized by a strong federal Executive Power that grants extensive powers to the President, including in its relationship with the National Congress (Figueiredo and Limongi, 2000; Pereira et al., 2008; Reich, 2002). During the democratic transition that took place in many countries in the region as of the 1980s, the historical inclination to centralize power was preserved and overshadowed by the progress made in the consolidation of democracy and expansion of social rights in their constitutions – a common phenomenon in the wake of the New Latin American Constitutionalism⁷ (Gargarella, 2015). Thus, the federal government can garner support to advance measures that strengthen its power over policies affecting subnational entities, even bypassing the veto power that states could exert to prevent centralizing initiatives – a point to which I will come back later.

The original text of the 1988 Federal Constitution and its numerous subsequent amendments reflect the ambiguous relationship between centralization and decentralization that have historically characterized intergovernmental relations and the division of jurisdictional powers in Brazil. As González (2007, p. 217) contends, the enactment of a constitution crystalizing a power arrangement between federal and subnational units does not mean that conflicts come to an end. Rather, “[t]he struggles over the distribution of power and resources continue over time and recurrently modify the relations between central and sub-national governments” (*Idem*).

In 1993, an amendment to the Federal Constitution eliminated the additional state rate of 5% that fell upon the federal income tax, apart from cutting off the municipal

5. It is interesting to note that these funds were created by an amendment to the Constitution in 1965 – i.e., during the civil-military dictatorship – which illustrates the argument that Brazil has long experienced a co-existence between centralization and decentralization.

6. https://ipcig.org/sites/default/files/pub/en/PBR86_Fiscal_equalisation_in_Brazil_Canada_and_Australia_Ipea.pdf

7. For an overview of the New Latin American Constitutionalism, see Curcó Cobos (2018).

tax on retail sales of liquid and gas fuels. As expected, these measures caused revenue losses for states and municipalities. Another source of tension between states and the federal government was raised in 2004 due to a change in the regime governing the compensation for losses arising from the exemption from the payment of ICMS on the exports of primary and semi-finished products or services established by the federal government in the mid-1990s. Such exemption had spurred controversy between the governors of exporting states and the federal government, but vertical conflicts were heightened when the compensation to states no longer fixed the amount of such payments. Thus, state governors saw themselves obliged to negotiate the amount to be transferred with the federal government every year, which undermined predictability.

Vertical conflicts have instilled enduring institutional changes in the dynamics of fiscal decentralization in Brazil. Long-ingrained centralizing devices that persist in Brazil's contemporary political and economic institutions enable the federal government to yield unilateral top-down policies and decisions that might constrain the states' fiscal autonomy. Intergovernmental fiscal relations in Brazil rest on a fragile balance between the unprecedented level of fiscal decentralization promoted by the 1988 Federal Constitution and horizontal and vertical tensions that, from time to time, change the dynamics of fiscal decentralization in the country. This ambiguity allows centralization and decentralization to co-exist in periods of institutional stability and leaves room for centralizing forces to take over when external shocks create a favorable environment for institutional change.

These centralizing forces can be unpacked into structural and agency elements. On the structural side, the historical prominence of centralizing political practices was reinforced in periods of authoritarian rule (1937-1945 and 1964-1985), thus undermining the political and fiscal autonomy of subnational units. As the next section will show, the enactment of the 1988 Federal Constitution did not completely erase centralizing devices from the central government's institutional repertoire. At first glance, the existence of federal safeguards (Schnabel, 2020), like a bicameral system that guarantees state participation in national decision-making, might suggest that such actors enjoy institutional mechanisms to act as veto players with powers to thwart unilateral actions over subnational matters. In practice, though, a combination of constitutional rules and poor party discipline weakens the veto power of subnational players. As Arrecthe (2013, p. 136) puts it, "there are few arenas where subnational units might be able to make use of vetoes. The centralization of policy competence, combined with the majority principle for changing federal legislation, means that no supermajority is needed to change the status quo of most subnational issues. The Brazilian federal state enables the center to initiate and approve general interest legislation". These structural features create an enabling environment for centralizing forces to flourish on the agency side. The 1988 Federal Constitution grants extensive powers to the President that allows it to explore the fragile balance between autonomy and coordination in the Brazilian dual federalism system to bypass subnational governments and impose unilateral decisions. In recent years, such unilateral actions have created further tensions amidst an increasingly contested system of checks and balances where the Federal Supreme Court frequently assumes an arbitrator role to settle intergovernmental conflicts.

2. The effects of the 2015-2016 crisis

While most countries grappled with the economic shocks provoked by the 2007-2008 crisis, it did not put a major toll on the Brazilian economy. The commodities boom that began in the early 2000s and continued through approximately a decade greatly benefited Brazil, whose economy is largely based on the export of commodities like crude oil, minerals, soy, and sugar. Brazil saw a growth of 5.1% in its GDP in 2008,

followed by a slight retraction (-0.1%) in 2009 and a strong economic recovery in 2010 (+7.5%)⁸. Back in 2008, then President Luiz Inacio Lula da Silva famously stated that while the crisis was a tsunami elsewhere, it would be nothing more than a small wave in Brazil⁹. Indeed, the favorable economic landscape for commodity exporters at the time helped Brazil navigate an otherwise turbulent period for most advanced industrial economies.

If the 2008 financial crisis did not affect the Brazilian economy immediately, the country went through its worst recession ever recorded between 2015 and 2016. The confluence between a sharp decline in economic growth, investments (both public and private), and consumption on the one hand and a rise in unemployment, interest rates, and public debt on the other created a challenging environment that had important social and political implications. The economic downturn that stroke the country helped fuel massive popular upheavals in 2013 (Marquetti et al., 2020; Saad-Filho, 2013) and general discontent among economic agents (Pena, 2018). Moreover, the 2015-2016 crisis played a relevant role in the impeachment process of then-President Dilma Roussef, who was removed from office. The political and economic elites extensively construed the mismanagement of the crisis under Roussef's leadership as an indication that she was no longer able to govern the country (Avritzer, 2017).

The causes of the 2015-2016 crisis involved both supply and demand shocks. However, many analyses¹⁰ (Barbosa, 2015; Oreiro, 2015) also draw attention to the role played by the *New Economic Matrix* (in Portuguese *Nova Matriz Econômica*) in the unfolding of the crisis. The New Economic Matrix (NEM) consisted of a set of economic measures pushed forward by the Roussef administration from 2011 onward that were characterized by a strong intervention of the federal government in several domains of the economy inspired by the developmental tradition that was highly influential in the country during the XXth century (Doering et al., 2017). The main goal of the NEM was to boost the industrial sector, which has undergone a trend toward deindustrialization since the 1980s (Flexor and Dias da Silva, 2021; Monteiro and Lima, 2017). To achieve this goal, the federal government adopted a broad range of measures that included new industrial and infrastructure plans, tax subsidies for businesses operating in 15 different sectors, a rise in tax rates for some foreign manufactured goods, and the concession of subsidized credit through public banks.

These measures, though, did not produce the results the federal government expected. Businesses that benefited from the tax rate reductions and exemptions the federal government granted used tax reliefs as an opportunity to recompose their profits instead of making investments to leverage production. Consequently, these measures did not translate into productivity gains or job creation (Garcia et al., 2018). This lack of investment was also explained by the limited demand levels, which the federal government had overestimated in the design of the NEM (Carvalho, 2018).

At the sub-national level, the 2015-2016 crisis affected the states' finances in different ways. In the first quarter of 2016, states saw a more than 22%¹¹ decline in their revenues and a concomitant increase in personnel expenses. Consequently, most states

8. <https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?locations=BR>

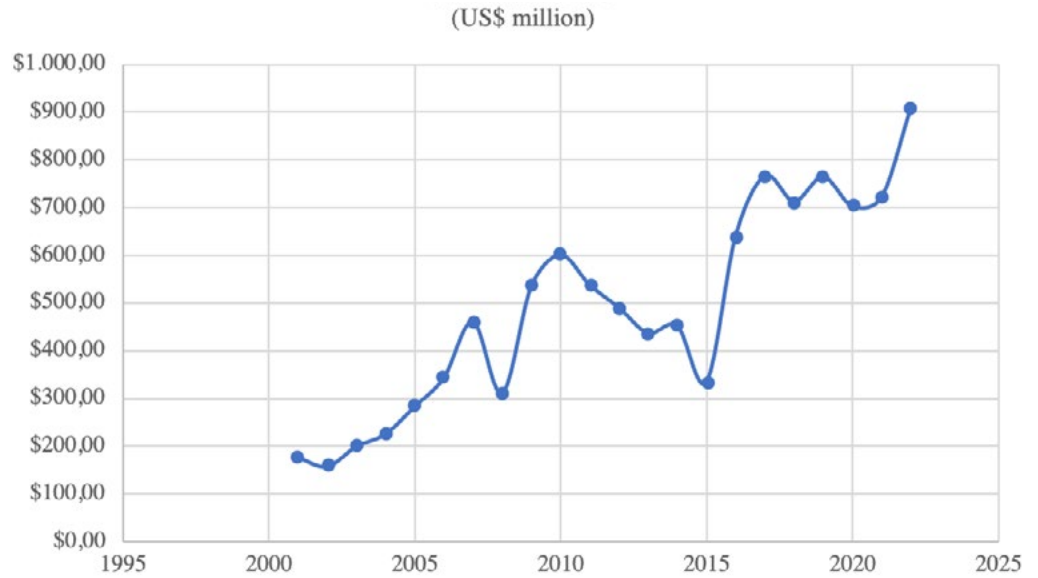
9. <https://mondediplo.com/2009/06/05brazil>

10. It is worth noting that some economists challenge the weight commonly attributed to the New Economic Matrix to the 2015-2016 recession. An example of this position can be found in Borges (2017).

11. Estimate based on data of the Brazilian Central Bank. Available at: <https://www3.bcb.gov.br/sgspub/localizar-series/localizarSeries.do?method=prepararFilaLocalizarSeries>

violated the expenditure-revenue ratio caps outlined in the *Fiscal Responsibility Act*. Moreover, as the federal government granted benefits involving taxes whose revenues are partially shared with states and municipalities, subnational entities saw a decline in intergovernmental transfer revenues, whose value is further deteriorated by rising inflationary pressures.

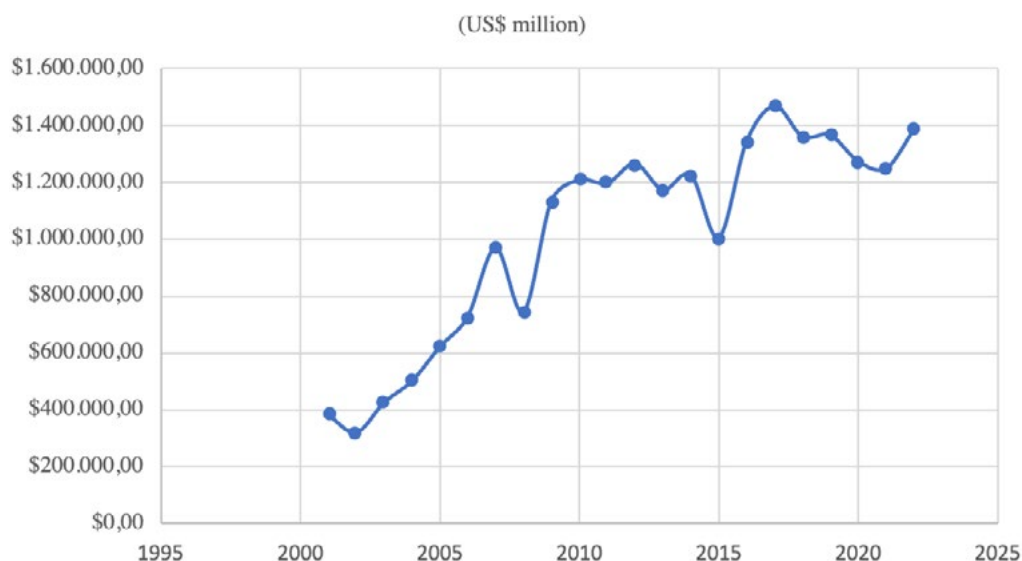
Figure 1. Evolution of the Federal Government’s Debt



Source: elaborated by the author based on the Brazilian Central Bank data

The deterioration of the states’ accounts and the pressure coming from political leaders at the state level led the federal government to act on the issue. In this sense, the federal government’s response came in the form of a *Fiscal Recovery Regime* that sought to restore fiscal balance at the state level through a comprehensive program to restructure the states’ finances. By adhering to the regime, states are allowed to enter into credit operations with the federal government (which is prohibited as a rule) and enjoy a temporary waiver of certain fiscal rules and suspension of debt payments. In exchange for those benefits, participating states must implement a series of institutional reforms required by the federal government, as I will discuss below.

Figure 2. Evolution of the Gross General Government Debt (federal, state, and municipal governments)



Source: elaborated by the author based on the Brazilian Central Bank Data

Destined to states facing serious fiscal problems, the Fiscal Recovery Regime came into force in 2017 after a period of negotiations led by the state of Rio de Janeiro, which was going under severe imbalances in its accounts and became the first to adhere to the regime. Since the program aims to support states with challenging fiscal imbalances, eligibility criteria are very strict. States need to fulfill four cumulative criteria to join the Fiscal Recovery Regime:

- 1) net annual current revenue lower than the consolidated debt at the end of the fiscal year before the request to join the regime
- 2) current expenses higher than 95% of the net current revenue measured in the financial year before the adhesion request
- 3) current expenses with personnel representing at least 60% of the net current revenue measured in the fiscal year before the adhesion request, and
- 4) total value of contracted liabilities greater than cash and cash equivalents of available non-earmarked resources.

If the Brazilian Treasury Board Secretariat approves their request to join the regime, states must submit a detailed *fiscal recovery plan* outlining all measures they intend to take to ensure that fiscal balance will be restored by the end of the program, which can reach up to nine fiscal years. This plan must establish a clear and well-founded link between the fiscal imbalance faced by the state and the envisioned measures, implementation deadlines, and expected impacts. A Supervisory Council composed of representatives from the concerned state, the federal Ministry of Economy, and the Federal Court of Auditors oversee the implementation of the measures listed in the fiscal recovery plan. Such measures are institutionalized through the introduction of laws and other legal instruments allowing for the adoption of the following:

1. Selling (totally or partially) public companies' shares owned by the state
2. Liquidating or terminating public companies to settle liabilities with the collected funds
3. Reducing tax or fiscal benefits that result in foregoing revenue by at least 20%
4. Adopting the social security rules applicable to federal public servants
5. Revising the legal regime governing the public service to reduce any benefits that are not granted to federal public servants
6. Establishing a complementary pension regime for public servants that is subject to the same limits as those for the general pension regime
7. Establishing rules and mechanisms limiting the annual growth of primary expenditures to the variation of the Broad National Consumer Price Index
8. Holding payment auctions to secure favorable conditions to settle liabilities, and
9. Adopting a centralized financial management system within the Executive Power.

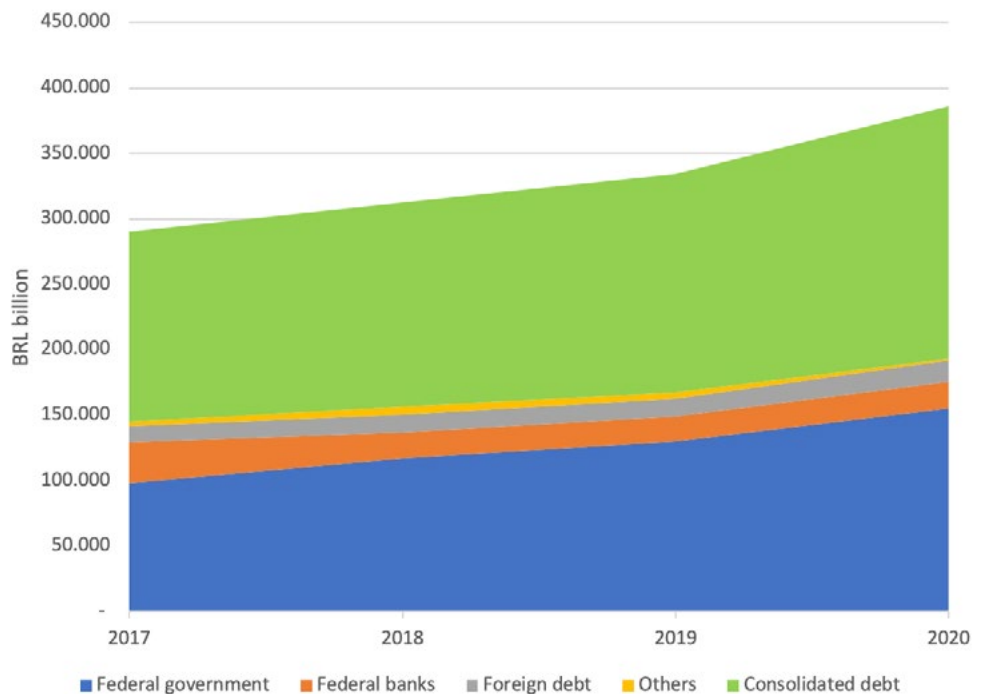
Along with these obligations, the Fiscal Recovery Regime also implies a series of prohibitions that states must observe. Among the most restrictive measures, one can find the prohibition of raising salaries in the public sector, creating ongoing mandatory expenses, and granting tax benefits apart from limiting the hypotheses in which hiring personnel is allowed. The rationale behind these measures is to decrease expenditure levels while curtailing actions that could lead to losses in tax revenue. Taken together, the mandatory actions and prohibitions display the restrictive character of the Fiscal Recovery Regime.

This overview shows that the stringent requirements that the Fiscal Recovery Regime imposes on states compel them to 1) adopt the same institutional framework governing the public service at the federal level and 2) dispose of economic assets. Additionally, they deeply constrain the expenditures they may undertake and their capacity to make public investments and fund policy programs. For instance, Paiva et al. (2016) highlight that the regime can yield detrimental effects on social assistance policies. On top of restricting expenditures, the regime does not support states on the revenue side, which is crucial to maintaining their fiscal balance in the long run. As time goes by, it will be important to assess the impacts of the Fiscal Recovery Regime both on the promotion of sustained balance in the states' finances and on policy expenditures.

The introduction of the Fiscal Recovery Regime changed the dynamics of fiscal decentralization in Brazil to the extent that it granted the federal government extraordinary powers to direct the finances of participating states. Even though adherence to the regime is voluntary, the top-down character of required measures and limited room for negotiation contradict the tenets of cooperative federalism enshrined in the Federal Constitution. Besides, the program conditioned federal support to the adoption of administrative, legal, and fiscal measures that curb the states' capacity to autonomously decide on important aspects of their policies during a time frame that can reach almost a decade. This centralizing character helps explain the limited adhesion of states to the regime. So far, four states (*Goiás, Minas Gerais, Rio de Janeiro, and Rio Grande do Sul*) have joined the Fiscal Recovery Regime.

The long-term implications of the Fiscal Recovery Regime are unclear. The economic literature posits that fiscal policy and economic performance are interrelated (Prescott and Gjerde, 2022), but the Fiscal Recovery Regime does not address the potential effects of the fiscal constraints it imposes on states on their economic outlook in the long run. Moreover, up to this point, the implementation of the fiscal recovery plan does not seem to be sufficient to put participating states back on the fiscal balance track. In their analysis of the impacts resulting from the implementation of the fiscal recovery plan in the state of Rio de Janeiro, Torrezan and Paiva (2021) show that not only did the state’s level of indebtedness grow, but, except for a decline in personnel expenses, it failed to comply with the federal government’s demands until the end of 2019. Despite the immediate financial relief brought by the suspension of the payment of its debt with the federal government, Rio de Janeiro was unable to make substantive progress towards fiscal balance and solvency, which justified the recent renewal of the Fiscal Recovery Regime until 2031.

Figure 3. Evolution of Rio de Janeiro’s Debt



Source: elaborated by the author with data from the Brazilian Treasury Board

IV. BRAZILIAN FISCAL FEDERALISM IN THE AFTERMATH OF THE COVID-19 PANDEMIC

Governments worldwide took bold measures to slow down the propagation of the SARS-COV-2 virus and tackle the COVID-19 pandemic. Some of those measures, especially lockdowns and social distancing requirements, sparked a decline in economic activities that negatively affected the economy of many countries (Chen et al., 2020; Chiatchoua et al., 2020; Zinecker et al., 2021). In line with emerging evidence on the issue (Dougherty and de Biase, 2021), the Brazilian federal government absorbed most of the economic shock stemming from the COVID-19 pandemic, while state governments rapidly rebounded from a short period of revenue losses. Federal public debt has spiked amid increased expenditures and intergovernmental transfers to cope with the health crisis. In 2020, the federal government approved new

legislation securing the provision of financial support to states and municipalities to mitigate the financial difficulties resulting from the state of public calamity amidst the COVID-19 pandemic.

Despite this growth in intergovernmental transfers, the pandemic triggered tensions between the federal and state governments. The spike in inflation led to a substantive increase in fuels price, which, in turn, harms political popularity. In response to the mounting pressure to bring inflation down, the federal government persuaded states to lower the ICMS rate falling upon fuels, energy, transportation, and telecommunications to reduce their final price to consumers. In this sense, the federal government imposed a cap of ranging between 17% and 18% on ICMS rates relating to certain essential goods. The federal government's main target was reducing fuel prices, whose increase had created an upheaval in society as a whole and, more specifically, among truckers and other professional drivers. In the past, strikes motivated by high fuel prices among transportation professionals caused significant economic impacts, which is something the federal government seeks to avoid in light of the coming general elections to be held in October 2022.

The federal government's policy to reduce the ICMS rates triggered an immediate reaction from state governors. The main concern of state leaders involved revenue losses and compensation mechanisms for such losses. For most Brazilian states, the collection of ICMS represents the primary source of revenue, so the federally mandated cap on ICMS rates could undermine the balance of subnational public accounts. States unsuccessfully tried to introduce a clause in the new legislation requiring the federal government to recompose health and education funds should these areas bear shortfalls resulting from the loss of tax revenues, which President Jair Bolsonaro vetoed. However, the states expect the reduction in the ICMS rates to spur a loss of approximately 17 billion Brazilian Reais (roughly USD 3.3 billion) from health and education alone.

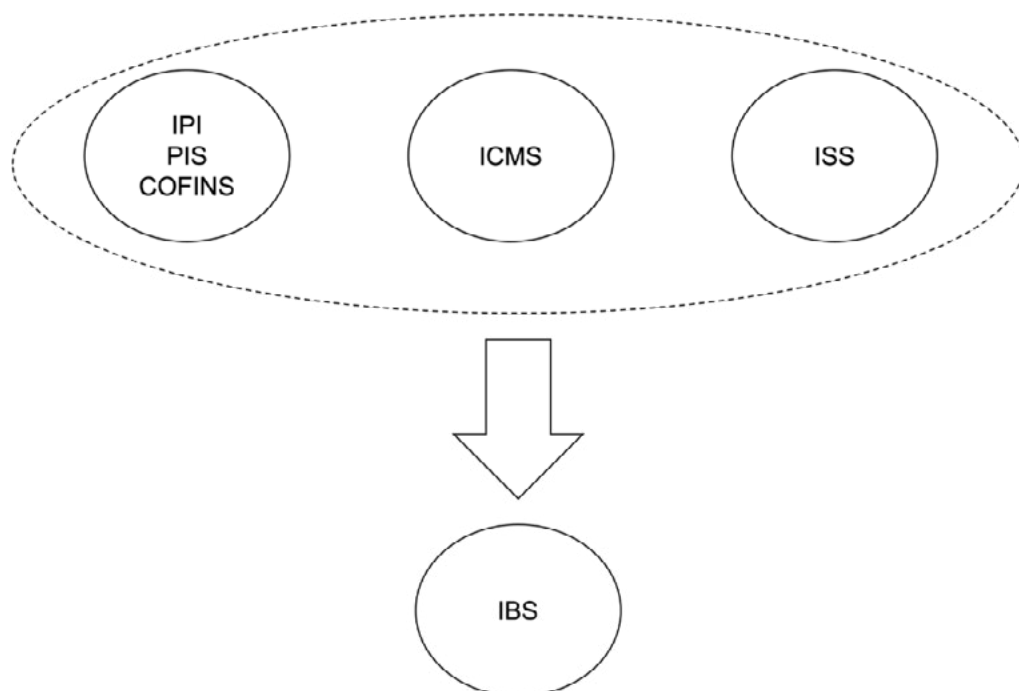
Some states filed lawsuits before the Supreme Court to thwart the federal government's strategy. Seven states (*Acre, Alagoas, Maranhão, Minas Gerais, Piauí, Rio Grande do Norte, and São Paulo*) resorted to the Supreme Court to secure compensation mechanisms for the loss of tax revenue in which they eventually incurred due to the federal government's policy. Through the favorable decisions they obtained before the court, these states are now able to compensate ICMS revenue losses by discounts in the payment of their debts with the federal government.

The financial strains faced in the COVID-19 pandemic renewed the debate over the need to reform the country's tax and fiscal system. In fact, calls for tax reform have been part of the public debate for at least three decades (Varsano, 2003; Werneck, 2000), but the controversial nature of the theme often hinders consensus-building around the scope of reform initiatives. Over the years, many bills have been proposed in the National Congress but failed to move along the legislative process. However, since 2019, three major proposals have been introduced by the House of Representatives, the Federal Senate, and the federal. Of these, the constitutional amendments proposed by the House of Representatives and the Federal Senate present the most consequential measures to subnational entities.

The two proposals presented by the chambers of the National Congress advance measures that, if adopted, would significantly change the tax system at the subnational and local levels. The main goal of the tax reform agenda is to simplify the Brazilian tax system. The core proposal within this simplification paradigm is replacing a bundle

of federal (IPI, PIS, and COFINS)¹², state (ICMS), and municipal taxes (ISS) for one single tax (IBS)¹³. This proposal is modeled after international practices with value-added taxes (VATs). Its defenders argue that it will reduce tax costs, create a better business environment, and instill fairness into the tax system. The federal government maintains that the reform will reduce regional inequalities, benefiting 98% of the municipalities and being positive or neutral for 100% of the states¹⁴.

Figure 4. House of Representatives Proposal



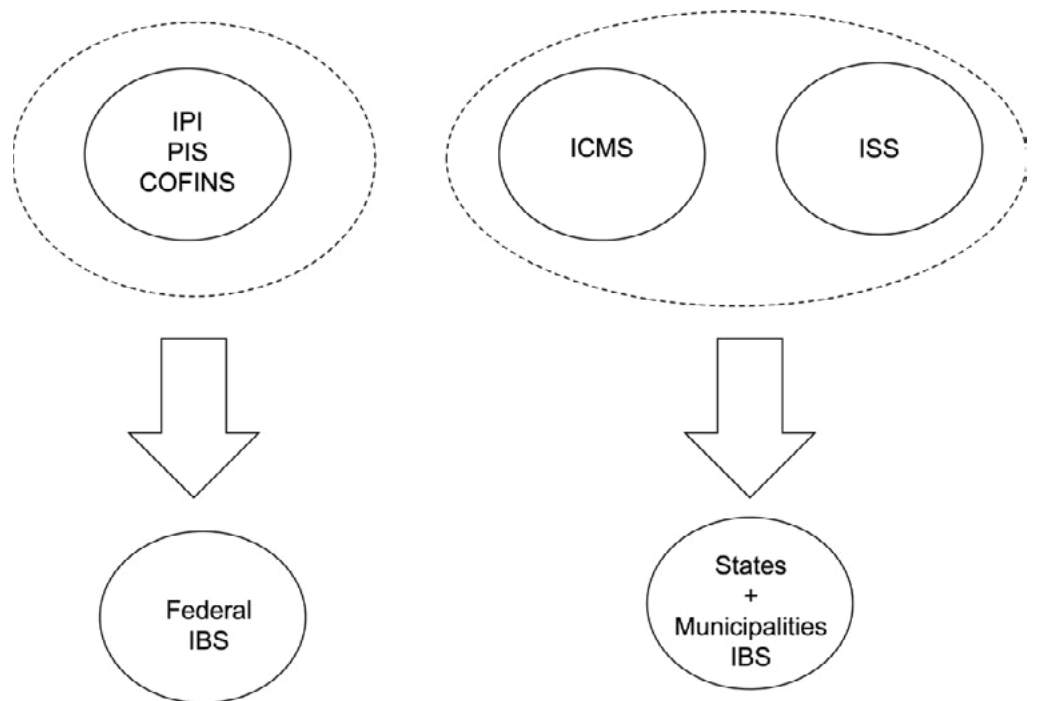
Source: elaborated by the author

Recent amendments to the Senate's proposal aim to create two VATs: one at the federal level (resulting from the unification of federal taxes and duties) and another one at the state and municipal levels (resulting from the unification of the states' ICMS and the municipalities' sales tax – ISS). This proposal also targets the fiscal war between states. On that account, it establishes a common tax rate for states and a general prohibition to grant benefits and exemptions relating to the common value-added tax at the subnational and local levels, with a few exceptions (for example, the food sector) that a specific law shall regulate.

12. IPI: Tax on Manufactured Goods; PIS: Program of Social Integration; COFINS: Contribution for the Funding of Social Security.

13. IBS: Goods and Services Tax.

14. <https://www.gov.br/fazenda/pt-br/acao-a-informacao/acoes-e-programas/reforma-tributaria/mitos-e-verdades>

Figure 5. Federal Senate's Proposal

Source: elaborated by the author

On top of these provisions, other proposed measures have also sparked discontent with the tax reform models among states. According to current rules, the ICMS is charged in the state of origin of a service or good and not in its place of consumption. The reform proposals determine that the tax shall be levied and collected in the state where consumption occurs, as is usually the case with VATs. In the short and medium terms, this provision would create a cleavage between producer and consumer states because that could harm the finances of poorer subnational entities, which tend to have lower consumption levels. To avoid such imbalance, the House of Representatives and Senate proposals envision the creation of a regional development fund to offset potential revenue losses that predominantly producer states could bear due to the new tax regime. Additionally, during the transition period, states and municipalities would receive financial resources from the federal government equivalent to their current ICMS and ISS revenue earnings. Still, such measures face much resistance from states and municipalities, which see these changes as a threat to their finances and fiscal autonomy.

Given the enormous impacts of these initiatives on the structure of the national tax system, all reform proposals aim to implement changes gradually over a time frame that could reach up to 50 years in the case of the House of Representatives proposal. The history of tensions and unfulfilled commitments undermine trust in intergovernmental fiscal relations, though. Together with the uncertainty around future tax rates and revenues, governors tend to be wary of the impacts such measures could entail for their states. One interesting issue is that despite states' representation in congress through the National Senate, they do not always constitute a relevant veto power to the federal government's aspirations. In the Brazilian National Congress, party coalitions tend to be stronger than purely regional coalitions (Arretche and Rodden, 2004), which is reflected in the limited impact of state-level actors on national party cohesion (Desposato, 2004).

The ambiguities upon which the Brazilian fiscal federalism system is built enable the persistence of strong centralization devices even if the new constitutional order inaugurated in the late 1980s is explicitly premised on a cooperative and decentralized federal

pact. As the analysis of the 2015-2016 and COVID-19 crises showed, the external and systemic shocks that permeated these contexts were followed by federal responses that undermined the autonomy of states, especially – but not only – in the fiscal realm. On the surface, the federal government's initiatives to quench the negative economic impacts of the pandemic might seem abrupt, but a more attentive analysis reveals that they are, in fact, part and parcel of the historical ambiguities and subtleties surrounding the relationship between *cooperation* and *conflict*, *centralization* and *decentralization* in the Brazilian federation.

V. CONCLUSION

Periods of systemic crises induce temporary strains on political and economic institutions and create windows of opportunity for institutional changes that may have lasting effects over time. This paper showed how two recent systemic crises affected the dynamics of fiscal decentralization in Brazil. Against the background of the 2015-2016 fiscal crises and the COVID-19 pandemic, I developed the argument that systemic crises create an opportunity for endogenous centralizing forces (at the structure and agency levels) to gain traction and push for institutional changes that reshape the dynamics of fiscal decentralization through policy displacement. These two crises entailed different financial implications for the states in the sense that the 2015-2016 crisis hit their economies hard, whereas the latter was mainly felt at the federal level. Despite these differences, the institutional responses to address them were similar: they granted more powers to the federal government and enabled it to dictate some aspects of the states' finances. I contend that these changes towards centralization were made possible because the endogenous centralizing forces that have persisted within Brazilian political and economic institutions over a long time harnessed the opportunity for policy change created by significant external shocks such as the 2015-2016 and COVID-19 crises.

The analysis of the institutional changes that emerged in reaction to two recent systemic fiscal crises endorses and expands earlier claims in the literature that in contexts of fiscal constraints, powerful presidents in Latin America seek to introduce measures that give them more control over financial resources either at the federal or subnational level. This paper goes beyond the usual focus on the expenditures side and draws attention to the implications of centralization to subnational revenues. The recent attempt by the Brazilian federal government to interfere in the main source of tax revenue at the subnational level – the ICMS – to curb fuel prices is a clear illustration of this centralizing trend. Furthermore, as the COVID-19 pandemic is gradually debunked as the top policy priority for many governments, legislative activities around the proposals to reform the national tax and fiscal systems are poised to gain more space.

This article showed that central governments can also change the dynamics of fiscal decentralization through institutional innovations that affect the dynamics of fiscal decentralization and intergovernmental fiscal relations for an extended period. The Fiscal Recovery Regime created in 2017 constrained the autonomy of participating states to make policy decisions and manage their accounts on the revenue and expenditure sides for approximately a decade. Likewise, the regime conditions the concession of fiscal benefits to adopting certain federal frameworks and regulations. More recently, amidst the inflationary pressures that have escalated since the beginning of the COVID-19 pandemic, the federal government managed to reduce the states' ICMS rates applying to energy and telecommunications. Tax reform proposal currently under discussion in the National Congress have the potential to introduce significant changes to the national federal system, overhauling the main sources of tax revenue for states and municipalities particularly.

This paper sought to shed light on the implications of systemic crises to fiscal decentralization in a federal system. However, some limitations and unaddressed issues deserve to receive attention in further research on the issue. First, while I have repeatedly referred to vertical tensions, the scope of this work did not allow me to explore in greater detail the relationships permeating federal and state actors. In this regard, situating such tensions within the Brazilian political system is a promising approach. Moreover, this paper was based on a single-case study of Brazil, a federation generally deemed to be centralized. Hence, it would be interesting to analyze how the relationship between systemic crises and fiscal decentralization plays out in more decentralized federations.

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