

**TEXTO PARA DISCUSSÃO Nº 279**

**FISCAL POLICY, CREDIT AVAILABILITY AND  
FINANCING OF REGIONAL POLICIES IN BRAZIL**

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**Dezembro de 2005**

Ficha catalográfica

336.1/.5(81)	Jayne Jr., Frederico G.
J42f	
2005	Fiscal policy, credit availability and financing of regional policies in Brazil / Frederico G. Jayme Jr.; Marco Crocco - Belo Horizonte: UFMG/Cedeplar, 2005. 26p. (Texto para discussão ; 279) 1. Política tributária – Brasil. 2. Federalismo – Brasil. 3. Desenvolvimento regional - Brasil. 3. I. Crocco, Marco Aurélio. II. Universidade Federal de Minas Gerais. Centro de Desenvolvimento e Planejamento Regional. III. Título. IV. Série. CDU

**UNIVERSIDADE FEDERAL DE MINAS GERAIS  
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**FISCAL POLICY, CREDIT AVAILABILITY AND FINANCING OF  
REGIONAL POLICIES IN BRAZIL \***

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**CEDEPLAR/FACE/UFMG  
BELO HORIZONTE  
2005**

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\* The authors would like to thank, without implications, Sueli Moro, Melissa Menezes, and João Romero for helpful comments.

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## **ABSTRACT**

This paper aims at analyzing regional development in Brazil regarding its financial conditions. It departs from the features of the federalism and decentralization in Brazil, as well as the state and local expenditures. We intends to investigate the role of the federalism and decentralization after the recentralization of taxes and budget in Brazilian economy. Conclusions highlight the importance of financial sector as one of the influential aspects of regional imbalances in Brazil.

*Key-Words:* Regional Development, Federalism, Tax Burden

*JEL:* R11, H70, H77

## 1. INTRODUCTION

The relationship between regional imbalances and strengthening of the financial system is not simple. In a nationwide based financial system as in Brazil this aspect deserves a special treatment, particularly if we recognize that regional development policy cannot be analyzed without a connection to macroeconomic policy, to fiscal mechanisms of public financing, to the nature of the fiscal federalism and to the Fiscal Responsibility Law.<sup>1</sup>

In this sense, the decentralization, the fiscal federalism as well as the autonomy of sub-national governments are crucial for articulating regional development policy in Brazil. In fact, tax revenues share and the autonomy of federative units are critical success factors for financing regional development. Therefore, the Constitutional Funds for regional development, created through the Constitution of 1988 in Brazil, as well as others regional development funds have an important role.

The Constitutional Funds – FNO (Constitutional Fund for the North), FNE (Constitutional Fund for the Northeast) and the FCO (Constitutional Fund for the Center-West) – perform the function of financing economic and social development of least developed regions. They are composed of 3% of two taxes, the Income Tax and the Tax on Industrialized Products (IPI). Of the total collected, 60% goes to the FNE and the remaining 40% to others funds. In order to evaluate the effectiveness and efficiency of these funds in reducing regional imbalances in Brazil its important to analyze the evolution of their transfers and their financing sources.

The main purpose of this paper is to evaluate the conditions within which regional policies are financed in Brazil as well as the inequalities in Brazilian financial system. The starting points are the financing sources in a context of tax resources sharing and expending autonomy of the federative states. We intend to investigate particularly the role of federalism in regional financing in Brazil. We shall denote federalism a system that favors, not only the financing autonomy of the subunits, but also the reduction of regional inequalities through an efficient program of tax transfers. The analysis of credit concentration and its role in the deepness of regional imbalances uses information at municipal level on credit supply and others variables obtained from the SISBACEN<sup>2</sup> database.

This paper is organized as follows. Sections 2 and 3 contain an appraisal of the federalism in Brazil and the Fiscal Responsibility Law. These aspects provide some empirical background for a discussion on Financing Funds and the role of credit at regional level focused on sections 4 and 5. We close with some concluding notes and proposals for financing regional development.

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<sup>1</sup> The Fiscal Responsibility Law, from 05.04.2000, establish the relationship among federal government, municipalities, and states in Brazil. It will be discussed more detailed ahead.

<sup>2</sup> Database from the Brazilian Central Bank.

## **2. FEDERALISM, FINANCING AND THE REGIONAL DEVELOPMENT IN BRAZIL**

The Constitution of 1988 increased tax revenue of states and municipalities in Brazil, concluding a process of decentralization started in the middle of the 1970's. The new Constitution tried to correct the distortions of the previous one and to rescue the principles of the fiscal federalism, lost with the tax reform on the first military government in the middle of the 1960's. With the merger of some taxes and modernization of others, the intention was to build a modern structure, progressive and less unfair than the previous one. More than this, the chapter on taxes of the 1988's Constitution allowed both more autonomy and an increase in the municipalities tax revenue. It aimed also to reduce regional inequalities through the creation of special Funds for financing least developed regions (FNO, FCO and FNE). These funds would have guaranteed sources since they represented the quota-part of two important taxes, the IPI and IR.

From the viewpoint of taxes, tributes and improvements of the system, the new constitution presented few differences regarding the previous structure. There were no significant differences in terms of simplification and volume of tributes, but a reduction from an amount of 17 taxes to 15. However, the merger of six indirect taxes in one tax of enlarged base, corrected some distortions and simplified the collecting. An important aspect concerning taxes on property (IPTU and ITR) was the possibility of the introduction of a progressive tax. Undoubtedly, this could have meant a great improvement comparing to the previous structure, as it could have increased the fairness in the distribution of the tax onus on urban property.

As for the distribution of tax competences, the new Constitution represented an improvement in the tax revenue for States and municipalities. According to SERRA AND AFONSO (1992), the municipalities were those who have owned the benefits of the tax decentralization.

Regarding the States, the volume of taxes remained unchanged, except for the base of tax revenue which was enlarged, mostly owing to the change of the ICM in ICMS (VAT). An important element in this enlargement was the possibility to include an addition over the income tax due to the Federal Government for individual or firms. This additional amounted up to 5% of the paid tax on profits and capital profits. Finally, the new Constitution enlarged the States Fund of Participation in the income tax and in the tax on industrialized products.

The municipalities, on the other side, were the main beneficiaries in the share of the tax system, through the amplification of tax competences and transfers from the Federal government and States. SERRA AND AFONSO (1992) notice that, even before the promulgation of the new constitution, there was already a process of increasing in the transfers from Federal Government to municipalities, besides the possibility of growing expenses through credit operations.

Regarding the transfers, the most important modification was the amplification of the quota part of the ICMS (VAT) from 20% to 25%. It's also important to notice that this change not only in the increase of the percentage of transfers, but also in the enlargement of the base of tax revenue. Besides, the proportion of transfers to municipalities Fund of Participation (IR and IPI) raised from 17% to 22,5%, and the IOF on the gold started to be shared in 70% on the municipalities. Finally, according to the Constitution of 1988 it is prohibited to the Federal Government the exemption of municipal taxes, altering a common practice used during the military period that hurts severely the fiscal federalism.

As for the structure of expenses, the changes represented a better society control on public budget. There were also restrictions to public debt and to credit operations exceeding capital expenses. This process culminated in the promulgation of the Fiscal Responsibility Law (FRL) in 2000, which limits the augmentation of expenditures via indebteding.

The period following the promulgation of the Constitution, particularly after the Real Plan, represented a decreasing capacity to the financing of States and municipalities. The reasons were twofold: the rise in social demands resulting from the increase in the unemployment and under-employment in metropolitan zones, and the centralizing policy implemented by federal government. Besides, the tax competition between states and the municipalities in metropolitan regions, by increasing the unemployment, produced an elevation in demand for social expenditures, which were difficult to afford by municipalities, unable to increase their debt due to the constraints imposed by the Fiscal Responsibility Law.

Despite last years economic stagnation, the Tax Burden in Brazil is persistently growing since 1994. However, it is not equally distributed between states. In fact, the federal government was the main beneficiary through taxes and federal contributions. From 1993 up to 2002, there was an elevation of almost 39%, which does not find equivalent at international level. The main reasons for this behavior are the policies of increasing social contributions and the positive effects of the stabilization on the amount of tax revenue. Besides, this outstanding growth is also a consequence of improvements in federal tax revenue and inspection strategies.

Regardless the difficulties of international comparison due to methodological differences in the measure of the tax burden, we may say that Brazil's levels of tax revenue are similar to developed countries. The largest tax burdens are those from European countries, exceeding, in some cases, 50 % of the GNP while USA's GTB is about 35 % of the GNP. In 2002, the GTB was 18,3 % in Mexico and 19,9 % in Chile.

The Tax Burden in Brazil can also be analyzed from the point of view of distribution of tax resources and of taxes by incidence. The first case is important since despite the increase in municipalities participation in the tax share following the 1988 Constitution, after the Real Plan the federal government has been trying to re-centralize the distribution of tax resources and at the same time is relocating many federal expenses to municipalities.

Concerning the sharing of tributes by base of incidence, there was an outstanding increase in the share of indirect and cumulative tributes. The literature on equity of tax base demonstrates clearly that indirect taxes are easier to collect. However, it is important to notice that this kind of tribute has a strong concentrating characteristic in economies with higher levels of income concentration, mainly because they disregard the consumer's distributive profile. This is precisely the Brazilian case. The tax incidence (direct and indirect) on income of individuals earning up to three minimum wages is higher if compared to individuals whose income is larger than ten minimum wages. This fact demonstrates the income concentrating characteristic of the tax structure in Brazil.

The tax incidence on Goods and Services represents almost half of the total amount collected. It's worthy to note that the Cofins - Contribution for the Financing of Social Security – (ex Finsocial) rose from 5,4%, in the beginning of 1990's to around 11% of the total tax revenue in 2002, more than duplicating its participation in the GNP in this period. The predominance of indirect taxes on goods and services is a typical example of the federal government strategy to speed up the tax collection.



Indirect taxes are politically more viable of approval and have a quite high productivity. This explains the increase in the participation of these taxes in the total tax revenue. Furthermore, this strategy, when based on cumulative taxes (like Cofins and CPMF), acts as a good mechanism to increase total tax revenue. However, this not only undermine equity principles, but also causes vertical conflicts, particularly when we observe that the cumulative taxes, mostly created in the last decade, are federal taxes. This is an important point, since the increase in Gross Tax Burden in Brazil, in the last ten years, came together with a tax re-centralization. It is also worthy to note that the tax incidence on Property and Income in Brazil, though it has increased in the last five years (particularly the Income tax), still very low, corresponding to around 8,5 % of the GNP and 24 % of the total tax revenue in 2002.

As already pointed out, the strategy of tax burden augmentation in Brazil in the last ten years decreased the share of States and municipalities over the tax allotment, resulting not only in a exasperation of the vertical and horizontal conflicts, but also in a negative impact on the opportunity of using tax transfers as a mechanism to reduce regional imbalances.

The share of the federal government grew from 61,7% of the total in 1995 to 64,1% in 2003. Nevertheless, after the voluntary transfers and other types of transfers, the municipalities share increased to the detriment of States and Federal government. Actually, an increase in the municipalities share would not be a concern per se. The central question in this point is that a great volume of voluntary transfers imposes to these sub-unities an unhealthy position of dependence on federal resources. Its important to note that the share of the municipalities in their own income revenue and in the available revenue rose after 1988, validating the argument that the Constitution of 1988 represented, particularly for municipalities, a better availability of tax resources.

For the States, however, the situation became worse, since the Available Revenues (in the enlarged concept) dropped from 27% in 1997 to 24,6% in 2003, accentuating the slow, although systematic, re-centralization process. The increase on GTB in this period obviously also represented an increase in the participation of the States in the ratio tax revenue/GDP. However, as already exhaustively observed, an increase in public expenditure, as a result of higher social demands and relocation of more attributions to these sub-unities, acted as a counterbalance to the process of augmentation of the tax revenue. Not forgetting that we also must include the financial costs of State debts re-negotiated in the Fernando Henrique Cardoso (1995-2002) government as well as the limitations imposed by the FRL<sup>3</sup> on the increase of expenses.

Since the Constitution of 1988, particularly from FHC years on, several tributes of strictly federal competence were created and re-articulated without distribution sharing with the federative sub-unities. More than this, the transfers of federal attributions represented additional responsibilities of great proportions for these sub-unities, particularly the municipalities.

As a result of the policies implemented by federal government in the last years, the decomposition of the Sales Tax Burden on value added tributes – ICMS and IPI – and cumulative - Cofins, Pis/Pasep, CPMF, IOF and ISS – points out to the decreasing tendency of the ICMS and IPI taxes, and to the augmentation of cumulative taxes, mainly the general sales taxes – Cofins, Pis/Pasep and CPMF.

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<sup>3</sup> These data can be obtained in Jayme Jr & Santos (2004).

There has been an excessive creation of cumulative social contributions, as they allow a rapid increase in the amount of both the tax revenue assembled and the availability of resources. The clear re-centralization of tax resources and the increase in States and municipalities expenses, particularly after 1995 and worsened since 1999 has increased the financial troubles. The result is a perverse combination: elevation of the Gross Tax Burden simultaneously to the collapse in the participation of the sub-spheres in resource distribution. We can add to the already tricky situation in terms of financing capacity of these federative units, an increase in expenses along with a federative horizontal competition.

### **3. THE FISCAL RESPONSIBILITY LAW AND ITS IMPACT ON REGIONAL FINANCING**

The Fiscal Responsibility Law (FRL), from 04.05.2000, aims at a more balanced and transparent administration of public resources. The rulers of Executive, Legislative and Judicial Powers, as well as the Federal Attorney and the three spheres of government (federal, state and municipal), are now responsible for their budgets and targets, in a way to avoid unmanageable expenses without the endorsement of the Federal Government. As regards control and accountability of public expenses to society, the FRL is an indisputable advancement. However, as an instrument of demand encouragement it has clear limitations. In this sense, allocation of public expenses as an instrument of development and mitigation of regional disparities challenges the law's major objectives. Actually, the theoretical approach behind the FRL, although not explicitly, restrains the fiscal instruments needed to economic cycle stabilization in a Keynesian way.

The FRL as originally conceived (what does not mean that it could be modified), depends on several items: a government that guarantees fiscal balance for its full efficiency, a Debt/GDB rapport that is compatible with inter-temporal solvency, institutional reforms that should ensure property rights and legal institutional conditions to assure private investments. A detailed analysis of its costs and benefits to fiscal policies is a subject of this topic.

Undoubtedly, the Fiscal Responsibility Law (FRL) constitutes a dividing wall in Brazilian public administration. It introduces new management practices of public finances as it establishes clear and precise rules for the control of expenses and public debt. It compels rulers to account for their acts or omissions in a regular basis and values the planning as a routine in fiscal administration. In addition, the FRL normalizes and modernizes the federative vertical relations. In fact, despite the efforts of democratization behind the reforms in the 1988's Constitution which provide more autonomy and a better financial structure for States and municipalities, the horizontal and vertical federative conflicts did not lessen. On the contrary, the absence of clear rules steering the relationship between federative units aggravated the conflicts. Furthermore, the State budgetary deficits were transferred to the Federal Government, breaking a valued principle to federative systems, the independence between federative units. So, the Constitution of 1988 created a system that increased the autonomy of States and municipalities, though it was not able to guarantee responsibilities to these sub-units. The FRL tries to correct part of this problem.

Understanding the role of the FRL in public and regional development financing as well as in the allocation of public expenses is important to avoid hasty evaluations, both positive or negative ones. More than this, to make possible the knowledge of better ways to use public resources to adequate the limits imposed by the law. Among the important innovations brought by the FRL we point out:

- a) Limitations in the expenses with the salaries, establishing not only the amount to be spent by each level of government according to the net receipt, but also - and that's a novelty - the percentage due to the executive, legislative and judicial power, removing the previous distortions mainly in State governments;
- b) Reaffirmation of more rigid limits which were already established by the Federal Senate for public debt, indicating that officials not behaving responsibly would be punished equally with more rigidity;
- c) Definition of fiscal annual targets and a requirement to present quarterly reports of fiscal administration, creating also other transparency mechanisms as the Council of Fiscal Management – to be constituted;
- d) Establishment of control mechanisms for public finances in electoral years;
- e) Prevention of financial help amongst the Federal Government and sub-national governments, creating a clearer relationship between the federative units and recovering the idea of fiscal federalism in its plenitude.

The five items quoted above are of basic importance to increase the social control on public expenses, which impose accountability, as well as strengthening the federalism. One of the points that deserves distinction is the public debt. It is well known that debt is a recognized fiscal instrument of increasing expenses, which can be used as an anti-cyclical mechanism. The Federal Government as well as some states and municipalities can use this instrument to increase public expenditure in order to avoid stagnation and recession. However, the FRL, by establishing excessively rigid and non-negotiable mechanisms, can lead to a fall in public investments. As a matter of fact, the monetary policy of the Central bank, in order to be compatible with the rigid targets of inflation, increases the debt by issuing bonds of the Federal Government and some states, which – given the limits of debt – is translated into a reduction of expenses particularly investments. In this way, there is an incompatibility between monetary and fiscal policies objectives. In order to maintain the debt inside the limits of the FRL there is a reduction of non-financing public spending to levels which are incompatible with the maintenance of the administrative engine. To sum up, from a macroeconomic point of view, the FRL combined with tight monetary policy, imposes significant restrictions on federative units, making it difficult for investments and for regional development policy that are based on public expenses. It's worth to note that the Constitutional Funds of Financing are already set up as an important instrument of reduction of these imbalances, and, in theory, they are not directly affected by the FRL. However, to the extent that the tight monetary policies is associated with a restrictive fiscal policy in federal level it will affect the short term economic growth and consequently the revenue of taxes and the sources of financing for regional development.

However, the FRL modernizes and democratizes the instruments of fiscal management of public finances. According to Khair (2000), the FRL rely on four axes: projection, transparency, control and accountability. In other words, it affects not only the fiscal results but also the way the public finances are administrated. In order to understand the impacts of the FRL in all dimensions it is necessary to consider other indicators, even those not immediately quantifiable. Hence, it is possible to connect the FRL with several axes of more democratization and control of the public finances.

At present we intend to emphasize the efficiency and the effectiveness of the law with respect to the four axes pointed above and to incorporate another one, which is related to the prohibition of help between governments, an essential innovation in Brazilian federative relationship. The five axes are the following: (1) the planning to manage revenues, expenditures and debts; (2) the publicity of the fiscal management reports; (3) the control of expenditures and debt; (4) the accountability, in other words, the submission of the accounts from the administrators of public resources to the governed ones and /or their representatives and (5) the elimination of the predatory characteristics of the financial relationship through the new rule that prohibits help between governments. To sum up, we intend here to point out the necessity of valuing the FRL in a multidimensional perspective.

One of the most important aspects of this Law is the article 19 which imposes limits for total personnel expenditures. If the expenses of federative units exceed the prudential limit (95 % of the legal limit), several actions will be prohibited. For example: the concession of advantages, raising salaries, any salary adjustment or revision; the creation of offices, jobs or functions, new admissions of public servants as well as any type of admission or employment of personnel. If the reduction does not reach the maximum limit after the legal term, the officials will not receive the voluntary transfers and contracting credit operations as well as obtaining others guarantees will be suspended.

However, the FRL promotes an inflexibility in the way federative units can spend their resources. Despite its importance in controlling expenditures – and we know that Brazil has a long time practice of bad public administration of States and municipalities - the FRL restrain the use of an anti-cyclical fiscal policy. The basis of these policies are such that in periods of economic slowing down, it is convenient to the State to increase expenses to support the level of the aggregated demand. In effect, keynesian policies use the anti-cyclical effect of public spending to moderate the harmful effects on income and GNP when the economy is slowing down. Increasing public spending (running into debt via emission of bonds) can produce a positive effect on the aggregated demand and the rise in the income allows, in a second moment, an increase of tax revenue. In periods of growing income, public spending can (and it has to) lessen. The FRL, such as approved, does not take into account the importance of the anti-cyclical effect of expenditure. In this sense, it ends up as an additional mechanism that eventually can aggravate the fiscal and financial situation of the federation. This happens because of the imposition of maintaining at any cost the inter-temporal budgetary balance in order to ensure primary surpluses that are compatible with the reduction of Debt/GDP rapport.

From the point of view of regional imbalances, the FRL contributes to a destabilization of regional development policies. In a perspective of growing commercial and financial opening, market integration as well as increasing productivity, the productive activities tend to concentrate. This happens mainly because the capital tends to flow to consolidated and more lucrative sectors. The consequence is an increase in regional concentration of productive activities. In effect, without public

policies favoring regional development and mitigation of income and wealth concentration both regional imbalances and concentration of income and wealth, will worsen. The FRL, despite its principles of increasing the democratization of information and budget may turn out to be another inhibiting instrument for policies aiming at moderate regional income and wealth inequalities.

#### **4. FINANCING SOURCES FOR REGIONAL DEVELOPMENT IN BRAZIL**

The sources for regional financing in Brazil are characterized for a myriad of instruments and institutions that not always attain efficiency and perfect application of available resources. To the constitutional financing funds we add the fiscal funds for regional development (formerly linked to the SUDAM, SUDENE and at present to ADD and ADENE) as well as some support agencies as BNDES, CODEVASF (Company for the Development of Saint Francisco Valley), DNOCS (Department of Works against the drought) and SUFRAMA (Manaus free-trade bureau), among others. Thus, the absence of a regional de-concentration process in Brazil, particularly after the 1988's Constitution, can not be attributed to a lack of financial instruments. Quite the opposite, as data on financing funds can demonstrate, the variety of subsidizing instruments is possibly one of the reasons for the inefficiency of the process. Besides, one cannot disconnect financing growing from economic development.

In the last years, public financing in Brazil was limited by contracting fiscal and monetary policies. The high interest rates stimulate support banks to apply on public titles in order to guarantee a better resource administration. As a consequence, the credit operations were affected, and so were the projects that could possibly be financed. This becomes clear when we analyze the relationship between annual transfers from the National Treasury to the funds and the amount loaned by the funds.

Table 4.1 shows the transfers from the National Treasury to Fiscal Financing Funds since 1994. It is possible to observe that the transfers to the FINAM did not undergo abrupt falls as did the transfers to the FINOR after 2001. The transfers to the FINOR and FUNRES showed an evolution close to the behavior of the economy, collapsing after 1999. The same did not happen with the FINAM. According to Crocco (2003), despite the smaller share of the Northern region on the GNP comparing to the Northeast region, this growth rate was higher in the 1994-2003 period. As a result, a vicious circle of stagnation and fall in the credit and financing to these regions was established.<sup>4</sup>

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<sup>4</sup> Besides these funds, there are indirect mechanisms of regional development financing spread by several institutions. As examples we mention the Codevasf, the Suframa, the DNOCS and the BNDES (Crocco, 2003, p.319).

**TABLE 4.1**  
**Transfers from the National Treasure to the Investment Fiscal Funds**

Year	In thousands of R\$ from the year 2000		
	FINAM	FINOR	FUNRES
1994	-	177.270	-
1995	331.836	336.079	11.897
1996	156.646	402.064	14.988
1997	257.263	468.044	22.802
1998	346.119	410.543	13.334
1999	401.930	329.595	18.576
2000	549.656	428.748	16.663
2001	(*)	119.530	(*)
2002*	440.000	174.322	(*)
2003*	465.000	(*)	(*)

Source: STN/SUDAM/BASA/SUDENE/BNB/GERES/BANDES

\* Refers to transfers to FDA

(\*) Data unavailable

Obs: The Fiscal Funds FINAM and FINOR were closed to new projects in 05/02/2001

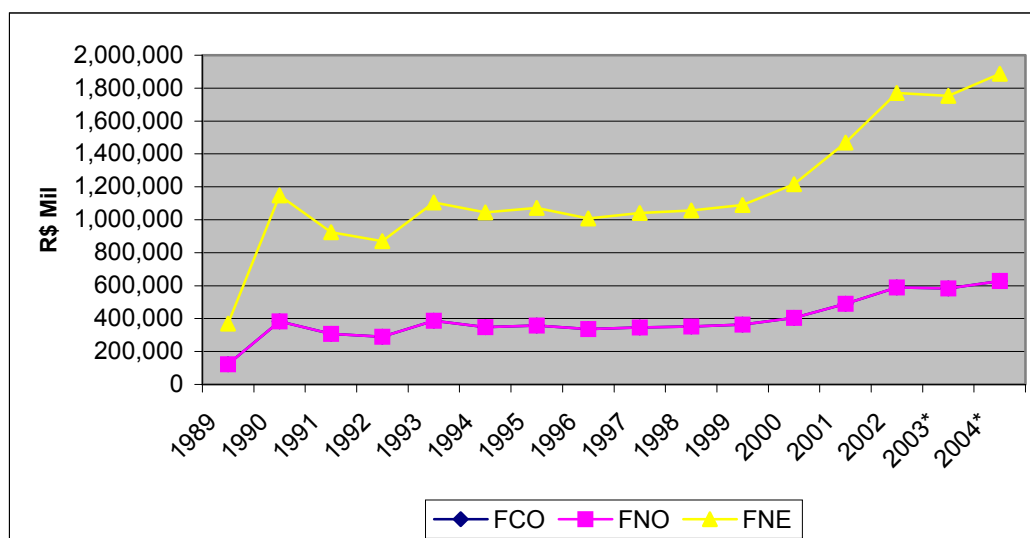
Together with the extinction of Sudene and Sudam.

The ADA (Agency for the development of Amazon) and ADENE (Agency for the Development of the North-east) were created.

The FDA and the FDN, replacing the FINAM and the FINOR respectively were also created.

Transfers from STN to FINOR after 2001 refers only to projects already in execution.

**FIGURE 4.1**  
**Annual Transfers from the National Treasure to Constitutional Financing Funds**



The transfers from the National Treasure to Constitutional Financing Funds (FNO, FCO and FNE) - the most important financing instruments for regional development as they are linked to the IPI and IR revenues – can be examined in Figure 4.1. In 15 years of the funds existence, the total transfers exceeded the significant amount of R\$ 31 billions, at March 2002 prices. Notwithstanding the relative

stagnation from 1994 to 2000, after 2001 we observe a systematic elevation in the transfers. This suggests that the economic growth of the 1994-98 period was not followed by an increase in the tax revenues composing these funds. Actually, as already pointed out, the Gross Tax Burden remained nearly stable in the 1994-98 period (around 29,5 % of the GNP), presenting a systematic growth since then. The transfers to the Constitutional Funds can prove this fact. Despite the GNP inflections in 1999, 2002 and 2003, the transfers increased, mainly due to the tax policies implemented by federal government<sup>5</sup>.

While the transfers from the Treasury remained stable until (up to) 2000 rising significantly afterwards, the contracted values and the operations administered by the funds increased after 1994. However, there was a reduction in the number of operations, reflecting a higher concentration in financing projects as shown in table 4.2. In fact, this behaviour fits well in the strategy of public Development Banks. By increasing efficiency and reducing the leveraging they also reduce their exposure to high risk credit.

**TABLE 4.2**  
**Number of Operations (OP) and Contracted Values (CV)**  
**Annual base - 1989/2002**

Fund Year	CV in thousands of R\$									
	FCO		FNO		FNE		Total			
	OP	CV	OP	CV	OP	CV	OP	%	CV	%
1989/1993	26.035	1.180.290	16.928	703.104	144.316	4.368.655	187.279	16,5	6.252.049	27,4
1994	12.825	295.688	20.674	471.228	64.652	847.784	98.151	8,6	1.614.700	7,1
1995	11.906	179.248	13.533	331.627	67.882	928.720	93.321	8,2	1.439.595	6,3
1996	15.179	226.629	14.486	190.172	80.616	1.163.848	110.281	9,7	1.580.649	6,9
1997	24.867	310.653	6.735	70.712	52.445	808.082	84.047	7,4	1.189.457	5,2
1998	30.400	384.375	15.629	185.043	137.720	843.881	183.749	16,2	1.413.299	6,2
1999	19.015	175.120	23.156	372.377	86.252	669.024	128.423	11,3	1.216.521	5,3
2000	12.963	296.591	31.298	722.232	47.621	589.626	91.882	8,1	1.608.449	7,0
2001	21.901	992.499	10.006	462.165	16.583	308.707	48.490	4,3	1.763.371	7,7
2002	20.986	1.494.462	14.125	628.692	25.093	264.365	60.204	5,3	2.387.519	10,5
2004	13.301	434.000	9.090	505.267	28.176	1.420.528	50.567	4,4	2.359.795	10,3
Total	<b>209.378</b>	<b>5.969.555</b>	<b>175.660</b>	<b>4.642.619</b>	<b>751.356</b>	<b>12.213.220</b>	<b>1.136.394</b>	<b>100</b>	<b>22.825.404</b>	<b>100</b>

Source: Bank of Brazil, Bank of Amazon and Bank of North-east reports.  
Values updated by BTN and TR, in march 2002 prices.

Table 4.3 demonstrates that the strategy of the Constitutional Financing Funds administrators (Bank of Brazil, BNB and BASA) was one of reducing the volume of operations *vis-à-vis* the amounts loaned. In the last ten years, the FNE loans were on average well below the values transferred annually by the National Treasury. This behaviour is the corollary of the defensive strategy of public banks regarding the risks of credit. In fact, when lending to private borrowers, the public bank prefers to operate with public titles, that are more profitable and less risky. Since the LRF prevents loans to

<sup>5</sup> Its worth to note that in the 1994-98 period, the GTB remained stable, so a simply growing in the GNP could produce an elevation in the tax revenue and as a consequence, in the transfers to the funds. The explanations for the stagnation of the federal transfers to the funds in this period are the probable low dynamics of the sectors responsible for collecting the tax revenues and the stagnation in the taxable income.

public institutions and the private sector has a low dynamism, even when linked to support programs, has been insufficient to stimulate local development and this way de-concentration.<sup>6</sup>.

Therefore, there is an asymmetry between the macroeconomic and regional development policies, and the search for better efficiency and less risk by bank institutions. As a consequence, there is a reduction in both credit supply and demand. The low dynamism of local private sector, combined with a credit system not much articulated, generate problems in the effective demand, compelling both public and banks to favor liquidity. Then a vicious circle of small volume of local credit (concentrated in more developed regions), low demand for resources and low economic dynamism is installed. Thus, the Funds do not fulfil their central objective of supporting development projects to reduce regional inequalities. Hence, financing and credit are crucial for success of regional development policy. More than merely a mirror of the inequalities, credit is fundamental to stimulate the effective demand.

**TABLE 4.3**  
**CV/Transfers STN**

Fund Year	FCO	FNO	FNE
1994	84,97	135,42	81,21
1995	50,14	92,77	86,60
1996	67,47	56,62	115,49
1997	89,61	20,40	77,70
1998	109,06	52,50	79,81
1999	48,22	102,54	61,41
2000	73,22	178,31	48,52
2001	202,79	94,43	21,03
2002	253,16	106,50	14,93
2003*	-	-	-
2004	69,03	80,35	75,31

\*Data unavailable

Source: Bank of Brazil, Bank of Amazon and Bank of North-east reports.

The financing funds have a central role in regional development policy. However, the results depend on the recuperation of State planning capacity as well as on the co-ordination between federal government, public and private banks, states and local authorities. As already mentioned in section 2, the asymmetric and conflicting character of the federalism in Brazil, along with the limitations imposed by the FRL points out to the need of more clarity and efficiency in planning articulation. The role of credit in financing regional development is fundamental, as well as it is the articulation of private banks. Thus, it is important to analyze the role of credit and financial concentration as the corollary of regional imbalances in Brazil. A study focusing on financing regional development must concentrate not only on the federative discussion and financing funds but also on the nature of financial inequalities in Brazil. This aspect is discussed in the next topic.

<sup>6</sup> To know more about the programs financed by the Constitutional Funds check the site of the Ministry of Integration: ([www.integração.gov.br](http://www.integração.gov.br))



## 5. CREDIT AND BANK REGIONAL SYSTEM

### 5.1. Bank system, Credit and the Center-Periphery relationship

One of the most common neglects in studies about regional imbalances is the role of money and credit. The theoretical discussion on the subject - including that strictly connected with the Keynesian tradition, for which the regional inequalities presuppose cumulative processes (Kaldor, 1966, Dixon and Thirlwall, 1975) - tends to disregard the role of money and credit in regional development. In this context, regional effects of the bank concentration process in Brazil after 1994 has not been deserving the proper attention in the literature; Amado (1998) is one of the few exceptions.

As initially formulated by Dow (1982, 1987), the process of cumulative causation, much discussed theoretically and empirically by Kaldor and Myrdal, finds in the financial system an important instrument of intensification of regional imbalances. The region is a *locus* where the expectations are shaped and, as the levels of private investment are sensitive to these expectations, in some regions, identified as more risky, the economic agents tend to favor liquidity. Therefore, these regions may experience inadequate levels of effective demand. As the credit supply and demand are directly related not only to monetary policy, but also to borrowers and banks defensive attitudes, least developed regions tend to present, through the effects on monetary and income multiplier, less financial dynamism. As a result, there is a concentration of credit in more developed regions, since they are characterized by less uncertainty and less liquidity preference. Since this aspect is important to economic development, it is not possible to neglect the dynamic of the financial sector at regional level. In fact, before being merely a reflect of the “ real economy ” at regional level, this sector influences significantly the path of regional inequalities.

The peripheral economies are characterized by a stagnated economy, with underdeveloped markets predominating the primary sector and low technological content manufactures as well as an immature financial system<sup>7</sup>. Its dynamism is dictated by the volume of exports to the centre. All these characteristics generate uncertainty about the economic performance of the region leading to a higher liquidity preference. The uncertainty about the future leads economic agents to seek for more liquid assets as a way of protection. Moreover, the investment decisions are delayed until more favorable economic setting (Dow, 1993 and Dow & Rodríguez-Fuentes, 2003). Concerning credit supply, it is plausible to suppose that the banking system is underdeveloped in peripheral regions and consequently less able to supply credit. Besides, the residents low levels of income in these regions restricts access to the banks, decreasing the amount of deposits (as a proportion of the income) and increasing the retention of paper-money by the public .

Distinctively, a central region is characterized by a prosperous economy and a sophisticated financial system. It is also a region with a productive system historically dominated by the industrial and services sector. Furthermore, it locates the financial institutions, making credit supply easier comparing to peripheral regions. All this picture increases security and confidence to invest in less liquid (and more profitable) assets leading to less liquidity preference in more prosperous regions. In effect, it is possible to infer that in central regions there will be more predisposition to demand as well

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<sup>7</sup> Even considering a national financing system without regional banks, its possible to believe that financial innovations implemented in central regions wil only be available to peripheral regions after a time lag.

as to supply credit. As a result, the process of cumulative causation takes place in a way that a decrease in the center's liquidity preference will reduce even more the supply of credit in the periphery. This happens because the credit supply will move to places where there is a higher demand (Crocco, 2005).

In order to understand the dynamics of the regional financing system and its relationship with the economic dynamics it is important to figure out what is called by Ron Martin (1999, p.9) as "a geographic circuit of the money". This circuit can be characterized by two aspects. The first one is the location structure of the financial system which is directly connected with the urban structure and its centrality in a particular region. The urban hierarchy determines a financial hierarchy, in other words, an agglomeration of banking institutions in a more developed place would also offer more sophisticated services.

Another aspect is the so-called institutional geography of the financial system, which refers to the dissimilarities in the institutional models between countries. These differences affect banking development. There are several implications resulting from the difference between a model of regional banks (small banks, with headquarter acting only in the region), as in United States and Italy, and a model composed by large national banks, as in England and Brazil.

Alessandrini (1999) and Martin (1999), among others, affirm that local banks tend to be more involved with the local economy being more affected by its economic oscillations. On the other side, national banks manage to protect themselves from local economic instability, compensating losses in these regions with profits in other localities. Banks of this type, with headquarter in the centre and acting also in the periphery, are more reticent concerning the extension of credit to periphery. The reasons are the higher volatility in the dissemination of information. In this way, different institutional geographies can produce different processes of money circulation (savings, credit and applications).

It is also worthy emphasize that, in general, peripheral economies have an informal sector more important comparing to central regions. As a result, the banks ratio cash-deposits is higher, generating a smaller monetary multiplier and consequently difficulties in access to credit. This vicious circle makes investment still more difficult in peripheral regions.

Brazil, as pointed out by Crocco (2004a), has strong regional financial disparities, which is a reflex of its economic inequality (*latu sensu*). Bank agencies are concentrated in most developed regions, so that these regions have a higher participation in the amount of deposits and credits. Taking as a starting point the relationship centre-periphery and its credit and monetary characteristics we intend to analyze the regional dimension of financing in Brazil, demonstrating also the relevant role of credit concentration and enhanced liquidity on regional imbalances in Brazil.

## **5.2. Regional and Financial Inequalities in Brazil**

To assess the regional influence of the financial variables, we extracted data from the Sisbacen (Central Bank System of Information) database. The database contain information on monthly statistics from 1988 to 2004 for all Federation Units. The data refer to main accounting items (assets and liabilities) of the financial system, with the aggregated monthly value for each operation for all local financial institutions. Through this database it is possible to evaluate the banking regional concentration and its effects on regional inequalities in Brazil.

By now we have already examined the Financing Funds for regional development; hereafter we focus on the role of financial system, particularly private banks. To date there isn't a well consolidated system to finance development in Brazil. An historical retrospect shows that the financial private sector, as states Alves Jr. (2002, p.332), *"was very competent to survive instability, but it did not appear able to produce the amount of credit and investment funding necessary to promote sustainable economic growth"*. It is from this perspective that we intend to seek for ways to block this adverse trajectory. The State intervention, mainly in credit supply can open "windows of opportunity" to increase private credit in less developed regions and, in this way, lessen the harmful effects of financial concentration on the perspectives of reducing the regional disparities.

From the sum of two accounts from the balance available in the Sisbacen database, the Loans and Deducted Bonds account and the Financing account, we calculated an index of credit concentration by region and state, taking as a basis the sum for the whole country. Table 5.1 shows the values for each State and region for 1991, 1997 and 2003.

**TABLE 5.1**  
**Index of Credit Concentration by Federative Unit - Brazil**

Region	1991	Region	1997	Region	2003
Roraima	0,01	Amapá	0,02	Roraima	0,05
Amapá	0,03	Roraima	0,04	Acre	0,08
Tocantins	0,04	Acre	0,06	Amapá	0,08
Piauí	0,16	Tocantins	0,10	Tocantins	0,18
Acre	0,20	Rondônia	0,17	Rondônia	0,20
Rondônia	0,21	Paraíba	0,27	Sergipe	0,27
Paraíba	0,22	Sergipe	0,28	Piauí	0,28
Sergipe	0,30	Amazonas	0,32	Alagoas	0,33
Rio Grande do Norte	0,37	Rio Grande do Norte	0,38	Amazonas	0,33
Amazonas	0,39	Piauí	0,38	Rio Grande do Norte	0,44
Alagoas	0,46	Maranhão	0,40	Maranhão	0,45
Maranhão	0,60	Pará	0,51	Paraíba	0,55
Espírito Santo	0,69	Alagoas	0,57	Mato Grosso do Sul	0,66
Mato Grosso do Sul	0,79	Espírito Santo	0,72	Pará	0,67
Pará	0,91	Mato Grosso do Sul	0,80	Mato Grosso	0,68
Mato Grosso	0,94	Mato Grosso	0,90	Espírito Santo	0,78
Goiás	1,21	Goiás	1,05	Ceará	1,13
<b>North</b>	1,80	Pernambuco	1,06	Pernambuco	1,44
Ceará	1,94	Ceará	1,06	Goiás	1,45
Pernambuco	2,34	<b>North</b>	1,27	<b>North</b>	1,59
Santa Catarina	2,68	Distrito Federal	1,80	Santa Catarina	1,93
Rio Grande do Sul	3,44	Santa Catarina	1,94	Bahia	1,94
Paraná	4,32	Bahia	2,72	Distrito Federal	2,35
Bahia	4,47	Paraná	3,59	Paraná	3,42
Distrito Federal	6,94	Rio Grande do Sul	3,93	Rio Grande do Sul	4,96
Minas Gerais	8,60	Minas Gerais	4,49	<b>Center-West</b>	5,13
<b>Center-West</b>	9,95	<b>Center-West</b>	4,54	Minas Gerais	5,37
<b>Sou</b>	10,44	<b>Northeast</b>	7,13	<b>Northeast</b>	6,85
<b>Northeast</b>	10,95	Rio de Janeiro	7,87	Rio de Janeiro	8,67
Rio de Janeiro	14,86	<b>Sou</b>	9,46	<b>Sou</b>	10,30
São Paulo	42,72	São Paulo	64,52	São Paulo	61,10
<b>Southea</b>	66,87	<b>Southea</b>	77,60	<b>Southea</b>	75,62
<b>Brazil</b>	100,00	<b>Brazil</b>	100,00	<b>Brazil</b>	100,00

Source: Sisbacen

It is clear, once more, the strong predominance of the South-east Region and the growth of its concentration, varying from 66,87 % to 75,62 % during the period. Its not a surprise that São Paulo State concentrates most of the credit (more than 60 % of the total credit in 2003). Its worth noting that in high inflation periods (and this can be reflecting indexation problems), the credit concentration was much smaller than in the period following monetary stabilization. The maps of credit concentration can demonstrate the process of increasing concentration in the nineties. To bank concentration, observed after the Real Plan (Alves Jr, 2002), we can add a concentration in credit supply. A well articulated process of economic de-concentration and reduction of regional imbalances can only be possible concomitantly with a process of financial de-concentration. However, without the participation of public development banks in this process it is not likely that the attempts will be successful .

### **5.2.3. Financial Intermediation and Financial Imbalances**

Through the annual Regional Accounts, which are GNP indicators for each State and economic activity, it is possible to obtain data from 1998 to 2001 about the activities related to financial intermediation at regional level. The concept of financial intermediation was set by the IBGE (Brazilian Institute of Geography and Statistics).

Table 5.2 shows the participation of the Regions, States and the Federal District (DF) in the economic activity as a whole and on financial intermediation. Table 5.3 presents the weight of financial intermediation in total economic activity for each state and the DF.

We remark the expressive participation of the DF in financial intermediation activity. However, this is due to the fact that many operations of the Central Bank, Federal Savings Bank and Bank of Brazil, as well as the National Treasure are accounted for the DF. Consequently, the values for the DF participation are overestimated.

Table 5.2 also demonstrates that geographic concentration in financial activities is more important than concentration in economic activity. Besides, the degree of concentration of financial activities increased along the period of analysis. This happens because financial services tend to concentrate in large economic centers. The economic concentration in South-east varied from 57.7% in 1998 to 57.2 % in 2001 while the financial concentration increased from 61.6 % to 69 % in the same period. In the Northern region, the less representative at national level, economic concentration varied from 4.5 % to 4.7 % and financial concentration from 1.5 % to 1.7 % in the period. The Manaus Free-Trade Area and the extractive activities in this region can explain these results. The small share of financial intermediation is explained, as for other less developed states, by the leaks of credit to more developed regions. In fact, although the production can take place in a particular region, as the financial system in Brazil is centralized and lacks regional banks (except the investment banks), part of the financing activities takes place in large centers like Sao Paulo. This fact corroborates the theoretical argument discussed above that the leaks in the financial sector tend to aggravate regional imbalances.

In Table 5.3 we observe that São Paulo is the State where the part of financial intermediation in the value added of productive activities and services is the largest one, 9.5 % in 2001 (against 8.2 % in 1998). In the Northern region we find the states where the relevance of financial intermediation in the economy are less important. At the end of the period, all states in this region, except for Tocantins (4.1 % in 2001), had participation of the financial activity below 3 %.

This behavior corroborates the argument that peripheral regions tend to prefer liquidity and consequently experience less supply and demand for credit. At the same time they also use less the bank sector in productive activities (less financial intermediation). The absence of a robust financial system to finance local economic activities support the vicious circle of stagnation and informality in the least developed regions. This environment makes it harder to overcome regional inequalities.

**TABLE 5.2**  
**Share of Regions and States in the Gross Added Value of Financial Intermediaries**

	1998		1999		2000		2001	
	total	Financial Intermediaire	total	Financial Intermediaire	total	Financial Intermediaire	total	Financial Intermediaire
<b>Brazil</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>
<b>North</b>	<b>4,5</b>	<b>1,5</b>	<b>4,5</b>	<b>1,6</b>	<b>4,6</b>	<b>1,9</b>	<b>4,7</b>	<b>1,7</b>
Rondônia	0,5	0,1	0,5	0,1	0,5	0,2	0,5	0,2
Acre	0,2	0	0,2	0	0,2	0,1	0,2	0,1
Amazonas	1,6	0,4	1,6	0,4	1,7	0,5	1,7	0,4
Roraima	0,1	0	0,1	0	0,1	0	0,1	0
Pará	1,7	0,8	1,8	0,9	1,8	0,9	1,8	0,8
Amapá	0,2	0	0,2	0	0,2	0,1	0,2	0
Tocantins	0,2	0,1	0,2	0,1	0,2	0,2	0,2	0,2
<b>North</b>	<b>13,1</b>	<b>7,3</b>	<b>13,1</b>	<b>7</b>	<b>13</b>	<b>7,8</b>	<b>13</b>	<b>7,9</b>
Maranhão	0,8	0,3	0,8	0,3	0,8	0,5	0,9	0,5
Piauí	0,5	0,1	0,5	0,1	0,5	0,3	0,5	0,3
Ceará	2,1	1,4	2	1,4	1,9	1,3	1,8	1,5
Rio Grande do Norte	0,7	0,4	0,8	0,5	0,8	0,4	0,8	0,4
Paraíba	0,8	0,2	0,8	0,2	0,8	0,4	0,9	0,5
Pernambuco	2,7	1,2	2,7	1,2	2,6	1,6	2,6	1,5
Alagoas	0,7	0,3	0,7	0,3	0,6	0,4	0,6	0,4
Sergipe	0,6	0,2	0,5	0,2	0,5	0,4	0,7	0,4
Bahia	4,2	3,1	4,3	2,9	4,3	2,5	4,3	2,3
<b>Southea</b>	<b>57,7</b>	<b>61,6</b>	<b>57,8</b>	<b>64,1</b>	<b>57,5</b>	<b>66,1</b>	<b>57,2</b>	<b>69</b>
Minas Gerais	9,8	5,4	9,6	6	9,7	6	9,4	6
Espírito Santo	1,7	0,5	1,8	0,5	1,8	1,2	1,7	1
Rio de Janeiro	11	10	11,8	10,8	12,7	10,9	12,5	10
São Paulo	35,3	45,7	34,7	46,8	33,3	48	33,6	52
<b>Sou</b>	<b>17,6</b>	<b>11,6</b>	<b>17,9</b>	<b>12,1</b>	<b>17,6</b>	<b>13,2</b>	<b>17,8</b>	<b>12,4</b>
Paraná	6,3	4,9	6,4	5	6	5,3	6,1	5,1
Santa Catarina	3,5	1,1	3,6	1,1	3,8	2	3,9	2
Rio Grande do Sul	7,8	5,6	7,8	6	7,8	5,9	7,9	5,4
<b>Center-West</b>	<b>7,1</b>	<b>17,9</b>	<b>6,8</b>	<b>15,2</b>	<b>7,2</b>	<b>11,1</b>	<b>7,3</b>	<b>9</b>
Mato Grosso do Sul	1,1	0,6	1,1	0,6	1,1	0,6	1,1	0,6
Mato Grosso	1,1	0,5	1,2	0,5	1,2	0,8	1,2	0,8
Goiás	1,9	1	1,8	0,9	1,9	1,4	2	1,3
DCI	3	15,8	2,7	13,2	3	8,3	2,9	6,4

Source: Brazilian Institute of Geography and Statistics ( IBGE) – National Accounts, 2001

**TABLE 5.3**  
**Share of Financial Intermediaries in the Grow Added Value by States**

		1998	1999	2000	2001
<b>Brazil</b>		<b>6,3</b>	<b>5,9</b>	<b>5,2</b>	<b>6,1</b>
North	Rondônia	1,4	1,3	1,6	2,1
	Acre	1,9	1,6	2	2,7
	Amazonas	1,6	1,5	1,4	1,4
	Roraima	1,1	1,2	2	2,5
	Pará	3,1	2,9	2,7	2,6
	Amapá	1,8	1,7	1,6	1,5
	Tocantins	2,7	2,5	4,6	4,1
Northeast	Maranhão	2,3	2	3,1	3,8
	Piauí	1,5	1,3	3,1	4,2
	Ceará	4,4	4,1	3,5	5,3
	Rio Grande do Norte	3,7	3,8	2,6	3,1
	Paraíba	1,8	1,7	2,7	3,8
	Pernambuco	2,9	2,6	3,1	3,4
	Alagoas	2,9	2,7	3,2	3,5
	Sergipe	2	1,8	3,8	3,4
	Bahia	4,7	4	3,1	3,3
Southeast	Minas Gerais	3,5	3,7	3,3	3,9
	Espírito Santo	1,8	1,6	3,4	3,5
	Rio de Janeiro	5,8	5,5	4,5	4,9
	São Paulo	8,2	8	7,5	9,5
South	Paraná	4,9	4,6	4,6	5,2
	Santa Catarina	2	1,8	2,8	3,1
	Rio Grande do Sul	4,6	4,6	3,9	4,2
Center-West	Mato Grosso do Sul	3,4	3	2,9	3,1
	Mato Grosso	2,9	2,5	3,4	3,9
	Goiás	3,3	3,1	3,7	3,9
	DC	33,4	28,8	14,7	13,5

Source: Brazilian Institute of Geography and Statistics ( IBGE) – National Accounts, 2001

Hence, the empirical evidence goes alongside the hypothesis that a bank system based on large national banks as in Brazil, stimulates bank concentration. Nevertheless, because their headquarters are localized in the economic centers (the South-east particularly São Paulo in Brazil), they feed and accentuate the industrial concentration process.

Owing to more stability and less uncertainty, the logic of the market leads to concentration of credit in the central region. Therefore, firms in that region are privileged with better access to credit and diversified bank services. However, in Brazil, there is an aggravating factor: the industrialization of the peripheral regions was stimulated by government in such a way that activities in those places started on mainly as branches of enterprises whose headquarters where in the center. Thus, the credit operations happen mainly in the headquarters and the leaking of deposits is high. Again, there is a predominance of a vicious circle that, in the absence of intervention, tend to perpetuate itself.

## 6. CONCLUSIONS

Although it may seem simple at first sight, the relationship between regional imbalances and financial system is not trivial. In fact, if credit concentration is the corollary of regional imbalances in Brazil, the dynamics of public and banks liquidity preference imposes more awareness in the formulation of regional development policies. The financing of regional development policy in Brazil cannot be understood without considering its connection to the fiscal mechanisms of public financing, to the Fiscal Responsibility Law and to the nature of the federalism.

In fact, the debate on regional development policies in Brazil must include broader issues, like the articulation of the banking system (public and private), the characteristics of tax resources distribution, and the limitations of public expenses imposed by the FRL. The role of the State, despite its distortions, is crucial in this arrangement since financing policies for regional development depends on government. Although it is not our purpose here to discuss this point, we must not forget that in Brazil the participation of the State in policies for regional development led to huge distortions. It benefited the local elite and sustained the stagnation of the poor regions. These effects can be reduced through the institutionalization of financing policies based on targets and results, where the creation of new credit supply will depend on goals accomplished by the projects.

The results obtained in this research demonstrate the importance of rethinking the strategy of use of the Constitutional and Fiscal Financing Funds for regional development. These funds must be used in its entirety in order to avoid that the transfers from the National Treasury are kept in the public banks being used for operations of better efficiency, but inefficient as public instruments for increasing credit supply.

In the same way, the existence of a competitive federative system<sup>8</sup> as well as the requirements of the FRL goes against the most efficient policies of regional development. It would be naïve to make the FRL responsible for the difficulties of increasing public expenses and rendering regional development policies not viable. The regional imbalances in Brazil are well known and certainly they did not worsen in the last years because of limitations imposed by the FRL. However, it is clear that fiscal policies preventing public investment, specially when combined with restraining monetary policies, produce harmful effects to economic growth in the short term and consequently, on the long term development<sup>9</sup>. This, plus the consolidation of an “obsession for the fiscal balance” policy generates an amplification of the regional imbalances. The main reason for this is the fact that investments and augmentation of credits in less developed regions are risky and have less return rate.

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<sup>8</sup> Competitive federalism stands for several federative sub-spheres trying to benefit of the possibilities to increase their own receipts while the federal government tries to create mechanisms to reduce tax transfers. Typical cases of federative competition are the fiscal war and the increase in the Tax Burden by the federal government through the creation of contributions not submitted to sharing as COFINS and CSLL.

<sup>9</sup> About the mistaken mix of economic policies in Brazil in the last years, its worth to emphasize that a restraining monetary policy base don high interest rates magnifies fiscal imbalances through increasing public debt cost. Confronted to the necessity of reducing the ratio debt/GDP to obtain more credibility in financial market its impossible to operate with a fiscal balanced fiscal policy. In the attempt to reduce the operational deficit (and to guarantee larger primary surpluses) the National Treasury reduces investment and funding expenses. Consequently, the “*worst of the worlds*” takes place: monetary policy with high interest rates to keep inflation targets and a fiscal policy whose most significant expenses are the payment of interests and the amortization of internal debt. Its easy to observe the difficulty in using this type of policy mix to stimulate regional development policies.

Finally, it's worth to emphasize the effect of the credit system on regional disparities. Confirming the theoretical argument, the empirical results for Brazil, using the Sisbacen database, reveal the important role of the financial system as a component of those inequalities. In fact, the concentration of credit in more developed regions (mainly South-east region and São Paulo State), the liquidity preference both of banks and public in the Northern and Northeast regions – and its effects on credit supply and demand – and, finally, the relationship of these variables with the financial intermediation, demonstrate the importance of the financial system and credit for regional development.

From the connection between the three elements above summarized the policy proposals must recognize the importance of the financial system regulations, of the tax resources distribution and of the institutional arrangement for public expenses. In this way, this subject must be introduced in the regional optics instead of being treated only under the macroeconomic point of view.



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