ABSTRACT

The importance of subnational governments in the provision of goods and services to the population in Brazil has gained ground in the eighties, as much as decentralization went deeper. In 2004, 76.7 million people – 42.4% of the population – lived in metropolitan regions in Brazil. Due to the lack of federal resources, initiatives in the area of urban development have been assumed mostly by the municipalities. Despite the importance of this process, we still do not have policies designed to deal with such an environment of blatant inequality.

The analysis of the evolution of federalism in Brazil makes clear that the institutional changes have not contributed to structure incentives for cooperation, a key issue in a country with huge inequality relating to the spatial distribution of product as well as to the personal distribution of income.

The experience in managing metropolitan problems suffers from those institutional deficiencies. Solutions for urban problems in Metropolitan Regions mostly require investment expenditures and so a long term commitment of the constituents of Brazilian federal system – the central government (or the Union), the States and the municipalities.

In 2003, following a recent trend, municipalities presented a general balanced financial situation. The same happened for municipalities belonging to metropolitan regions. Nevertheless, when we analyze them separately, through the use of the indicators of revenues, expenditures, investment and indebtedness, we see that there is great diversity of funding breakdowns among cities of a same region. Although in the social domain an adequate funding has been secured, the same does not apply areas related to urban development – such as transport, housing, sanitation. At present, due to credit restrictions, the most important external source of investment financing comes from capital transfers, which are available only during the fiscal year. They are, therefore, not suitable for projects which demand a long implementation period. The lack of proper funding may cause the implementation of a development policy for metropolitan regions to become unfeasible, even though solutions have been found to deal with institutional difficulties.
1. Metropolitan Regions and Urban Development – Introduction

Brazil is a highly urbanized country. In 1970, 55.9% of total population of 93 million people lived in urban areas. The Southeast Region was the most highly urbanized – 72.7% of the population was classified as urban. By the year 2000, the rate of urbanization reached 81.2% of the total population of 170 million people. The most highly urbanized region was still the Southeast, but by this time 69% of the population in the Northeast already lived in urban areas.

The importance of state and municipal governments in providing public goods and services to the population increased during the 1980’s, in a process of decentralization, through which they have assumed complex and diverse responsibilities. Due to the lack of central government resources, initiatives in urban development were assumed mostly by municipal governments. In 2002, while the central government spent just 0.15% and States 0.47% of GDP on environmental protection and housing and community amenities, municipalities devoted funding amounting to 1.26% of GDP to those functions of government1.

Despite the growth in available revenue2 – the municipal share rose to 16.1% in 2003, up from the 10.8% of the fiscal pie they had in 1988 – the resources are clearly inadequate to meet the needs of urban development3. This assertion becomes even more important as problems caused by accelerated urbanization worsened. In 2004, 76.7 million people – 42.4% of the population – lived in metropolitan regions in Brazil, in an environment of blatant inequality. In the major cities, the general indicators currently used do not show the extent of the contrasts. Although the core cities in the metropolitan regions are the richest areas of the country, they are those where intra-urban inequality is greatest.

The supply of public goods and services, based on tax revenues and, within a federal system, on intergovernmental transfers may compensate for, or at least reduce, the losses from inter-jurisdictional externalities. In less developed countries, the design of such a system is at the heart of efforts to reduce spatial and interpersonal income differences. Besides these resources, capital expenditures may be financed through public debt. Since the benefits of these projects will be distributed over several generations, the benefits principle suggests that it will be up to future generations to pay for a share of those loans4.

This paper focus on metropolitan regions and urban infrastructure. We will examine the institutional and financial difficulties in undertaking coordinated efforts directed to the solution of common problems. To better understand this issue, a fundamental question becomes whether the present design of Brazilian fiscal federalism is adequate to the task of dealing with the infrastructural problems faced by the population living in those areas. Cooperation becomes equally important since the solutions for these problems generally require substantial amounts of investment expenditures. In the long run, the specificity of urban development5 expenditures emerges more clearly: they differ from current expenditures on education and health services, for example, not so much by the amount of resources they require, but rather by the fact that they are basically capital expenditures. The demand for these expenditures is therefore time-concentrated and calls for guaranteed funding. Moreover, any

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1 This section and the following bring data prepared by the author for the Overview of Public Expenditures in Brazil – Part I, background paper prepared by the author for the Worldbank in 2004. Data come from the federal bureau of statistics – IBGE and from the Secretary of the National Treasury/Ministry of Finance. Classification of fiscal data followed the IMF GFS 2001.
2 Understood as own tax revenue plus revenue sharing transfers.
3 In the same period, States’ participation on available revenue fell from of 26,9% to 24,9%.
5 We agree that urban development necessarily includes government activities related to the social area: education, health, social assistance, among others. In this paper, we’ll be focusing on the infrastructure aspect. We will also use the term “investment” to mean the acquisition of financial and non financial assets.
agreement among different jurisdictions and different levels of government must rely on a solid institutional basis to avoid transaction costs resulting from poorly defined rules.

Institutions, according to Douglas North, are “the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction. In consequence, they structure incentives in human exchange, whether political, social or economic”.

Following this line of reasoning, institutions exist to reduce the uncertainties involved in human interaction. These uncertainties are the result of the complexity of the problems to be solved and of the instruments available to individuals to resolve them. Institutions evolve to compensate for the difficulties derived from institutional limitations and incomplete information. On the other hand, the institutional structure limits the set of choices of the actors.

North makes a clear distinction between institutions and organizations – “groups of individuals bound by some common purpose to achieve objectives”. Organizations, for North, include, political groups, economic and social bodies, among others, that are bound by common purpose to achieve objectives. The way organizations evolve influences and is influenced by the institutional structure. Organizations may therefore be the agents of institutional change.

On a federal system, efforts must be coordinated, otherwise there is a risk of wasting scarce resources. Coordination of the activities of organizations at the three levels of government – central, state and municipal – is required to face the problems of urban development. The institutional environment should motivate the constituent units to engage in lasting agreements that demand the commitment of financial and technical resources in exchange for the possibility of solving, or at least alleviating common problems.

Under the fiscal austerity the Union, most of the States and some of the major Municipalities are currently experiencing, it becomes crucial for responsible fiscal management to determine the appropriate level of funding to finance urban infrastructure investments. In 2002, the breakdown of consolidated expenditures shows that 23% were assigned to payments of the public debt, 10.5% went to general public services (legislative and judiciary agencies, financial, fiscal and external affairs), and another 26.4% to social welfare programs, mostly for pensions and social security. Transportation programs absorbed 2.7% of total expenditures, only a portion of which were related to urban projects and a mere 4% went for environmental protection and housing and community amenities.

The recent evolution of public accounts in Brazil shows that, notwithstanding the Union’s commitment to sound fiscal policies, the search for a sustainable position was mostly supported by increasing taxes and high interest rates. In 1995, the total tax burden was 28.3% of GDP, of which the central government collected 18.4%. In 2002, central tax collections were 24.4% of the total tax burden and 35.5% of GDP. The state share increased from 8.5% of GDP in 1995 to 9.4% in 2002, and the Municipalities gained only 0.3 percentage points, reaching a tax collection of 1.7% of GDP.

Investments suffered the impact of fiscal adjustment, falling from an average 2.55% of GDP in 1995-1998 to 2.13% of the GDP in 1999-2002, a reduction felt mainly at the central level. Although municipal investments experienced a downward trend since 1995 (in relation to GDP), they continued, after 1998, to absorb more than 12.0% of municipal taxes and intergovernmental grants (except in

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6 North, 2002, p.3
7 Idem, p.25
8 Ibidem, p.5
9 Figures for the central federal government, States and municipalities, including indirect administration. Estimation of consolidated figures by the author, based on IBGE data.
10 Garson, 2005(a) p.7-10
11 IBGE, National Accounts
12 When analyzing investment performance, we must pay attention to the administration term: 1995 and 1996 were final years of municipal administration, following the Plano Real, a period where some of the major municipalities may have spent substantial amounts of accumulated cash.
The investments by States accounted for an average 7.1% of their taxes and grants received from the Union in 1999-2002.

This paper has five sections. The introduction is followed by Section Two, that contains basic information on the political structure and economic aspects of the country. Section Three points out some basic features of Brazil’s federal system, showing how it has evolved over time. Section Four deals with the institutional and fiscal difficulties faced by metropolitan regions. It describes the brief Brazilian experience with structuring a system to manage metropolitan regions in the seventies, in an attempt to understand why it did not last after democratization. It also discusses the new rules brought about by the Constitution of 1988 and new proposals for improving cooperation. The analysis of fiscal data in 2003 make clear the present fiscal obstacles to financing investments for urban development. Section Five draws some preliminary conclusions.

2. Economic and Political Structure – Basic Features

Brazil is organized as a Federal Republic, composed of 26 States, a federal district and about 5,500 Municipalities. It has a population of 184 million. Unlike other countries, Municipalities in Brazil are granted status as members of the federation under the 1988 Constitution.

The President is the head of State and the government. The bicameral legislative structure consists of an upper house, the Senate, with 3 seats per state and a lower house, the Chamber of Deputies with 513 seats. Senators are elected to 8-year terms, while Deputies are elected to 4-year terms.

The most populous State – São Paulo – has 70 representatives at the lower house, while the minimum number of Deputies for the smallest State is 8 representatives\textsuperscript{13}. In the States, the chief executive and the head of the government is the Governor. The legislative structure is unicameral, with members of the State Legislative Assembly elected to serve 4-year terms. Municipalities are constituent units, led by an elected Mayor. The legislative structure is also unicameral, with members of the City Council elected to serve for 4-year terms.

By 2002, Brazil’s per capita Gross Domestic Product – GDP – was US$ 7,450\textsuperscript{14}. However, Brazil is ranked among the countries having the highest degree of inequality of income distribution. According to a recently published study of the standard of living in Brazil, around one third of Brazil’s population - 53.9 million people - is classified as poor\textsuperscript{15}, from which 21.9 million are considered very poor or indigents.

Besides differences in personal income, the country suffers from huge regional economic imbalances. In 2002, around 75 million people – 43% of the population – lived in four States in the Southeast, where 56% of total GDP was generated. At the other end of the scale, 13.5% of GDP was produced in the Northeast, where 28% of the Brazilian population lives. The per capita income of the Northeast was just 37% of the wealthier region\textsuperscript{16}.

The States and Municipalities are very heterogeneous, not only with regard to economic and social indicators, but also from the point of view of their fiscal and technical capacity to manage tax collection and administer the provision of goods and services to the population. Although lower income implies a smaller tax base, differences in tax collection among regions may also be attributed to deficiencies in tax administration: a lower effort on tax collection and a related low priority given to

\textsuperscript{13} For the discussion of the consequences of overrepresentation in Brazil, see Stepan, 2002.

\textsuperscript{14} 2004 World Development Indicators. Brazilian figure, in US$ per capita, is close to Uruguay’s 7710 and Colombia’s 6150, higher than Venezuela’s 5220, Peru’s 4880, Paraguay’s 4590 and Ecuador’s 3340, but lower than Argentina’s 10190, Chile’s 9420, Mexico’s 8800.

\textsuperscript{15} So considered those whose per capita household lies up to half a minimum salary: Instituto de Pesquisa Econômica Aplicada – IPEA – Ministry of Planning, Budget and Administration. See www.ipea.gov.br – Radar Social

\textsuperscript{16} Basic data from the National Bureau of Statistics Instituto Brasileiro de Geografia e Estatística – IBGE
improving technical capacity. In 2000, States in the Southeast were responsible for 58.9% of total state tax collection. The Northeastern States were responsible for 13.5% and the North for 4.5% of total state taxes collected. The disparities were much greater among municipalities where 68.9% of municipal tax collections came from the Southeast17, 11.6% from the Northeast and just 3.0% from the North18. These regional differences are essential to understanding intergovernmental relations in Brazil, as will be shown below.

The provision of services by States and Municipalities needs the support of permanent and consistent planning. This becomes even more important when we note that even though they are politically autonomous, smaller States and municipalities are highly dependent on other levels of government transfers to finance permanent activities like education, health and social assistance (care for children and the elderly, for example). A survey by the IBGE in 2001 showed that less than half of the municipalities having fewer than 100,000 people – 96% of the Brazilian municipalities - had a government plan. Besides that, some of them had not even have passed the necessary authorizing legislation – the Organic Law. Moreover, while most of the Municipalities have multiyear plans and annual budgets, the consistency of those instruments is often weak.

There is a degree of consensus among those who study social sciences that lasting poverty is closely linked to the inability to access the goods and services provided by the government. Lack of access to housing and transport facilities, due to income insufficiency, makes it difficult for the poor to benefit from other services, such as health and education, so that poverty becomes a permanent condition19.

But the poor are not the only ones who suffer from deficiencies in the provision of public services, particularly those related to urban services. Well designed transport systems and proper maintenance of the water distribution network are requirements for any urban economic activity to develop.

3. Federalism in Brazil

3.1. Federal Systems – Basic Characteristics

Elazar20 wrote that “federalism involves the linking of individuals, groups and polities in lasting but limited union, in such a way as to provide for the energetic pursuit of common ends while maintaining the respective integrities of all parties”21. Although federal political systems may have great functional differences, some basic characteristics and operational principles are present at all the genuine federal systems. Three of these are essential22:

- a written constitution, that defines, among other things, the terms under which power is divided or shared in the political system and the terms under which it may be changed, but only through extraordinary measures;
- de-centralization, meaning that the political system should assure the diffusion of power among the constituents, which entails the existence of self-sustained centers, frequently identified to these constituents. They must be able to develop partnerships in national government activities and act with autonomy in constitutionally defined areas, even in opposition to national policies. Authority to exercise assigned powers can not be taken away from either the general government or the constituents.

17 We may observe that the most important municipal tax, the ISS, is a tax on services, which major tax bases are modern services, mostly provided in developed cities.
18 Data from IBGE- “Regionalization of Public Sectors Transaction – RSTP”, a research led by IBGE, based on the 1993 SNA
19 Some of the ideas brought to this paper were discussed on Garson, Sol, 2005(a)
20 Elazar, 1991,p.33
21 Idem, p.5
22 Ibidem, p.157-167
• a real division of power, even if other elements contribute to define the federal division.

Following Elazar and Abrucio, we can summarize the conditions required for success in federal systems:23:

• existence of the federated contract guaranteed by a solid institutional structure – the term “Federal” as Elazar has shown, comes from the Latin foedus, that means covenant, combining self-rule – autonomy – and shared rule – interdependence.

• republicanization of the public sphere, in particular at the sub-national level. For Elazar, “federalism, by its very nature, must be republican in the original sense of res publica – a public thing”. A federal polity belongs exclusively to its public.25

• coexistence of autonomy and interdependence in order to accommodate the natural tensions of federal systems. For Elazar, federalism entails commitment to partnership and to cooperation, without giving up the integrity of individuals and institutions. Successful federal systems require that its members be capable of negotiation for the establishment of partnerships, the self imposition of limits in the search for common objectives and the ability to consider the consequences of the acts of each participant.26

3.2. Federalism in Brazil

An interesting approach of Brazilian federalism, following the country’s history, is presented by Abrucio, who discusses the role of State Governors in the return to a democratic system in the eighties, pointing out the direct link between federalism and the Brazilian political system. Some of the ideas developed in his book are evidenced in this paper. We do not aim here at describing the evolution of federalism in Brazil, but only to stress some features of that evolution to set the stage for understanding the country’s metropolitan experience and to provide a background to better understanding the problems of urban financing in Brazil.

According to Abrucio, the conditions for success in federal systems are not generally found in Brazil, given that the combination of autonomous sub-national governments and interdependence does not exist at different levels of government.28

Federalism has developed throughout Brazilian history, with alternating movements of centralization and decentralization of power. The centralized power during the Second Empire evolved into the Federal structure adopted by the first constitution of the Republic in 1891. It is true that the decentralization of revenues primarily benefited the more powerful States of an exporter of primary products country, transferring to them, among other things, the control over export taxes. However, what unified the States under the new republican system was political autonomy, which gave them control of the electoral process in its area of jurisdiction: from the President of a Province, nominated by the Emperor, control then passed to the Governor, chosen by popular vote, dominated by a regional oligarchy and subordinate to it.

Once past the first phase of military governments, regional oligarchies would dominate not only the political scene in their respective States but would maintain national power as well. The “Politics of Governors” permitted the representatives of the economically stronger States – Minas Gerais and São...
Paulo – to control the process of presidential succession. The Brazilian federation structured itself in an unbalanced fashion\textsuperscript{30}, and placed at the other end of the spectrum the vast majority of States that were supported by the Federal Treasury. This situation continued until the coup of 1930.

The power of the Governors was a function of the type of political relationship that they had with the state they administered. Their relationships with the local chieftains – the “Colonels”\textsuperscript{31} – assured them of control over the electoral process. In return for the support by the local chieftains for the official candidates nominated for state and central offices, the “Colonels” were given complete freedom in all matters relating to local government, including the naming of candidates for state jobs in their locations.\textsuperscript{32}.

The depression of 1929 combined with the coffee crisis led to important changes in the political scenario: the more powerful and developed States, linked to agriculture and exports and involved in disputes for power were obliged to yield.

There it is no doubt that the changes that the country experienced during the First Republic brought more and more new actors to the political scene: a middle class and a working classes, coming from the transfer of the dynamic axis of the economy to the manufacturing activity\textsuperscript{33}.

During the period from 1932 - 1945, while the country was under the command of Getúlio Vargas, the federal characteristics of the Brazilian political system were suppressed. The elected officials were replaced by temporary Governors appointed by Vargas, with the exception of the State of Minas Gerais, removing from local oligarchies the instrument of control of the federal Legislature. Administration of States and Municipalities was placed entirely under central control. The protection embraced both the political and administrative areas.

The authoritarian regime however also made gestures of accommodation toward local economic groups: the agrarian structure remained practically intact and the demands of the business sector, principally that of São Paulo, were heard by the federal bureaucracy and discussed in commissions especially created to deal with matters of the economy, finance and international trade\textsuperscript{34}.

With the fall of the Vargas dictatorship, the Constitution of 1946 restored the federal structure and brought back elections for State Officers and Legislators, allowing the election not only of City Councilmen but also Mayors\textsuperscript{35}.

With the return of the federal structure, Governors returned as active participants in the political scene, but differently than in the First Republic. The long period under authoritarianism strengthened the national components of the political system – in particular the central government and the Presidency – and reduced, in terms of political power, the distance between the central and state governments.

Multi-polarity was reinforced by a significant increase in the public turnout at the polls – 10% of the total population, compared with 3.3\% in 1933\textsuperscript{36}, distributed over a larger number of States. This fact had a direct impact on the elections for President, that began to depend on a larger number of States.

The modernization that began in the Vargas era, followed by the constitution of a National “Developmentist” State, produced a federal bureaucracy with the power to influence economic

\textsuperscript{30} Abrucio, 2002, p.40

\textsuperscript{31} De forma simplificada, o termo identifica os chefes locais do Brasil agrário. Sua origem está nos coronéis da Guarda Nacional da época imperial, em geral pessoas de prestígio em suas localidades. Com o tempo, o título passou a ser comercializado.

\textsuperscript{32} Leal, 1997, p.70

\textsuperscript{33} Penalva, 2005, p.6

\textsuperscript{34} Abrucio,2002, p.46-47

\textsuperscript{35} As constituíncias estaduais definiam se os prefeitos de capitais e de estâncias hidrominerais beneficiadas pelo estado ou pela União seriam eleitos ou indicados pelos governadores.

\textsuperscript{36} Nicolau, 2002, p.46
decisions. However, because the modernization of administration had been limited to the central government, the return to federalism found state and municipal governments profoundly backward in terms of their administrative structures and therefore vulnerable to the exercise of power inside the States. The relationship of the central government with the States in meeting their specific requests was “clientist”.

One of the reasons was the weakness of the political parties. The federal parliamentary mandates were limited to the jurisdiction of the States. The Governors guaranteed the elections of federal and state candidates that supported them, using their political bases in the State. In doing so they continued to bow to the demands of the political overlords.

The military government that took power in 1964 adopted a strategy based on three essential elements:

- Financial - centralizing public revenues, the changes in the fiscal and tax environment being integrated into the Constitution of 1967, shortly after the coup. The States, that in 1965 accounted for 35.1% of disposable revenues, fell to 22.1% in 1982, while the Municipalities went from 10.1% to 8.9%. The Union share increased from 54.8% to 69.0% of total revenues. During this period, the tax burden increased from 18.9% to 26.34% of GDP (see Graph I and Graph II, below). To compensate for the loss in revenues by the States and Municipalities, special funds were created for the purposes of redistribution of revenues, mainly for the benefit of the poorer ones. Central resources assigned to these funds were limited by 1968, and were redirected to “earmarked” transfers. The control over the sub-national governments was accomplished by eliminating the competence of legislation for control of their own taxes, as well through earmarking federal transfers to States and Municipalities. To encourage private investments, the central government created a large number of fiscal incentives, which were revised in 1970 – redirecting part of the funds to transfers linked to sector-based programs.

- Administrative - by establishing a new model of decentralized public administration and providing autonomy for indirect administration – agencies, foundations, public enterprises and mixed public private companies. Supposedly more efficient, a large part of the production of goods and services was transferred to them. According to Bresser Pereira, flexibilization allowed greater economic efficiency “and strengthened the political alliance between a highly technical state, civil, and military bureaucracy and the private sector business class”. The administrative rationale was accompanied by systematic planning activity, which implementation began in 1964 and included the creation of a federal agency for the preparation of studies and monitoring of government planning, the EPEA. Long-term plans, to which strategic programs were linked, set the guidelines for economic policy for specific sectors, trying to direct activities at all levels of government, under the direction of the central command. This led to the I NDP (National Development Plan) of the General Médici Government, for 1972-1974, that gave top priority to large projects for national integration, especially in the areas of transportation and telecommunications. The II NDP – from 1974-1979 – called for heavy investment in basic raw material inputs (petrochemical, paper and cellulose and others), infrastructure and energy, as well as capital goods. The creation of Metropolitan Regions, was conceived in the I NDP. It would contribute to consolidate the developed Center-South under the heading of a Regional Strategy driven to national integration, that included setting up new regional development poles distributed throughout the country.

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37 Abrucio, 2002, p. 52
38 Idem, 2002, p. 63
39 Varsano, 1996, p. 10
40 Pereira, 2003, p. 244
41 Law n. 5727, 4th November 1971
- Political – through the attempt to weaken existing political connections, especially the power of the Governors.
The crisis in the authoritarian model began in 1974, when the government (official) party suffered significant defeats in the State Legislatures, the Chamber of Deputies and the Senate. The failure of the technocratic model and the centralization of power and resources, combined with the attempt to legitimize the model through the electoral process, became more and more obvious. The maintenance of state elections, even though indirect, allowed the “Colonellist” model to survive to a certain degree.

The reaction to the lack of autonomy on the part of the sub-national governments led to an increase in redistributive transfers. However, the decentralization was compensated for by measures taken for the benefit of central government revenues, maintaining its share of the taxes and the ratio of these tax receipts to GDP.

The elections of 1982 were the first to be held via direct vote since 1965. This marked the first step in the re-democratization of Brazil. The return to elections allowed the Governors to recoup their sources of power, creating alliances with local governments – the more so because that year coincided with state and municipal election years. Despite the return to a multi-party system, the central government managed, using electoral legislation, to control the emergence of new parties. But the economic crisis – the GDP fell by 4.25% in 1981 – and the political crisis, combined with a substantial increase in the number of electors, help to explain the election of 10 opposition Governors out of 22 elections – including the largest and most powerful States – São Paulo, Minas Gerais and Rio de Janeiro – dramatically changing the structure of power.

The elections revealed a new alliance of forces – the Governors became more independent of the central government and more attentive to their constituents and the composition of forces inside their States. Abrucio calls this new phase, that extended to 1987, “statist federalism”. They returned to an intensive use of “client-based” instruments of power: public employment increased significantly. We should point out that, given the significant regional disparities, the demands by the different States towards the central government did not always coincide. This explains why the central government developed various strategies: when it needed support from the least developed States, for example, they increased fiscal transfer of a redistributive nature or increased the representation of the States in the Chamber of Deputies. For Abrucio, the return to power by the Governors did not promote cooperation: “the Governors formed coalitions for specific vetoes and not coalitions to govern”. The partnerships were formed basically to preclude changes in the federal order.

While the central government lost political influence, the Governors benefited from the economic recovery in 1984 and higher rates of economic growth in 1985, and were able to complete their mandates with high levels of investment. The GDP increased by 5.4% in 1984, 7.8% in 1985 and 7.5% in 1986.

As shown on the Graphs above, the States, which in 1982 received 22.1% of disposable revenues, increased their share to 26.9% in 1988, while at the same time the Municipalities increased their participation from 8.9% to 10.8%. The central government share fell from 69.0% to 62.3% of the total. During this period, tax revenues declined from 26.3% to 22.4% of GDP, the smallest burden since 1970. Intergovernmental transfers increased at the same time as the central government lost part of its ability to collect taxes - all of the reduction in tax receipts was the result of the decline in federal revenues.

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42 Abrucio, 2002, p.64
43 Varsano, 1996, p.11
45 Abrucio, 2002, p.94-95
47 Villela, Rezende, 1986, p.215
48 Varsano, 1996, p.12
The wave of democratization in the context of a central government fiscal crisis encouraged the population to address their demands to the sub national governments, closest to them: responsibilities were taken by States and Municipalities as the result of the failure of other entities to act.

It is in this context - of weakening of central power and a return of political power to the subnational governments - the discussions in the National Constituent Assembly took place, the Governors and Mayors joining together to fight for a larger share of public revenues. However, the redistribution of functional responsibilities in the federation did not receive the same attention. In fact, at the time the National Constituent Assembly was discussing the new Constitution, a coordinated decentralization process was envisaged, counting on a financial fund to support the transfer of responsibilities from the central government to States and Municipalities. However, this was not included in the final text, depending of a Complimentary Law that has not yet been prepared. In the absence of institutions to encourage intergovernmental cooperation, the process of decentralization proceeded in a disorganized fashion. The clientist approach, and the low transparency on policy making made the development of joint activities more difficult. Besides, cooperation on the provision of public services is generally not restricted to a single fiscal year, requiring budgetary commitments over various years. The lack of institutions through which functional responsibilities could be assigned render coordinated activities sometimes unfeasible, wasting scarce resources.

The institutional difficulties – the lack of coordination and the absence of mechanisms for cooperation - continued even after the Constitution of 1988 was adopted. As Rezende points out, the attempts to resolve the regional conflict through intergovernmental transfers has reversed the vertical imbalance, but increased horizontal unevness. Later developments, mainly raising the tax rate, allowed the central government to essentially recover its share of available revenue. However, the horizontal inequalities continued, and did not allow the use of sharing revenues as an instrument for financing expenditures consistent with the spatial location of the demands for public services.

The factors above demonstrate that, up to the moment, we have not succeeded on defining institutions to stimulate the coordination of activities and cooperation among the constituent units of Brazilian federation, providing for interdependence without reducing their degree of autonomy. In the absence of these rules, the relationship among the Union the States and the Municipalities depend more heavily on political arrangements of convenience, where republican requisites are absent. The fragility of this institutional environment is a major obstacle to the development of public policies and for the solution of metropolitan problems as will be demonstrated in the following.

4. Cooperation in Metropolitan Regions – Institutional and Fiscal Difficulties

4.1. The Brazilian experience

The metropolitan regions created by the central government in 1974-1975, conforming to the Constitution of 1967, as well as the structures created in the States for their administration, entered into a crisis beginning in 1979. The rules adopted by the Constitution of 1988, that transferred to the States the responsibility to deal with this matter, suffered from legal and administrative difficulties. The institutional bases upon which rested the experiences in metropolitan administration up to this time present specific issues and weaknesses that deserve attention. This section highlights several features that could help to understand this problem.

The acceleration of the process of urbanization raised the discussion of the metropolitan issue and the urban experiences under way since the 1960s. At the central government level, urban policy was

50 Rezende, 1995, p.248
based on sector activities to resolve city problems, making them a responsibility of public companies with the guarantee of funding and speed in its allocation. The spatial articulation of the sector programs would count, among other instruments, on the structure for managing Metropolitan Regions, which creation was provided for in the Constitution of 1967\textsuperscript{51}. It took seven years to pass the Complimentary Law nº 14/73, to create eight Metropolitan Regions\textsuperscript{52}, and to define their municipalities. The Law defined, among other things, the services of common interest, independent of regional differences, the structure of management and the mechanisms of program and project administration. It gave priority to municipalities that participated in integrated projects and services to use central and state funds, including loans.

As above described, the constitutionalization of the metropolitan issue is found therefore in the system of planning developed by the military regime. In addition, the treatment of the issue is linked to the assignment of resources for sector projects, as well as the allocation of resources of the National Urban Development Fund – FNDU, created in 1975, as a substitute for resources connected to annual budgets.

In assigning to the Union the competence for creating Metropolitan Regions, the central government reasserts its power over the more developed regions of the country. Araújo points out the contradictions in federal action since, although concentrated in the definition of an institutional and organizational base for urban planning, the allocation of resources was influenced by political alliances and sector interests “that found space in the fragmentation of the administration of the Brazilian State”\textsuperscript{53}. Demands from “clients” were disguised in the new clothing all of technical studies, conducted by state bureaucracies, responding to the demands of the chiefs in the executive power of the States.

The difficulty in developing projects adapted to specific regional demands, the lack of a forum for the municipal constituents to discuss their demands and the political and economic crisis that appeared at the turn of the decade seriously weakened this system of metropolitan administration.

With the political crisis in the military regime, that overtook the dynamic of metropolitan activities, the focus on planning was lost and the funds for urban areas became increasingly scarce. In fact, government planning entered a period of crisis: the scope of II NDP (1974-1979) was followed by III NDP that never got started and the I NDP of the New Republic which also failed to start. Instead, Brazil suffered through a series of plans to stabilize the economy in an attempt to bring the macroeconomic situation under control. Between the periodic crises, episodic inflation sometimes raced out of control, eroding not only the currency and the ability to plan, but also rendering the budgetary instruments useless. A new attempt to define an institutional basis for dealing with the Metropolitan regions was made when the Constitution of 1988 was drawn.

The decentralization drive of the Constitution of 1988 carried with it important implications for metropolitan financing. First, the responsibility for creating and organizing metropolitan areas in Brazil was transferred from the central government to the States. Second, changes in the fiscal federal system implied greater autonomy for State and local governments to collect taxes and to dispose of the portion of major central taxes shared with them. Third, Municipalities were recognized as members of the federation in a similar status to the one held by the States.

After 1988, the States, by means of a complementary legislation to their own Constitution, were allowed to establish Metropolitan Regions to integrate the organization, planning and operation of public functions within the common interest of the State and the respective Municipalities. Insofar as

\textsuperscript{51} Araújo, 1996.
\textsuperscript{52} Em 1974, a Lei Complementar nº 20 tratou, entre outros assuntos da fusão do Estado da Guanabara com o Estado do Rio de Janeiro e instituiu a Região Metropolitana do Rio de Janeiro.
\textsuperscript{53} Idem, p.65
the States cannot interfere with municipal autonomy, the institutions that were created to oversee the activities are administrative but not political in nature, which means they lack legislative power. Nevertheless, the transfer of the responsibility for the institution of Metropolitan Regions to the States was politically inconsistent with the new status of the Municipalities. In fact, one of the basic reasons for the institutionalization of metropolitan areas is the need for coordinated investments and the integration of the provision of public services within these regions. Without effective means to enforce coordination, state governments could not lead the effort to avoid conflicting and overlapping policies. The lack of conditions for coordination is exacerbated at times when the Governor and the Mayor of the core city have different political affiliations, as both compete for greater influence in the whole region\textsuperscript{54}.

New proposals for dealing with metropolitan management are being developed, mostly since the mid – 1990s, calling for a more effective participation of the Municipalities and a wider involvement of the civil society, NGOs as well as private sector representatives. Cooperation through consortia, which legislation has recently been passed, are experiences under way.

New experiences included voluntary associations of Municipalities to deal with one or more specific issues – garbage collection, health and transportation – or to develop projects related to the multiple use of water resources through the institution of water basin committees. In the State of Minas Gerais, 92\% of the municipalities were involved in health consortia\textsuperscript{55}. It is worth noting the central incentive to the health system organization that counts on stable and significant transfers of resources to sub-national governments.

The State of São Paulo, with three Metropolitan Regions hosting more than 22 million people, has been improving its model of metropolitan cooperation. The São Paulo Metropolitan Region, now including 39 municipalities, was created in 1973, with cities that form the industrial belt around the City of São Paulo. The “Baixada Santista”, a group of 9 municipalities under the influence of the most important Brazilian harbor, came in 1996, to which followed the Região Metropolitana de Campinas, in 2000. The latter region encompasses 19 cities. The regions’ participation in the state GDP is 47.6\%, 3.6\% and 12\% respectively. Their net revenue in 2002 accounted for 34.0\% of total revenues for all Brazilian Metropolitan Regions.

The ABC consortium – Região do Grande ABC – home of the motor vehicle industry, was created by the initiative of 7 Southeastern Municipalities of the Região Metropolitana de São Paulo to face together the common challenge of industrial restructuring in the area. Initially focused on the management of water resources, the Consortium expanded the scope of its activities – to include economic and social development – and brought new actors into the scene through the Citizenship Forum. Although the experience may have proved the importance of cooperation, a need for a more sound solution to deal with financing is pointed out by specialists, together with improvements in relationship with the state government and in participation of the municipal City Councils\textsuperscript{56}.

Up in the Northeast, the Metropolitan Region of Recife, formed by 14 municipalities responsible for 68.0\% of the state GDP, has put out a strategic plan to design common policies for dealing with the challenges it will face in the next twelve years. In this region, the study showed the potential to mobilize fiscal resources and to access domestic credit to cover part of the investments visualized in the plan..

\textsuperscript{54} Rezende and Garson, 2004
\textsuperscript{55} Farah, apud Rolnik, 2000
\textsuperscript{56} Rolnik, 2000
Attempts to achieve greater coordination of public activities in metropolitan areas face not only the institutional problems discussed above but also obstacles related to the fiscal situation of the constituents, as discussed in the next item.

4.2. Metropolitan Regions – Fiscal Aspects

As stated above, urban development usually requires a substantial investment in multiyear projects. Put another way, urban development entails a long term commitment to coordinated actions. Besides the differences in the fiscal situation of the States, Municipalities belonging to one Metropolitan Region may have significant differences in the structure of their revenues and expenditures, which affect their ability to cooperate in long term urban development projects.

In 2003, Brazilian Municipalities managed revenues corresponding to 7.6% of GDP. Data for municipal revenues and expenditures are broken down in Table I, underscore the amounts going to core cities and to other metropolitan municipalities out of the total Municipalities.

| TABLE I |
| MUNICIPAL REVENUE AND EXPENDITURES IN BRAZIL – 2003 |
| TOTAL AND METROPOLITAN CITIES* |

<table>
<thead>
<tr>
<th>REVENUE</th>
<th>TOTAL</th>
<th>METROPOLITAN REGIONS</th>
<th>METROPOLITAN REGIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>CORE CITIES</td>
<td>OTHER CITIES</td>
</tr>
<tr>
<td>Population in 1000</td>
<td>160,862</td>
<td>40,874</td>
<td>30,198</td>
</tr>
<tr>
<td>TOTAL NET REVENUE</td>
<td>7.60</td>
<td>2.58</td>
<td>1.32</td>
</tr>
<tr>
<td>Own Taxes and Transfers</td>
<td>6.69</td>
<td>2.20</td>
<td>1.17</td>
</tr>
<tr>
<td>Own Taxes</td>
<td>1.74</td>
<td>1.02</td>
<td>0.31</td>
</tr>
<tr>
<td>Shared Tax Revenues</td>
<td>3.13</td>
<td>0.72</td>
<td>0.58</td>
</tr>
<tr>
<td>Other Grants</td>
<td>1.83</td>
<td>0.46</td>
<td>0.28</td>
</tr>
<tr>
<td>Other Revenues</td>
<td>0.91</td>
<td>0.38</td>
<td>0.14</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>EXPENDITURE</th>
<th>TOTAL</th>
<th>METROPOLITAN REGIONS</th>
<th>METROPOLITAN REGIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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<td>CORE CITIES</td>
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<tr>
<td>Population in 1000</td>
<td>160,862</td>
<td>40,874</td>
<td>30,198</td>
</tr>
<tr>
<td>TOTAL NET EXPENDITURE</td>
<td>7.68</td>
<td>2.65</td>
<td>1.31</td>
</tr>
<tr>
<td>Personnel</td>
<td>3.35</td>
<td>1.09</td>
<td>0.60</td>
</tr>
<tr>
<td>Debt Service</td>
<td>0.29</td>
<td>0.17</td>
<td>0.04</td>
</tr>
<tr>
<td>Other Current Expenditure</td>
<td>3.19</td>
<td>1.10</td>
<td>0.50</td>
</tr>
<tr>
<td>Acquisition of Nonfinancial/Financial Assets</td>
<td>0.85</td>
<td>0.28</td>
<td>0.17</td>
</tr>
</tbody>
</table>

* Includes the Federal District, Brasilia, a city-state
Source: Ministry of Finance – Brazil
Prepared by Sol Garson

Metropolitan Municipalities received, in 2003, 51.3% of total municipal revenues. Some aspects are worth noting:

- Core cities of Metropolitan Regions rely mostly on their own tax revenues. Although they house 25% of the population, they collect 58.6% of municipal tax revenues, representing 39.5% of their Total Net Revenue. Credit operations and discretionary capital transfers, included in Other Revenues, have a small share in Total Net Revenues of this group;
- Own Taxes are much lower in other (non-core) metropolitan cities – they account for 23.5% of Total Net Revenue, due to a smaller tax basis and poor tax administration. Transfers from the Union and from the States provide 65.1% of total resources of these cities, part of which are discretionary capital grants assigned to investments. Per capita transfers to small cities may reach 33 times the
amount of municipal taxes they collect. On the other hand, medium sized and some large metropolitan cities may have total per capita revenues 40% below that of small non-metropolitan cities;

- On the expenditure side, personnel and debt servicing expenditures account for almost half of Total Net Expenditures. It is worth noting that acquisition of assets is significant: reaching 10.6% and 13.0% of Total Net Expenditures in core cities and other cities, respectively. nevertheless, the structures of financing are quite different and may vary from one year to the other.

Table II shows the sources of investment financing. The composition of sources varies over time and according to the size of population group. Capital transfers and interest on cash available are important for some groups, but are not appropriate for financing multiyear projects. Metropolitan Regions include municipalities of all population sizes, which makes cooperation more difficult.

### TABLE II
**MUNICIPAL ACQUISITION OF ASSETS 2003 – SOURCES OF FUNDS**
**TOTAL AND METROPOLITAN CITIES***

<table>
<thead>
<tr>
<th>Sources of Funds</th>
<th>TOTAL</th>
<th>METROPOLITAN REGIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>CORE CITIES</td>
</tr>
<tr>
<td>Acquisition of Nonfinancial/Financial Assets</td>
<td>100.00</td>
<td>100.00</td>
</tr>
<tr>
<td>Sources of Funds</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>External Sources</strong></td>
<td>19.50</td>
<td>19.50</td>
</tr>
<tr>
<td>Credit Operations</td>
<td>6.92</td>
<td>14.76</td>
</tr>
<tr>
<td>Capital Transfers</td>
<td>12.57</td>
<td>4.74</td>
</tr>
<tr>
<td><strong>Internal Sources</strong></td>
<td>71.61</td>
<td>54.02</td>
</tr>
<tr>
<td>Sale of Assets</td>
<td>1.59</td>
<td>1.39</td>
</tr>
<tr>
<td>Other Capital Revenue</td>
<td>2.94</td>
<td>5.71</td>
</tr>
<tr>
<td>Interest on Cash Available</td>
<td>19.32</td>
<td>29.11</td>
</tr>
<tr>
<td>Current Surplus less Interest on Cash Available</td>
<td>47.76</td>
<td>17.82</td>
</tr>
<tr>
<td>Total Balance (deficit)</td>
<td>8.89</td>
<td>26.48</td>
</tr>
</tbody>
</table>

*Includes the Federal District, Brasilia, a city-state
Source: Ministry of Finance – Brazil
Prepared by Sol Garson
In 2003, Municipalities relied basically on internal sources to finance investments. Budget year savings responded for almost half of Municipalities’ investment financing. Core cities depended strongly on interest on cash available, which may fluctuate during the term of administration and depends on the interest rate. For major core cities, credit operations were the second most important source of income. Nevertheless, this is a source available only to few municipalities, due mostly to hard budget constraints at the central level. Capital transfers were the third most important source for other metropolitan cities. Those resources are generally related to amendments made by congressmen in the central and state year budgets, so that they are not appropriate to finance long term investments. The importance of capital transfers as a source for financing investments depends on the size of the municipality. In 2002, they were responsible for around one third of investments in municipalities of less than 100 people (95% of total municipalities, where around 50% of Brazilian population lives). Among 380 metropolitan cities with data available for 2003, 274 (75%) had less than 100 people.

We constructed a set of fiscal indicators and applied them to Metropolitan Regions. They help the analysis of the capacity as well as the obstacles facing those cities in engaging in cooperation actions. A wide variety of problems were found:

- Revenue indicators emphasize the importance of the different components of total revenue, the legal foundations and the degree of freedom in their utilization. Although the various components of revenue may differ according to restrictions in use, they are highly regulated. More than 80% of municipal revenue is circumscribed by law. On the other side, revenues are highly earmarked: around 40% of Total Revenue has to be driven to specific uses, mainly to health and education. In the Fortaleza Metropolitan Region, almost 17% of the revenues for the core city come from municipal taxes, while peripheral cities were dependent on other revenues for as much as 96% of the total funding.

- Expenditure indicators show the degree of rigidity in public expenses: expenses from earmarked revenue (e.g. education, health), personnel (generally stable), legislative and debt servicing may absorb an average 72% of the total, as in the Metropolitan Region of Rio de Janeiro and 63% in São Paulo. If we turn to the priorities in resource allocation, urban works and services (e.g. garbage collection, street lightening), housing, transportation and sanitation are responsible for 12% of expenditures in the peripheral cities of the Metropolitan Region of Fortaleza. They are 23% in the City of São Paulo.

- Investment indicators are an attempt to evaluate the sustainability of investment, according to the quality of the sources of investment financing, as above discussed. In the long run indicator, we considered only the amount financed by internal sources other than the sale of assets and estimated a lower amount of interest on cash available (2/3 of actual revenue). Major cities would have to reduce investments to less than 50% of present amount if these hypothesis prevailed.

- Indebtedness among cities may be compared through the ratio of net debt to revenue. The ratio of debt service to net current revenue is generally low, due to credit restrictions, exceptions are the 10,0% for cities of Rio de Janeiro and São Paulo.

5. Conclusion

Brazil is a highly urbanized country. In the last thirty years, the process of urbanization has intensified. In 1970, 56% of the population was urban. In 2000, more than 80% of total population

57 Public managers may accumulate cash during the first 2 or 3 years of an administration term, to spend along the remaining time.
58 The basic study was supported by the Ministério das Cidades and led by the author, as a researcher of the Observatório das Metrópoles. See Garson, 2005(b), for more information.
59 Municipal taxes and revenue sharing defined at the Constitution, as well as other transfers guaranteed by law.
lived in urban areas. In 2004, 76.7 million people – 42.4% of the population – lived in Metropolitan Regions in Brazil. Despite the importance of this process, we still do not have policies designed to deal with such an environment of blatant inequality.

The importance of sub national governments in the provision of goods and services to the population has gained ground in the eighties, as much as the process of decentralization continued. Because of the lack of central resources, initiatives in the area of urban development have mostly been assumed by the Municipalities. In spite of an increase in available revenue, there is clearly a lack of adequate resources to meet the needs of urban development. Although investment is relatively high, the sources of finance may not be appropriate to long term implementation projects.

This paper deals with Metropolitan Regions, areas where the geographic boundaries of each jurisdictional unit are blurred by an intense movement of people who are residents of one city, and work or study in another, where they consume public goods. We focused on the need for urban infrastructure investment, and examined the institutional and financial difficulties involved in undertaking coordinated efforts driven to the solution of common problems.

The rules that regulated the creation of Metropolitan Regions and the experiences of managing those areas were discussed. According to Douglas North’s assertion, institutions exist to reduce the uncertainties that result of the complexity of the problems to be solved and of the instruments available to individuals to resolve them. But the institutional structure also limits the set of choices of the actors. Again following North, we considered the constituents of Brazilian federal system – the Union, the States and the Municipalities – as organizations, as different political groups bound by some common purpose to achieve objectives. With this concept in mind, we discussed briefly the evolution of federalism in Brazil, and concluded that institutional changes have not built in incentives for cooperation, a key issue in a country with huge inequality relating to the spatial distribution of product and to the personal distribution of income.

Successful federalism entails a commitment to partnership and to cooperation. The history of Brazilian federal system does not meet the conditions for the constitution of a genuine federal system. Alternating periods of explicit centralization with others of decentralization and considerable administrative freedom, we were not able to create autonomous – but interdependent – centers. Relationship among constituents may depend instead on political arrangements of convenience where the republican prerequisites are absent, and cooperation and coordination of activities is not promoted. The fragile nature of this institutional environment has made the development of a coherent set of public policies considerable difficult. In other words, we may accept that the path followed by intergovernmental relations in Brazil has even created obstacles to build structures of cooperation, a key element for the solution of common problems in Metropolitan Regions. The differences in fiscal structure among municipalities is an example.

In 2003, following a recent trend, Municipalities presented a general balanced financial situation. The same happened for Municipalities belonging to Metropolitan Regions. Nevertheless, when we analyze them separately, using the indicators of revenues, expenditures, investment and indebtedness, another picture comes into focus: we see that those are quite different relating to financial structure, what may raise obstacles to long-term commitment to the solution of common problems.

On the expenditure side, the structures are inflexible: besides a far-reaching provision of services financed by “earmarked” funds, barely compressible expenses on personnel, legislative institutions and debt service impacts negatively the propensity to engage in new long term commitments. Municipalities devote a significant amount of resources to expenditures in social areas – health, education and social assistance. Typically intensive in current expenses, though permanent, this does
not seem to be a temporary condition. On the contrary, population growth tends to make it more pressing.

On the revenue side, a high degree of legal support was observed. In health area, an adequate SUS\textsuperscript{60} financing structure, as well as an institutional design in which cooperation is the cornerstone, has paved the way to considerable progress. In education, Fundef\textsuperscript{61} played a pioneering role by adopting a structure of education financing that makes up for externalities: if a municipality cannot provide a sufficient supply of school enrollments, driving students to go after education in other cities or in state-run schools, it must compensate the suppliers of such services.

Although in some areas adequate funding has been secured, this does not generally apply to municipalities. Areas related to urban development – such as transport, housing, sanitation – require guaranteed funds to keep pace with the speed of project implementation. At present, the most important external source of investment financing comes from capital transfers, which are available only during the fiscal year, because of credit restrictions. They are, therefore, not suitable for projects which demand a long implementation period. The lack of proper funding may mean that the implementation of a development policy for Metropolitan Regions is not financially feasible, even though solutions for other institutional difficulties have been found.

\textsuperscript{60} The health services integrate a regionalized and hierarchical network and constitute a unified health system – the SUS – financed with resources from the Union, the States and the municipalities.

\textsuperscript{61} A Fund for development and Improvement of the Elementary Education, financed with resources of the States and the municipalities. The Union may make additional transfers to fund a minimum amount per student.
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Secretary of the National Treasury, at www.stn.fazenda.gov.br/estados_municipios/index.asp


SUMMARY BIOGRAPHY

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