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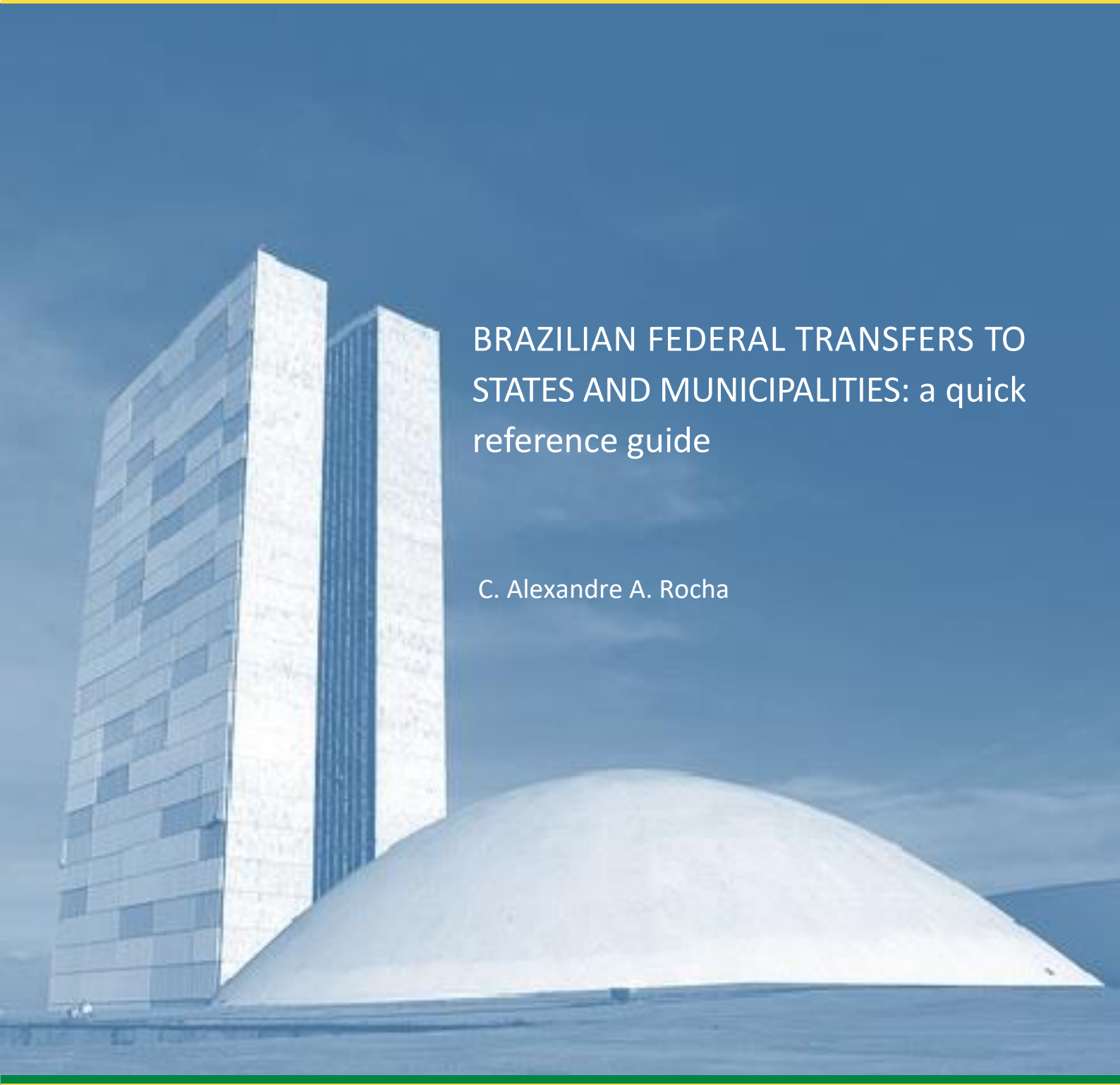

BRAZILIAN FEDERAL TRANSFERS TO STATES AND MUNICIPALITIES: a quick reference guide

C. Alexandre A. Rocha

SENADO FEDERAL

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BRAZILIAN FEDERAL TRANSFERS TO STATES AND MUNICIPALITIES: a quick reference guide[1]

C. Alexandre A. Rocha[2]

[1] Report based, with additions and updates, on the Discussion Paper n. 40 from the Legislative Advisory Board of the Senate of Brazil, entitled "Intergovernmental Transfers in Brazil: Diagnosis and Proposal for Reform", authored by Marcos Mendes, Rogério Boueri Miranda and Fernando Blanco Cosio, available at: https://www12.senado.leg.br/publicacoes/estudos-legislativos/tipos-de-estudos/textos-para-discussao/td-40-transferencias-intergovernamentais-no-brasil-diagnostico-e-proposta-de-reforma (Dec. 2008).

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Núcleo de Estudos e Pesquisas
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BRAZILIAN FEDERAL TRANSFERS TO STATES AND MUNICIPALITIES: A QUICK REFERENCE GUIDE

ABSTRACT

This report summarizes the main fourteen types of transfers from the federal government to states and municipalities. It is based on previous work, drawn up in 2008. During the past eleven years there have been substantial changes in the apportionment of both the States Participation Fund, although the practical result was almost zero, and the compensations for the exploitation of petroleum and natural gas, whose consequences have not arisen yet as a result of a judicial injunction. The compensation for the effects of Complementary Law n. 87/1996 and the financial aid for the promotion of export operations were also affected by decisions by the Judiciary and are currently undefined. In parallel, the transfers toward education were expanded, the disbursements for public security policies are being incremented and the emergency financial support to subnational entities gained undisputed legal status. However, the problems pointed out in 2008, as will be shown, are still largely present.

KEYWORDS: Intergovernmental transfers, fiscal federalism, public finance.

RESUMO

O presente trabalho resume as características das catorze principais modalidades de transferências de recursos do governo federal para os estados e os municípios. Partiu-se de trabalho anterior, elaborado em 2008. No intervalo de onze anos houve mudanças substanciais no rateio do Fundo de Participação dos Estados e do Distrito Federal, ainda que o resultado prático seja quase nulo, e das compensações pela extração de petróleo e gás natural, cujas consequências ainda não se fizeram sentir em decorrência de liminar judicial. A compensação pelos efeitos da Lei Complementar nº 87, de 1996, e o Auxílio Financeiro para Fomento das Exportações também foram afetados por decisões emanadas do Poder Judiciário e estão presentemente indefinidos. Paralelamente, os aportes na área da educação foram ampliados, as transferências na área de segurança pública estão sendo incrementadas e o apoio financeiro emergencial aos entes subnacionais ganhou status jurídico indisputado. No entanto, os problemas apontados em 2008 continuam, como será demonstrado, amplamente presentes.

PALAVRAS-CHAVE: Transferências intergovernamentais, federalismo fiscal, finanças públicas.

SUMMARY

LIST OF GRAPHS

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INTRODUCTION

Brazil is a federation that uses intergovernmental transfers intensively. The majority of transfers are unconditional (the recipient government has total freedom to allocate the resources), mandatory (the donor government is required to make the transfer, by constitutional or legal determination) and non-matching (the recipient government is not obliged to complement the resources received).

The emphasis on the use of this type of transfer is a typical result of the decentralization of revenue without decentralization of responsibilities implemented by the 1988 Constitution: the allocation of resources was immediate and automatic, while the decentralization of the provision of public services was left undefined and, three decades after its promulgation, it was not yet completed.

Typically, the compulsory and non-matching transfers have as positive characteristics high autonomy of subnational governments and high independence in relation to political factors. However, they fail with respect to accountability, fiscal responsibility and managerial efficiency

The formula for calculating the amount to be transferred (the percentage of the collection of some taxes by the donor government) is procyclical and results in low flexibility for shock absorption. In general, the criteria for sharing the resources between the states or the municipalities do not promote regional redistribution and reduce the fiscal gap.

The second large group of transfers is one of earmarked resources (conditional ones). In other words, they should be applied only in the areas for which they were intended. Health and education are the areas covered with more resources. These transfers are divided into different categories, some of which are mandatory and other, voluntary; some are matching grants, while others are not.

Transfers for health policies have been successful in terms of regional redistribution, allowing the equalization of the per capita resources intended for health in different regions of the country. However, they present serious

problems regarding managerial efficiency and are unable to reduce the fiscal gap (difficulty to share resources between states and municipalities according to health needs) or to internalize externalities (there is a perverse incentive to act as a free rider, passing through to other governments the cost of medical and hospital care).

Transfers earmarked to education have improved in terms of accountability and managerial efficiency. However, their equalizer effect is smaller than the desired, since transfers per child are unbalanced in favor of the richest regions.

Other conditional transfers deserving attention are: those earmarked to investments in transport infrastructure with funds coming from a contribution on oil and gas (CIDE-Combustíveis); and the Constitutional Fund of the Federal District (FCDF), which partially covers the payroll expenses of the national capital.

CIDE transfer has the merit of internalizing externalities resulting from state or municipal investment in roads. However, there are problems regarding the efficiency of its allocation, since it is shared among a large number of municipalities. This type of investment, which involves significant economies of scale, requires the mobilization of large amount of capital, which is incompatible with the dispersion of resources among many local governments.

FCDF, by its turn, has no plausible explanation for its existence, generating several problems: it increases regional inequality, amplifies the fiscal gap, reduces accountability and discourages fiscal responsibility and managerial efficiency. The states of Roraima and Amapá receive similar treatment. In order to be elevated from territories to states, both have their military police and civil servants kept on the payroll of the federal government.[1] More recently, this prerogative was extended to the civil servants hired during the installation period of both states and to the municipal civil servants in the same situation.[2]

[1] Constitutional Amendment n. 19/1998, article 31.

[2] Constitutional Amendments n. 79/2017 and n. 98/2016.

A third block of transfers consists of financial compensations for negative externalities resulting from the exploitation of natural resources and, also, for the non-taxation of exports. The first one concentrates too much resources in few jurisdictions, generating negative effects similar to those ascribed to the FCDF. The second one, by its turn, exists as consequence of distortions in the tax system.

All types of transfers can be improved. It should be noted that policy outcomes are not used as transfer sharing criteria. Better local public policies could be fostered by using, as sharing criteria, social indicators dependent upon policies implemented by subnational entities. Rates of infant mortality, indexes of educational proficiency, violence reduction or sound fiscal management could be used in this regard.

In addition, most of the time, transfers are based on specific federal taxes. For instance, the State and Municipal Participation Funds (FPE and FPM) are funded by the income tax (IR) and the tax on industrialized products (IPI). Each tax or basket of taxes observes its own rules, which makes the amount transferred dependent on the performance of these taxes. It makes transfers procyclical, weakening local finances during economic downturns. Exceptions to this rule are the transfer to basic education (Fundeb) and to the Unified Health System (SUS), whose resources come from the federal and state revenues as a whole.

1 OVERVIEW

Intergovernmental transfers are very common in Brazil. They are a central element of the federal system as well as a key source of revenue for the vast majority of subnational governments. Indeed, the 1988 Constitution is characterized by a strong decentralization of revenue, mainly by means of transfers. It resulted in a strong increase in the participation of municipalities and of various states in the total tax revenue.

In general, state governments rely less on transfers than municipalities. It is due mainly to the fact that the value added tax (ICMS), the most important tax in the country, is collected by the states.

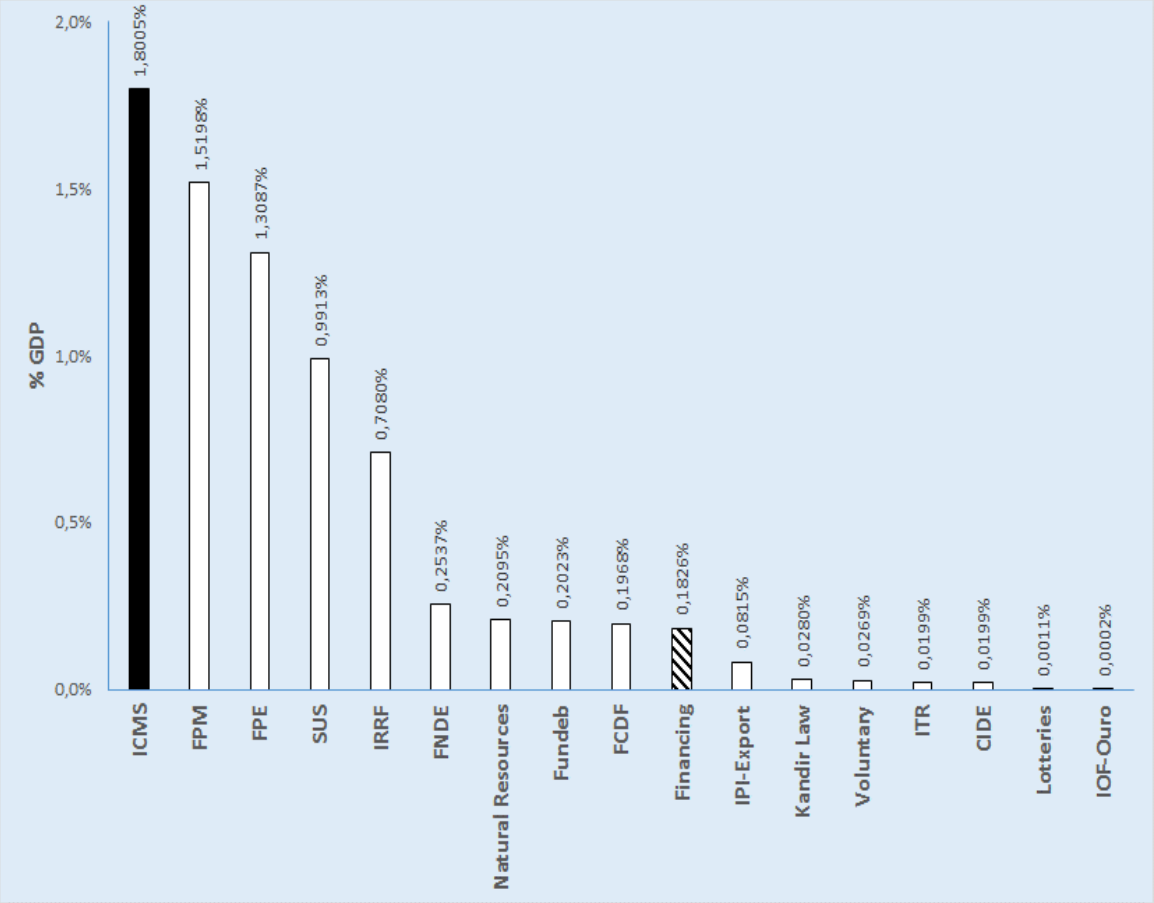
Nevertheless, it should be noted that the dependence on federal transfers has a well-defined geographic locus. Except for the atypical case of the Federal District, the fifteen states that rely the most on transfers belong to the North and Northeast regions. They have income and quality of life indices lower than the ones observed in the South and Southeast regions and manage more restricted tax bases. As a consequence, they are benefited by the regional redistribution embedded in the transfer criteria.

In the case of the municipal governments, high dependence on revenue transfers is widely disseminated. Only the most populated municipalities have significant tax collection and other current revenues. In municipalities with up to fifty thousand inhabitants, which represent 88% of the total, the dependence on transfers exceeds 80% of the total revenue.[3]

Graph n. 1 shows the main modalities of federal transfers to states and municipalities (white bars), expressed in terms of percentages of the gross domestic product (GDP). The transfer of the ICMS municipal quota (black bar) was included for comparison purposes. There is also a federal transfer to finance private investment in the North, Northeast and Midwest regions (streaked bar). Although the last one is not strictly an intergovernmental transfer, it has been included because it disputes resources with other transfers (the resources involved come from the same taxes shared by other transfer instruments). In addition, this mechanism is strongly supported and defended in Congress by the parliamentarians from the benefited regions, constituting an important element in the negotiations of the Brazilian federative pact.

[3] See Table n. 6 from the report "As Finanças Municipais em 2017", by François E. J. de Bremaeker, available at: http://www.oim.tmunicipal.org.br/abre_documento.cfm?arquivo=_repositorio/_oim/_documentos/5692940D-FC44-AF79-776F3A069819DBC718102018043020.pdf&i=3126 (Oct. 2018).

Graph 1: Federal Transfers to States and Municipalities



Sources:

a) FPM, FPE, Fundeb, IPI-Export, Kandir Law, voluntary transfers, ITR, CIDE, transfers from lotteries and IOF-Ouro (2018): http://www.tesouro.fazenda.gov.br/transferencias;

b) ICMS, SUS, IRRF, FNDE and compensations for the exploitation of natural resources (2017): https://siconfi.tesouro.gov.br/siconfi/pages/public/consulta_finbra/finbra_list.jsf;

c) FCDF (2018): http://www.portaltransparencia.gov.br/orgaos/25915?ano=2018;

d) GDP (2018): https://www.ibge.gov.br/estatisticas/economicas/contas-nacionais/9300-contas-nacionais-trimestrais.html?t=resultados.

Notes: constitutional financing funds estimated from FPE and FPM transfers; municipal data reach 5,488 out of 5,570 entities; Latin notation for decimals.

Graph n. 1 shows that the three most important transfers are unconditional, non-matching and mandatory. The transfers related to SUS, Fundeb and the automatic ones by the Ministry of Education (FNDE) also deserve attention. SUS transfers are conditional because the law specifies the services on which the resources should be spent (e.g., basic and hospital care). In addition, they require matching resources from states and municipalities in public health financing.

Fundeb aims to ensure a minimum amount of resources per student at early childhood education (three-year cycle with entry-level age of four years

old), basic education (eight-year cycle with entry-level age of seven years old), secondary education (three-year cycle with entry-level age of fifteen years old) and the education of youth and adults (people returning to studies with lagged age).[4]

Several transfers tied to education, typified as conditional, voluntary and non-matching, are financed by the so-called "salário-educação" (wage-education). It is a social contribution paid by the firms to provide additional resources for public education. The amount collected is shared between the federal government, the states and the municipalities. The federal share is directed to the National Fund for the Development of Education (FNDE). This fund has a series of programs providing resources and material goods for state and municipal schools (e.g., school meals, textbooks, student transportation, etc.). The objective is also to provide a minimum standard of quality.

It should be noted that the majority of these programs are executed in a decentralized manner: the federal government transfers resources to states and municipalities and both buy school meals and hire student transportation, among others services. An important exception is the program for the distribution of textbooks, whose purchasing is centralized in the federal government. The portion of the wage-education transferred to the states and municipalities must be used in maintaining the local public schools.

There are also transfers classified as conditional and voluntary, matching or non-matching, in other areas of administration (social assistance, transport, sports, etc.). However, these transfers occupy a gray area between those that constitute federal structured programs, ensuring minimum standards of a basket of public services, and those that are simply pork barrel projects. Even in areas like education and health, in which prevail a well-organized division of labor, a hierarchy of responsibilities and the co-financing by the three levels of government, there is room for projects arising from bargains between the policy makers.

The third large group of transfers deals with financial compensation arising out of negative externalities. They included transfers to states and municipalities for the exploitation of mineral resources, water and oil (Natural

[4] Law n. 11,494/2007.

Resources). All transfers of this group are unconditional, mandatory and non-matching.

The next fourteen sections will describe in more detail the main federal transfers, followed by our final remarks.

2 MUNICIPAL PARTICIPATION FUND (FPM)

FPM is a redistributive transfer paid to all municipalities. It is unconditional, mandatory and non-matching. It is the second largest transfer, losing only to the ICMS. This fund was established by article 21 of the Constitutional Amendment n. 18/1965.

Currently, FPM is laid down in article 159, I, *b*, *d* and *e*, of the 1988 Constitution. These legal provisions determine that 24.5% of IR and IPI revenues pertain to FPM. With the exception of two tranches of 1 percentage point delivered annually in July and December,[5] the resources due to the prefectures are delivered every ten days.

The resources of FPM are divided into three parts: 10% are delivered to the state capitals; 86.4% go to the non-capitals (interior); and 3.6% supplement the payment received by the most populated interior municipalities. This arrangement is the result of a long process, subjected to political pressures from different groups of municipalities. The general logic is as follows: *(i)* the first installment (FPM-Capital) limit the amount absorbed by the capitals, considered more developed and, therefore, capable of financing their own expenses; *(ii)* the second (FPM-Interior) is shared according to the population; *(iii)* the third (FPM Reserve) seeks to mitigate the disadvantage of the most populated municipalities in the calculation of the second installment.

FPM-Capital is distributed based on a participation coefficient obtained through the multiplication of the following terms:

- a factor representing the population, based on the percentage of the population of each capital in relation to the total population of all capitals;
- a factor representing the inverse of the per capita income of each state.

[5] Constitutional Amendments n. 55/2007 and n. 84/2014.

In order to make the distribution more uniform, the values assumed by both factors have floors and ceilings. The population factor varies from 2 to 5, with increments of 0.5. The inverse of the per capita income factor varies from 0.4 to 2.5, with increments of 0.1 up to 1, 0.2 from 1 to 2 and, finally, of 0.5. In this way, the resulting distribution function is discontinuous. Mathematically, the FPM-Capital formula is the following:

$$V_e = 0.1 \times FPM \times \frac{CP_e \times CIRP_e}{\sum_e (CP_e \times CIRP_e)};$$

Where:

V_e = amount to be received by the state capital *e*;
FPM = total amount distributed by FPM;
CP_e = coefficient of the population of the state capital e in relation to the total population of all state capitals;
$CIRP_e$ = coefficient related with the inverse of the per capita income of the state *e*;
$\sum_e (CP_e \times CIRP_e)$ = sum of the coefficients of all state capitals.

FPM-Interior is apportioned through a participation coefficient obtained from the number of inhabitants in each municipality. Also in this case the factor representative of the population takes discrete values, ranging from 0.6 to 4.0, with increments of 0.2. The function of distribution takes the form of a "ladder", with significant discontinuous jumps.

In order to avoid that the creation of new municipalities by one state affects the quotas due to the municipalities of other states,[6] it was stipulated that the sum of the state coefficients should remain bonded to the size of the population of each state on July 1st, 1989.[7] Thus, with the non-update of the state sums, the quotas of municipalities with similar populations, but located in different states, tend to diverge, with those located in states that allowed the emergence of new municipalities receiving less than those located in states that did not. Next, the FPM-Interior formula:

$$V_{ie} = 0.864 \times FPM \times \theta_e \times \frac{CP_{ie}}{\sum_e CP_{ie}};$$

Where:

V_{ie} = amount to be received by the municipality *i* located in the state *e*;
FPM = total amount to be distributed by FPM;
θ_e = state participation of state *e* in FPM-Interior;
CP_{ie} = coefficient related with the population of the municipality *i* located in the state *e*;
$\sum_e CP_{ie}$ = sum of all coefficients of the municipalities in the state *e*.

6 Complementary Law n. 62/1989, article 5, sole paragraph.

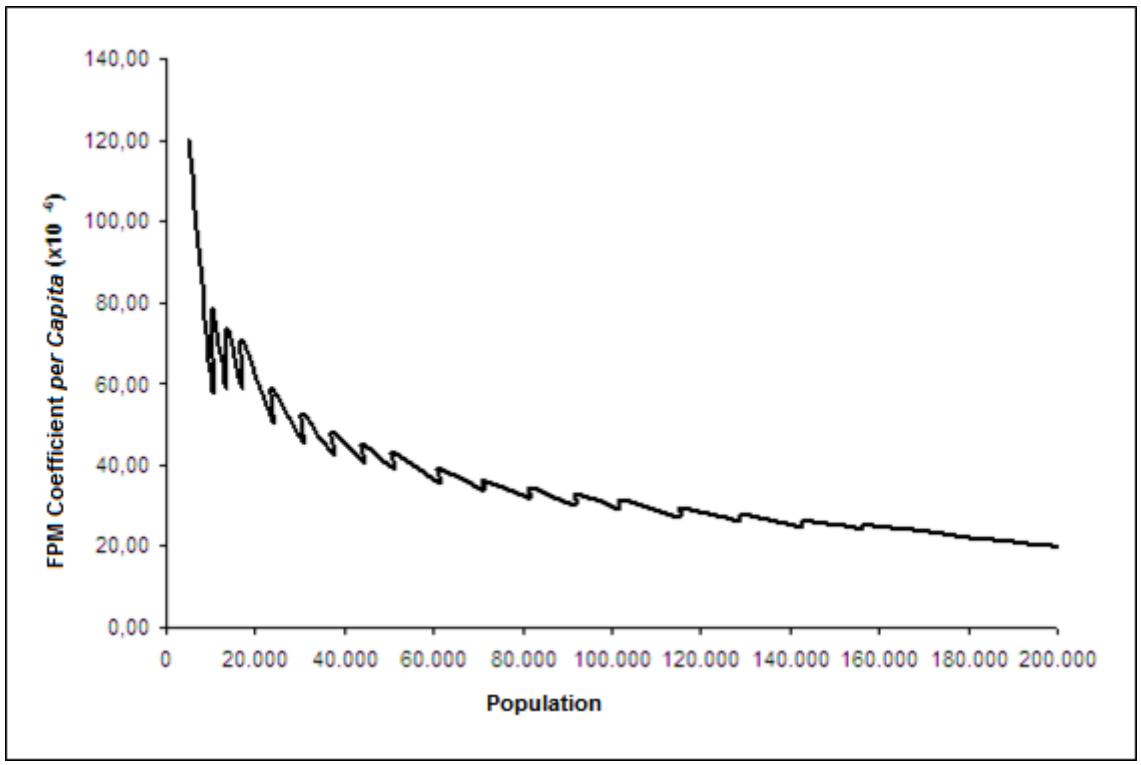
7 Annex II of the Resolution n. 242/1990 of the Brazilian Court of Accounts (TCU).

FPM Reserve, by its turn, comprises the municipalities with a population greater than or equal to 142,633 inhabitants (with a coefficient greater than or equal to 3.8). These municipalities also participate in the apportionment of the FPM-Interior. The distribution is made according to the FPM-Capital criteria.

Among the municipalities that participate in the apportionment of the FPM-Capital and the FPM Reserve, the beneficiaries are those with bigger population and lower income, in spite of the distortions generated by the floors and ceilings present in the factors used by their formulas.

FPM-Interior favors the less populated municipalities.[8] This occurs because its per capita coefficients decline sharply with the increase of the population, although there are "peaks" at each change of population class, as shown in the Graph n. 2.

Graph 2: FPM-Interior Coefficients per Capita



Note: Latin notation for decimals and thousands.

In this way, it is advantageous for a municipality with, for example, 10,188 inhabitants, which gets a coefficient 0.6, to be divided in two, which would get the same coefficient. Everything else constant, a simple

[8] See Judgment by the TCU Plenary n. 1,120/2009 for a critique of the presumption that less populated municipalities are poor.

administrative rearrangement would double the inflow of resources for a given population.

In addition, the steps of the "ladder" formed by the coefficients by the FPM-Interior have been a constant source of administrative and judicial complaints, because the loss of a single inhabitant in the annual reviews of the size of the population by the Brazilian Institute of Geography and Statistics (IBGE) may cause significant reductions in the amounts received.

A practical problem that arises from the periodic population estimations is that, when the demographic censuses occur every ten years, the coefficients of the municipalities need to be adjusted according to the population effectively surveyed. Those municipalities that have had their populations overestimated between demographic censuses tend to suffer significant reductions in their coefficients. To avoid abrupt losses of revenue, the National Congress has passed laws establishing transitional periods, in which the coefficients are not reduced immediately, but only over time. Since the amount apportioned by the FPM is exogenously fixed and is not influenced by the transition rule, municipalities with growth rates higher than the ones estimated between demographic censuses receive, during the transition, fewer resources than they should. Complementary Laws n. 91/1997 and n. 106/2001, for example, defined transitional periods for the coefficients of FPM.[9] More recently, Complementary Law n. 165/2019 froze the coefficients of entities whose coefficients had decreased, diluting among many entities the losses of a few.

3 STATES PARTICIPATION FUND (FPE)

FPE is a mandatory, unconditional, non-matching and redistributive transfer for all states. It is the third largest type of transfer, losing only to the ICMS and FPM transfers. This fund was also established by article 21 of the Constitutional Amendment n. 18/1965. Currently, it is laid down in article 159, I, *a*, of the Constitution, which stipulates that 21.5% of IR and IPI revenues belong to it. Therefore, it involves the same taxes shared by FPM.

[9] See Judgment by the TCU Plenary n. 196/2003 for a critique of the criterion of adjustment, which ended up harming the intended beneficiaries.

Until 2015, the FPE apportionment was defined by Annex I of the Complementary Law n. 62/1989. The participation coefficient of each state was fixed, with the states from the North, Northeast and Midwest taking 85% of the total shared.

However, on February 24, 2010, the Federal Supreme Court (STF) declared this apportionment unconstitutional and demanded the a new law with new criteria.[10] The problem laid in the immutability of the coefficients, judged incompatible with effective policies for the reduction of the socioeconomic disparities among the states, as required by the Constitution.[11] This resulted in the adoption of Complementary Law n. 143/2013, with the following characteristics:

a) 100% of the inflation adjustment and 75% of the real GDP variation was tied to the participation coefficients ascribed by the Complementary Law n. 62/1989;
b) the residue would be apportioned based on a participation coefficient obtained through the sum of the factors representing the population and the inverse of the per capita household income, both computed continuously;
c) the factor representing the population would vary from 0.07 to 0.012, benefiting the less populated entities; and
d) the coefficients of the entities with income higher than 72% of the national per capita household income would be curtailed.

Mathematically, the FPE formula is the following:

$$FPE_t^n = \begin{cases} FPE_t - FPE_{(2015+i)}^o \text{ se } FPE_t > FPE_{(2015+i)}^o \\ 0 \text{ se } FPE_t \leq FPE_{(2015+i)}^o \end{cases};$$

$$t = (2015 + i) \text{ com } i > 0;$$

$$FPE_{(2015+i)}^o = FPE_{2015} \times \prod_i \left[0{,}75 \times \left(1 + g_{(2015+i)}\right) \times \left(1 + \pi_{(2015+i)}\right)\right];$$

$$CFPE_{e,(2015+i)}^o = CFPE_{e,2015};$$

$$\sum_e CFPE_{e,t}^{n,a} = 1;$$

$$CFPE_{e,t}^{n,a} = \frac{1}{\sum_e CFPE_{e,t}^n} \times CFPE_{e,t}^n;$$

$$CFPE_{e,t}^n = 0{,}005 < \left(1 - \varphi_{e,(t-\varepsilon)}\right) \times \left[FPOP_{e,(t-2)}^a + FIRDpC_{e,(t-\varepsilon)}^a\right] < \infty;$$

[10] Direct Actions of Unconstitutionality (ADI's) n. 845, n. 1,987, n. 2,727 and n. 3,243.

[11] Federal Constitution, article 161, II.

$$\varphi_{e,(t-\varepsilon)} = 0 < \left(\frac{RDpC_{e,(t-\varepsilon)}}{0{,}72 \times RDpC_{n,(t-\varepsilon)}} - 1 \right) < 1;$$

$$\sum_{e} FPOP^{a}_{e,(t-2)} = \sum_{e} FIRDpC^{a}_{e,(t-\varepsilon)} = 0{,}5;$$

$$FPOP^{a}_{e,(t-2)} = \frac{0{,}5}{\sum_{e} FPOP_{e,(t-2)}} \times FPOP_{e,(t-2)};$$

$$FIRDpC^{a}_{e,(t-\varepsilon)} = \frac{0{,}5}{\sum_{e} FIRDpC_{e,(t-\varepsilon)}} \times FIRDpC_{e,(t-\varepsilon)};$$

$$FPOP_{e,(t-2)} = 0{,}012 < \frac{POP_{e,(t-2)}}{\sum_{e} POP_{e,(t-2)}} < 0{,}07;$$

$$FIRDpC_{e,(t-\varepsilon)} = \frac{1/RDpC_{e,(t-\varepsilon)}}{\sum_{e} 1/RDpC_{e,(t-\varepsilon)}}.$$

Where:

FPE_t = amount distributed by FPE in year *t*;
$FPE^{o}_{(2015+i)}$ = amount distributed by FPE in the year *(2015+i)* by the original criteria;
FPE^{n}_{t} = amount distributed by FPE in *t* by the new criteria;
$g_{(2015+i)}$ = real economic growth in the year *(2015+i)*;
$\pi_{(2015+i)}$ = inflation rate in the year *(2015+i)*;
$CFPE_{e,2015}$ = coefficient of state *e* in *2015*;
$CFPE^{o}_{e,(2015+i)}$ = coefficient of state *e* in the year *(2015+i)* by the original criteria;
$CFPE^{n}_{e,t}$ = coefficient of state *e* in the year *t* by the new criteria;
$CFPE^{n,a}_{e,t}$ = adjusted coefficient of state *e* in the year *t* by the new criteria;
ε = amount of years up to the last publication of per capita household income;
$RDpC_{e,(t-\varepsilon)}$ = per capita household income of state *e* in the year *(t-ε)*;
$RDpC_{n,(t-\varepsilon)}$ = national per capita household income in the year *(t-ε)*;
$\varphi_{e,(t-\varepsilon)}$ = $RDpC_{e,(t-\varepsilon)}$ surplus in comparison to 72% of $RDpC_{n,(t-\varepsilon)}$;
$FPOP_{e,(t-2)}$ = representative factor of the population of state *e* in the year *(t-2)*;
$FPOP^{a}_{e,(t-2)}$ = adjusted representative factor of the population of state *e* in the year *(t-2)*;
$FIRDpC_{e,(t-\varepsilon)}$ = representative factor of the inverse of $RDpC_{e,(t-\varepsilon)}$;
$FIRDpC^{a}_{e,(t-\varepsilon)}$ = adjusted representative factor of the inverse of $RDpC_{e,(t-\varepsilon)}$.

Therefore, the option was for marginal changes in the FPE apportionment, perceptible only in the long term. Besides, the preferential treatment of the North, Northeast and Midwest regions was maintained. In practice, the amount transferred to the states in 2015 started being corrected by 75% of the national GDP real growth of the year prior to the base period (the year when the budget law is formulated), combined with the corresponding inflation adjustment. Only the portion exceeding the corrected amount has been apportioned by the new criteria. In the current context of low growth experienced by Brazil, the transition to the new criteria has been even slower than originally expected.

4 OTHER UNCONDITIONAL TRANSFERS

There are three other federal unconditional transfers: the income tax withheld by state and municipal governments from their employees (IRRF), the tax on rural land ownership (ITR) and the tax on financial transactions with gold (IOF-Ouro).

The portion of the IRRF that belongs to the states and municipalities is the one retained by these entities as employers or contractors.[12] ITR is charged by the federal government, which transfers 50% to the municipality where the rural property is located. The municipalities that assume the levying of this tax can withhold 100% of the revenue. However, this option is not exercised frequently.[13] The IOF-Ouro is collected by the federal government and distributed as follows: 30% for the states and 70% for the municipalities. Also in this case, the transfer goes to the entity where the tax was collected.

It is worth mentioning that, adding the three transfers, the amount obtained is very low, which reinforces the prior questioning about the relevance of establishing transfers tax by tax.

5 UNIFIED HEALTH SYSTEM (SUS)

SUS is organized hierarchically (in increasing levels of complexity) and decentralized. The central government outlines policy guidelines and transfers resources for the states and municipalities to execute them. The general idea is to delegate to the municipalities the primary care (prevention, first aid and outpatient and hospital procedures of low complexity), while more complex treatments are borne by the state and bigger municipalities. Economy of scale and cooperative action between the various levels of government are central issues in the design of the system.[14]

SUS is the result of more than three decades of evolution of the Brazilian health system. It was created by the 1988 Constitution and coexisted during a certain period with the preceding system. Previously, the coverage of the public health system was not universal, providing assistance only to workers in the

[12] Federal Constitution, article 157, I, and article 158, I.

[13] Federal Constitution, article 153, paragraph 4, III, and article 158, II.

[14] Federal Constitution, article 198, and Law n. 8,080/1990, article 8.

formal labor market (with signed contracts), a fact that concentrated the expenditures on the wealthiest regions of the country, which had a higher level of labor formalization. With the new Constitution, the universalization of the right of access to health was implemented, as well as the inclusion of all municipalities in the system.

SUS is funded by resources from the three levels of government, with states and municipalities providing, respectively, at least 12% and 15% of their tax revenue. The federal government, with the Constitutional Amendment n. 86/2015, began to contribute 15% of its net current revenues. More recently, with the introduction of the New Fiscal Regime,[15] that amount was replaced by a floor equal to the 2017 disbursement, yearly adjusted by inflation.[16]

Transfers made by the federal government concerning the SUS can be classified as intergovernmental transfers to states and municipalities or as direct payments to service providers. In the second case, the federal government pays directly to hospitals, doctors, etc. for services rendered in accordance with the payments table established by the Ministry of Health. This modality has decreased with time, being replaced by the first type of transfers, allowing the subnational entities to hire and pay the service providers in a decentralized way.

Intergovernmental transfers concerning the SUS can be divided into two modalities: agreements and transfers "fund to fund". The first one covers a series of transfers supporting agreements between, on one side, the federal government and, on the other, the state or municipal governments, with specific purposes and rules defined on a case-by-case basis, in accordance with the objectives of each action. They are conditional transfers (should be spent on activities defined by the agreement), voluntary and may or may not require some matching from the recipient. The agreements can also be carried out between the federal government and philanthropic entities. In this case, however, they do not qualify as intergovernmental transfers, but as direct payments to service providers.

The second modality (fund to fund) is a mechanism of automatic transfers in which the federal government complements municipal and state

[15] Constitutional Amendment n. 95/2016.

[16] Transitional Constitutional Provisions Act (ADCT), article 110.

resources earmarked to health services. The designation of this modality comes from the fact that these transfers are made automatically by the National Health Fund (FNS) in favor of the municipal and state health funds. The subnational governments also contribute with their own resources to their respective health funds. In this way, these funds are central pieces of the financing of the health sector.

There are four arrangements for the “fund to fund” modality. The first is the “Minimum Extended Fixed Service of Basic Care”, which channels the funds intended for the basic care of the population's health. The programs covered are: controls of tuberculosis, hypertension and diabetes; elimination of leprosy; and health programs for children and women as well as buccal care. These transfers are mandatory and conditional (compulsory use in the health programs for which they were intended). They assign a fixed amount per capita to each subnational government.

The second method is the “Variable Service of Basic Care”. The resources transferred in this manner are for the development of specific programs, such as basic medicines, combating nutritional deficiencies, community health agents and family health. This transfer is mandatory (passed along to all states and municipalities fit to participate in these programs) and conditional. In addition, its total amount depends on the level of production or coverage of each program. However, there is a ceiling per state or municipality.

Another modality is the sanitary surveillance and the epidemiological control. In this case, the coverage and/or the production of the programs define how much should be transferred up to a limit per subnational unit.

Finally, there are the transfers for medium and high complexity procedures, covering more sophisticated outpatient and hospital care, such as surgeries and the distribution of especial drugs for chronic patients. This transfer is also mandatory, conditional, based on production and subject to a ceiling.

In the context of high complexity care, the Ministry of Health has created, in 1999, the Strategic Actions and Compensation Fund, enabling a clearing house through additional resources. Since the institutions capable of offering high complexity care are concentrated in more developed municipalities and

states, which receive patients from all over the country, there is a need to compensate these subnational entities for the patients coming from other locations.

The SUS transfer modalities were reformulated after the "Pact for Health 2006."[17] Although the transfer categories have been changed, the same pattern remained, namely: sharing of resources in per capita terms or by some measure of program production/coverage, with the imposition of a ceiling on expenditure for each state or municipality. The novelty was the reservation of resources for investments, constituting a conditional and voluntary transfer, passed along upon the approval of the projects by the Ministry of Health. The new blocks are basic care, medium and high complexity care, health surveillance, pharmaceutical care and the management of SUS.

Law n. 8,142/1990 prescribed as a criterion for the apportionment of the resources the simple per capita division (*see* article 3, paragraph 1). To circumvent this rigidity, the Ministry of Health has used the prerogative enshrined in the same law (see article 5) to edit ministerial decrees. This allowed the establishment of an *ad hoc* system of transfers based on negotiations with the states and municipalities. The advantage is to allow higher flexibility to the health policy. The disadvantage is the risk of political interference in the decision-making process.

6 Fund for the Development and Maintenance of Fundamental Education and Teacher Valorization (Fundeb)

The implementation of Fundeb began in January 2007, reaching national coverage in 2009.[18] The resources contemplate all basic education (nursery, pre-school, elementary, middle and high school, and the education of young people and adults). Starting in 2010, the federal government began to transfer to the fund an amount equivalent to 10% of the state and municipal contributions.[19] The subnational governments, by their turn, dedicate 20% of their tax and transfer revenues to Fundeb.[20] It must be noted that the resources are

[17] Decree of the Cabinet of the Minister of Health n. 399/2006.

[18] Constitutional Amendment n. 53/2006.

[19] ADCT, article 60, VII, *d*.

[20] Law n. 11,494/2007, article 3.

administered at the state level by means of state funds. In this way, the state contributions are appropriated locally, while the municipal contributions are redistributed among the entities belonging to the same state. The fund is expected to last until 2020, but its extension is being debated. [21]

The Fundeb operation relies on the finding that, as a consequence of different funding capacities by the states and municipalities, some entities fell far short of the minimum amount deemed appropriate. Thus, it is up to the federal government to provide, up to the transfer amount mandated by law, the per capita resources necessary to the achieve the educational goals. In this way, the federal transfers for the Fundeb have an eminently equalizer character.

The minimum amount per student vary from state to state, as well as on the urban or rural location of the student (higher in the second case), the grade coursed by the student (higher for the final grades) and the type of education (special or regular). There is also a differentiation for children enrolled in daycare centers, in pre-school, in full-time elementary, middle, urban or rural education, in middle courses integrated with professional education, in schools aimed at indigenous and quilombola communities and in educational project for young people and adults.

Overall, it should be noted that the 1988 Constitution requires that the states and municipalities should spend 25% of their taxes and transfers revenues in education.[22] The federal government, by its turn, should spend 18% of its tax revenue. At least until 2026, however, the New Fiscal Regime substituted this floor for the amount disbursed in 2017 adjusted by inflation.

7 CIDE-COMBUSTÍVEIS

CIDE-Combustíveis is a constitutional provision.[23] On the collection side, its goal is to smooth the fluctuations in fuel prices. On the expenditure side, its main purposes are: *(i)* to finance the subsidies for alcohol fuel, natural gas and its derivatives and petroleum derivatives; *(ii)* to finance environmental projects

[21] See article "Vigência do Fundeb Poderá Ser Prorrogada para Dezembro de 2040", available at: https://www2.camara.leg.br/camaranoticias/noticias/EDUCACAO-E-CULTURA/575549-VIGENCIA-DO-FUNDEB-PODERA-SER-PRORROGADA-PARA-DEZEMBRO-DE-2040.html (April 26, 2019).

[22] Federal Constitution, article 212.

[23] Federal Constitution, article 177, paragraph 4.

related to the oil and gas industry; and *(iii)* to finance transport infrastructure programs.

From the amount collected, 29% must be transferred to the states and the Federal District.[24] The first ones should, by their turn, transfer 25% of the received revenue to their municipalities. The transfers to municipalities observe the following criteria: 50% according to the population and 50% according to the FPM coefficients.[25] The states and municipalities must apply the transfers received in financing transport infrastructure.[26]

The amounts transferred are based on four criteria: 40% according to the extent of the federal and state paved roads existing in each state and the Federal District; 30% according to the consumption of fuels in each state and the Federal District; 20% according to the population; and 10% divided equally among the states and the Federal District. The National Department of Transportation Infrastructure (DNIT), the National Petroleum Agency (ANP) and IBGE are, respectively, the agencies responsible for computing the first three criteria.

8 CONSTITUTIONAL FUND OF THE FEDERAL DISTRICT (FCDF)

FCDF is a transfer of the federal government to defray the payroll of the Federal District in the education, health and public safety areas.[27] Therefore, it is a mandatory, non-matching and conditional transfer. Annually, the federal government must deliver R$ 2.9 billion (in 2003 values), adjusted by the yearly variation of its net current revenue.[28]

The alleged reason for the existence of this transfer is that, as the headquarter of the three branches of the Union, the Federal District incurs administrative costs to provide the infrastructure and the security required by the operation of the federal public administration.

Besides this financial advantage, the judiciary branch and the offices of the public prosecutors and of the public attorneys of the Federal District are

[24] Federal Constitution, article 159, III.
[25] Federal Constitution, article 159, paragraph 4, and Law n. 10,336/2001, article 1-B, paragraph 1.
[26] Law n. 10,336/2001, article 1-A.
[27] Federal Constitution, article 21, XIV.
[28] Law n. 10,633/2002, article 2.

entirely funded by the federal government.[29] In other words, while other states have to bear all costs of their respective judiciary branches and offices of the public prosecutors and of the public attorneys, the Federal District, with a per capita current revenue much bigger, is free of such expenditure.

9 FINANCIAL COMPENSATION FOR THE EXPLOITATION OF NATURAL RESOURCES

The states, the Federal District and the municipalities receive transfers as financial compensation for the exploitation of natural resources in their territories or contiguous areas. This revenue is classified as intergovernmental transfer because these resources belong to the Union.

The transfers are compulsory, unconditional and non-matching. They are partially devolutive because they result from some kind of economic activity developed in the subnational territories associated with the exploitation of natural resources. However, the sharing criteria are quite biased, so there is not a full correspondence between the revenues generated locally and the transfers received.

There are three oil exploration regimes and three apportionment rules of the revenues. The regimes are:

a) concession:[30] it comprises the majority of the producing blocks, but tends to decline as the other regimes begin to produce; this regime pays royalties and the special participation;

b) onerous assignment:[31] it is an exceptional regime, in which the federal government gave onerously the right of exploitation of five billion barrels to Petrobras; this regime pays only royalties; there is no collection of the special participation;

c) production sharing:[32] it pays royalties and the Union has a share on the oil extracted; this latest share is similar to the special participation, since both operate as a kind of tax on the profit generated by an oil field.

[29] Federal Constitution, article 21, XIII.

[30] Law n. 9,478/1997.

[31] Law n. 12,276/2010.

[32] Law n. 12,351/2010.

In the case of the production of oil and natural gas, the law establishes four types of payments to the public sector: *(i)* signature bonus (payment made through auction for the concession to exploit an area); *(ii)* payment for the occupation or retention of the area to be exploited; *(iii)* royalties (monthly payment based on a percentage of the production); *(iv)* and special participations (additional payment made for large production volumes or high profitability).[33]

In relation to the apportionment between, on one hand, the three levels of government and, on the other hand, the entities that produce/confront areas of exploitation on the continental shelf and those that do not produce/do not confront, the Congress approved in 2012 a new apportionment, which affected including the contracts already signed.[34] Formerly concentrated in states and municipalities closer to oil fields, the new criteria increased the share of the non-producers. Although partially vetoed by the president of the Republic, the new law was fully restored by the parliamentarians. The entities harmed appealed to the Supreme Court and obtained a provisory injunction suspending the new allotment on March 18, 2013.[35] Since then, the previous criteria have been kept, including for the new exploitation contracts. Tables n. 1 and n. 2 detail the two apportionments and highlight the conflict between the entities that produce/confront and those that do not produce/do not confront, as well as the planned loss of participation of the federal government.

Table 1: Special Participation Apportionment

BENEFICIARIES	LAW 9,478/1997	LAW 12,734/2012* (suspended)
Producing or confronting states	40%	20%
Producing or confronting municipalities	10%	4%
Special Fund (shared by FPE)	–	15%
Special Fund (shared by FPM)	–	15%
Union (Mines and Energy, and Environmental Ministries)	50%	–
Union (Social Fund)	–	46%
TOTAL	**100%**	**100%**

Note: (*) starting in 2019, after a transitional period, if in force.

[33] Law n. 7,990/1989 and Law n. 9,478/1997.

[34] Law n. 12,734/2012.

[35] ADI n. 4,917 (see article "Em Liminar, Ministra Cármen Lúcia Suspende Dispositivos da Nova Lei dos *Royalties*", available at: http://www.stf.jus.br/portal/cms/verNoticiaDetalhe.asp?idConteudo=233758).

Table 2: Apportionment of Royalties from the Exploitation of the Continental Platform, the Territorial Sea or the Exclusive Economic Zone

CONCESSION REGIME		
BENEFICIARIES – ROYALTIES ≤ 5%	**LAW 9,478/1997**	**LAW 12,734/2012*** (suspended)
Producing or confronting states	30%	20%
Producing or confronting municipalities	30%	4%
Affected or with installations municipalities	10%	3%
Special Fund (shared by FPE)	10%	27%
Special Fund (shared by FPM)		27%
Union (Navy)	20%	–
Union (Social Fund)	–	20%
TOTAL	**100%**	**101%**
BENEFICIARIES – *ROYALTIES* > 5%	**LAW 9,478/1997**	**LAW 12,734/2012*** (suspended)
Producing or confronting states	22.5%	20%
Producing or confronting municipalities	22.5%	4%
Affected municipalities	7.5%	3%
Special Fund (shared by FPE)	7.5%	27%
Special Fund (shared by FPM)		27%
Union (Navy and Science and Technology Ministry)	40.0%	–
Union (Social Fund)	–	20%
TOTAL	**100.0%**	**101%**
PRODUCTION SHARING REGIME		
BENEFICIARIES	**LAW 12,351/2000#**	**LAW 12,734/2012*** (suspended)
Producing or confronting states	–	22.0%
Producing or confronting municipalities	–	5.0%
Affected municipalities	–	2.0%
Special Fund (shared by FPE)	–	24.5%
Special Fund (shared by FPM)	–	24.5%
Union (Social Fund and other deductions)	–	22.0%
TOTAL	**–**	**100.0%**

Notes: (*) starting in 2019, if in force; (#) resources shared, by default, according to Law 9,478/1997.

The signature bonus are withheld by the National Treasury and the payment for the occupation of the area goes to the ANP budget. The subnational governments shares the royalties and special participation revenues. ANP stipulates, in the bidding notices for new area concessions, the percentage of royalty of each area. It may vary from 5% to 10% of the oil or natural gas production. There are three distinct criteria: *(i)* for the minimum value of royalties (5%); *(ii)* for the portion of royalties that exceed the minimum value; and *(iii)* for the special participations. In the first two cases, the criteria are still divided based on place exploited: on the continent or on the continental shelf.

Three important facts should be observed about these distribution criteria. Firstly, there is a strong prevalence of states and municipalities at the expense of the federal government: subnational governments receive from 50% (special participations) to 100% (5% royalty, continental exploitation) of total resources. Secondly, as long as the injunction granted by the Supreme Court holds, the main beneficiaries, in descending order, are: the producing or confronting states and municipalities; those that host embarkation and disembarkation activities (ports or ducts) or are affected by these activities; the municipalities belonging to states that receive royalties (part of the state royalty is distributed according to the ICMS criteria); finally, a residual amount is shared among all states and municipalities. Thirdly, the federal government current share of the resources is already earmarked for the education and health sectors – 75% and 25%, respectively.

Firms that use water for electric power generation pay a financial compensation equivalent to 7% of the value of the energy produced.[36] In addition to the federal government, the states, the Federal District and the municipalities with installations for electrical energy production or with inundated areas also receive a share of this levy. Also in this case, the subnational governments are the main beneficiaries, receiving 80% of the total compensation, as Table n. 3 shows:

TABLE 3: APPORTIONMENT OF THE FINANCIAL COMPENSATIONS CONCERNING ELECTRIC POWER PRODUCTION, THE ROYALTIES FROM ITAIPU HYDROELECTRIC PLANT AND THE EXPLOITATION OF MINERAL RESOURCES

BENEFICIARIES	HYDRAULIC RESOURCES	ITAIPU ROYALTIES	MINERAL RESOURCES
States affected directly	22.32%	21.25%	15.00%
Municipalities affected directly	58.04%	55.25%	60.00%
Municipalities affected indirectly	–	–	15.00%
States with upstream reservoirs	–	3.75%	–
Municipalities with upstream reservoirs	–	9.75%	–
SUBTOTAL	**80.36%**	**90.00%**	**90.00%**
Union	19.64%	10.00%	10.00%
TOTAL	**100.00%**	**100.00%**	**100.00%**

Sources: Law n. 7.990/1989, Law n. 8.001/1990, Law n. 9.648/1998, Law n. 13.360/2016, Law n. 13.540/2017, Law n. 13.661/2018 and Law n. 13.823/2019.

[36] Law n. 7,990/1989, and Law n. 9,648/1998, article 17.

Still about energy generation, Itaipu hydroelectric plant pays royalties[37] to the federal government and to the affected states and municipalities, with subnational governments absorbing 90% of the total amount.

The financial compensation for the exploitation of mineral resources other than petroleum and natural gas is up to 3,5% of gross sales revenue, net of taxes.[38]

10 COMPENSATION FOR LOST REVENUES ON EXPORT OPERATIONS

The states and the Federal District receive compensation for the loss of tax revenue over export operations. The loss comes from ICMS, which is a state tax partially accrued at the origin of the commercial transaction. Consequently, the exemption of export operations harms the ICMS collection of the exporting state. If this tax were fully collected at the destination of the just mentioned transactions, the export operations would be automatically exempt, since foreigners do not pay domestic taxes.

Bearing in mind that the export stimulus is in the interest of the central government, in charge of macroeconomic policy, state governments demand compensation for the taxes not collected, which, they contend, is a negative externality of a federal policy.

There are two compensation mechanisms: one associated with the export of industrialized products and another associated with the export of primary and semi-elaborated products. Both are laid down in the Constitution:

- IPI-Export:[39] it distributes among the states and the Federal District 10% of the amount collected by IPI in proportion to the value of their exports of industrialized products; 25% of this amount are passed along to the municipalities by the same criteria of the ICMS sharing;
- Compensation for the Effects of the Complementary Law n. 87/1996 (a.k.a., Kandir Law):[40] it lays down the obligation for compensating the export operations of primary and semi-elaborated products[41].

[37] Law n. 8,001/1990, article 1, paragraph 3.
[38] Law n. 8.001/1990, article 2.
[39] Federal Constitution, article 159, II.
[40] Subsequently validated by article 91 of the ADCT.

IPI-Export has been operating on an automatic basis since the promulgation of the Constitution, constituting a compulsory, unconditional, non-matching and devolutive transfer.

The second compensation, by its turn, has been the object of intense conflicts between the federal and the state governments. The ICMS exemption on export operations of primary and semi-elaborated products began as a provisory rule set by law, but was later incorporated into the ADCT. As a consequence, the legal exemption became a constitutional tax immunity. The transfer due to the subnational entities was defined discretionarily at each budget cycle, distributed as follows: 75% for the states and 25% for the respective municipalities. The participation coefficient of each state was fixed.[42]

In order to increase the amount of the transfer and to introduce some flexibility in its apportionment, it was instituted, from 2004 to 2017, the Financial Aid for the Promotion of Export Operations (FEX). It was an atypical voluntary transfer (it was not mandatory or automatic, being approved annually, but dispensed any agreement signing).[43] Altogether, the two compensations (Kandir Law and FEX) totaled, most of the time, R$ 3.9 billion annually, including a portion intended for Fundeb.

However, the STF, on November 30, 2016, decided that the Complementary Law n. 87/1996 was not entitled to regulate the matter.[44] It was defined that a new norm was required. In the event of prolonged omission, the TCU will have to arbitrate the dispute between the federal and the state governments. These latter have demanded annual compensations ten times bigger than those being paid. As a consequence of the standoff, there was no FEX transfer in 2018. The same may occur in 2019 with both the FEX and the Kandir Law transfers.

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41 It also covers acquisitions aimed to permanent assets.

42 Complementary Law n. 115/2002, Annex I.

43 See Judgment by the TCU Plenary n. 2,201/2008 for a critique of the atypical character of this transfer.

44 Direct Action of Unconstitutionality by Omission (ADO) n. 25.

11 CONSTITUTIONAL FUNDS FOR REGIONAL DEVELOPMENT

The Constitution has established three funds for financing private enterprises located in North, Northeast and Midwest regions, known as "constitutional funds."[45] As already pointed out, these are not typical intergovernmental transfers, since the resources are not intended for the states or municipalities. However, the goal of these funds is to reduce regional inequalities, likewise the intergovernmental transfers. Furthermore, they share federal tax revenues, competing with the typical transfers in respect to their sources.

There are three Constitutional Financing Funds, one for each region: North → FNO, Northeast → FNE and Midwest → FCO. They are supported by 3% of amount collected by IR and IPI – the same sources of FPM and FPE – and fund private productive activities in the most in need regions. Their main objectives are to increase the productivity of private enterprises in these regions, generate new jobs, improve tax collection and improve the distribution of income.

The annual transfers by the Treasury compound with the interest and amortization paid by the debtors. Thus, the funds grow both by the addition of new resources (transfers by the Treasury) or by the capitalization of the amounts invested. Of course, the speed of this growth diminishes when defaults occur on loan operations, because, in this case, the interest and the principal do not return to the lending fund.

The resources are administered by state-owned banks: Bank of the Northeast (BNB), in the case of FNE, Bank of the Amazon (Basa), in the case of FNO, and Bank of Brazil (BB), in the case of FCO. They evaluate the credit profile of the debtors and deal with the legal requirements concerning the completion of the credit operations.

A central problem of these funds relates to their internal rates of return. It has been observed that these rates are highly negative, indicating that the funds lose resources at the end of each accounting period. In practice, there is a donation of fiscal resources to private borrowers of subsidized credit. Therefore,

[45] Federal Constitution, article 159, I, *c*.

the funds would simply wear out if the National Treasury did not replenish them periodically. These negative rates of return are the consequence of strong political influence in the allocation of the resources, added to the low managerial efficiency of the funds.

12 NATIONAL PENITENTIARY FUND (FUNPEN)

In 2017, annual mandatory transfers of Funpen budget appropriations were set in favor of funds belonging to the states, the Federal District and the municipalities.[46] These transfers will reach, in 2019, up to 25% of the fund budget, after abating the expenditures and investments of the National Penitentiary Department (Depen). Starting in 2020, the transfer share will increase to 40%.

From the amount transferred, 10% belong to the municipalities in which there are prisons, distributed equitably. The amount received supports programs for the social reintegration of prisoners, interned and discharged or programs for alternative penalties. The other 90% belong to the states and the Federal District. It should be spent on programs for the improvement of the penitentiary system. Its distribution observes the following rules: one third follows the FPE criteria, a third according to the prison population and a third equitably.

This distribution reconciles two criteria: the equalization of the expenditure capacity of the less developed states and the size of the inmate population. It emphasizes the role of the states and the Federal District in ameliorating the penitentiary system and ensures that the municipalities with smaller levels of disposable income, as well as sheltering penitentiaries have the appropriate financial conditions to the address the programs under their responsibility.

Until January 26, 2018, from the amount transferred in 2016 for the creation of places at prisons (R$ 862.5 million), the subnational entities had disbursed only R$ 19 million – around 2% of the funds received. There was not, until February 2018, at the state level, any integral construction of new penal institutions or renovation of existing criminal units with the resources

[46] Law n. 13,500/2017.

received.[47] Neither there was any sign that any construction or renovation would occur until the end of 2018, representing the deadline for the use of the funds transferred. Consequently, the deadline was moved to December 31, 2019 by the Decree of the Ministry of Public Security n. 222/2018.

Therefore, Funpen resources have been accumulated in state funds, little contributing to the generation of prison vacancies and to the improvement of the penitentiary system. The main reasons for the slow expansion of prison places are problems concerning the allocation of land for the construction of penitentiaries as well as bureaucratic obstacles, like the licenses and authorizations required.

13 NATIONAL FUND OF PUBLIC SECURITY (FNSP)

Recently, the FNSP began receiving permanently and continuously a fraction of the gross revenue of lotteries.[48] As a result, it became viable to institute mandatory resources transfers from this fund to the states and the Federal District. The minimum percentage was set at 50% of the lotteries resources channeled to the fund.

These resources can support capital and current expenditures, except personnel and administrative units. Their purpose is to increase the amount spent by the subnational governments in policing, covering the purchase of firearms, uniforms, jackets and vehicles as well as police officers training and investigative and forensic capabilities.

In 2016, the expenses with these activities by the states and the Federal District totaled R$ 4 billion. That year, the FNSP transferred R$ 40.6 million, including deferred payments from previous fiscal exercises, from an authorized budget of R$ 469.9 million. In 2020, the first budget totally conceived according to the new legal framework, it is expected that the minimum mandatory transfers to the states and the Federal District will reach R$ 489.6 million, not considering the effects of the new Instant Lottery.

[47] See Judgment by the TCU Plenary n. 972/2018.

[48] Law n. 13,756/2018.

Regarding the distribution of the FNSP resources, it is up to the current Ministry of Justice and Public Security (MJSP) to set up the criteria for the transfers to the states and the Federal District.

14 AUTOMATIC TRANSFERS OF THE NATIONAL FUND FOR THE DEVELOPMENT OF EDUCATION (FNDE)

FNDE is responsible for the implementation of the educational policies of the Ministry of Education.[49] Its mission is to transfer financial resources and provide technical assistance to the states, the Federal District and the municipalities, in order to ensure a high quality education for all. The resources transfers are divided on three types: constitutional, automatic and voluntary (with agreements).

The constitutional transfers (Fundeb and the wage-education contribution) and the voluntary ones were dealt previously. The automatic, by its turn, are the programs "Brazil Affectionate" and "Money Direct to Schools" (PDDE), and the national programs "School Meal" (PNAE), "Support to School Transportation" (PNATE) and "Public School Restructuring and Acquisition of Equipment for Early Childhood Education" (Proinfância).

The program "Brazil Affectionate" consists in an automatic transfer, without the need of any agreement or any other instrument similar, to defray the maintenance and development expenditures on early childhood education and to contribute to actions concerning integral care and food and nutritional security, as well as to ensure children access and permanence in child education. The resources are intended for students from zero to 48 months enrolled in public or outsourced kindergarten and whose families benefit from the program "Bolsa Família" (family stipend).

The financial support is due to municipalities informing during the previous year school census the number of children enrolled from aged zero to 48 months. The same goes for the Federal District. The transfers are made in two installments. The amount is calculated based on 50% of the minimum annual value per enrollment in public or outsourced kindergarten, integral or partial period, as defined for Fundeb.

[49] Law n. 5,537/1968, amended by the Decree-Law n. 872/1969.

PDDE aims to provide supplementary financial assistance to schools, in order to contribute for the maintenance and improvement of its physical infrastructure and pedagogical resources, elevating the school performance. It also aims to strengthen social participation and school self-management. The transfers are made in two annual installments. The first happens until April 30, while the second happens until September 30 of each year.

It is up to the FNDE Deliberative Council to approve the criteria concerning allocation, distribution, execution, accountability of the resources and the per capita values, as well as concerning the organization and functioning of the executing units.[50]

PNAE offers school meals and food and nutrition education to students of all stages of basic public education. The federal government transfer, to state, municipal and federal schools, supplementary financial resources in ten monthly installments (February to November), covering 200 school days, according to the number of students enrolled in each school network. Currently, the values transferred by the federal government to states and municipalities per school-day for each student is defined in accordance with each teaching stage and modality: nursery → R$ 1.07; pre-school → R$ 0.53; indigenous and quilombola schools → R$ 0.64; elementary and middle school → R$ 0.36; education of young people and adults → R$ 0.32; integral education → R$ 1.07; program for the promotion of full time elementary schools → R$ 2.00; students attending specialized educational care on opposite school shift → R$ 0.53.

PNATE consists in the automatic transfer to defray expenditure on maintenance, insurance, licensing, taxes and fees of the vehicles transporting public basic education students residing in rural area. It also serves to pay outsourced school transportation. The resources are transferred directly to the states, the Federal District and the municipalities in ten annual installments, from February to November. The financial resources allocated annually to the subnational entities are calculated based on the school census of the previous year, multiplied by the per capita value defined by the FNDE Deliberative Council.

The states may authorize the FNDE to make transfer to the municipalities. A formal authorization is required. In the absence of this

[50] Law n. 11,947/2009, article 24.

authorization, each state should manage the resources received, being prevented from making transfers to the municipalities.

Proinfância, finally, aims at ensuring the access of children at daycare centers and schools, as well as at improving the physical infrastructure of early childhood schools. The program is intended to municipalities and the Federal District. It acts according to two main axes: construction of nurseries and pre-schools, with FNDE standardized designs or with projects drawn up by bidders; and purchase of furniture and equipment appropriate to the operation of early childhood schools, such as tables, chairs, cribs, refrigerators, stoves and drinking fountains.

15 FINANCIAL SUPPORT TO STATES, THE FEDERAL DISTRICT AND MUNICIPALITIES (AFE/AFM)

Financial support to states, the Federal District and municipalities is a type of sporadic relief paid by the federal government to the subnational entities. It seeks to meet the demands of these entities in exceptional moments of financial stress. It was granted, until now, in four distinct moments:

a) in 2009-2010 to municipalities, totaling R$ 2.38 billion;[51]

b) in 2010 to states and the Federal District, valuing R$ 800 million;[52]

c) in 2013-2014 to municipalities, valuing R$ 3 billion;[53]

d) in 2018 to municipalities, valuing R$ 2 billion.[54]

In the case of the 2010 and 2013 transfers, the distribution criteria were the FPE or the FPM participation coefficients. The same goes for the 2018 one. In 2009, the sharing criterion was the negative nominal variation of the FPM resources credited between 2008 and 2009. It should be noted that the use of these resources was unconditional (not restricted to any specific area or activity).

[51] Law n. 12,058/2009.
[52] Law n. 12,306/2010.
[53] Law n. 12,859/2013.
[54] Provisional Law n. 815/2017.

FINAL REMARKS

This report summarizes the main fourteen types of transfers from the federal government to states and municipalities. It is based on previous work, drawn up in 2008. During the past eleven years there have been substantial changes in the apportionment of both the FPE, although the practical result was almost zero, and the compensations for the exploitation of petroleum and natural gas, whose consequences have not arisen yet as a result of a judicial injunction. The Kandir Law and FEX transfers were also affected by decisions by the Judiciary and are currently undefined. In parallel, the transfers toward education were expanded, the disbursements for public security policies are being incremented and the emergency financial support to subnational entities gained undisputed legal status.

However, the problems pointed out in 2008 are still largely present, which are: *(i)* excessive complexity of the apportionment rules; *(ii)* overlap between the objectives pursued as well as between the calculation basis of the amounts transferred, generating disputes over scarce resources; *(iii)* inability to close the fiscal gap, with several transfers being ill dimensioned and presenting conflicting effects; *(iv)* induction of strategic behavior by the beneficiaries, as in the case of the stimulus to municipal subdivisions by the FPM "ladder"; and *(v)* moral hazard, with sporadic aid stimulating fiscally irresponsible behavior by subnational entities. It is especially problematic the absence of apportionment criteria focused on the performance of the public policies implemented by subnational entities. The political agents' attention seems to be all concentrated on the input (money allocated), while the outputs (results achieved) are largely ignored when formatting intergovernmental transfers.

What is really new is the recent change of the modus operandi of the Brazilian model of fiscal federalism, driven by decisions in political and legal spheres. In retrospect, in the years following the promulgation of the 1988 Constitution, this model had as defining characteristics: *(i)* the primacy of the executive branch in representing the federal government interests; *(ii)* a finite set of compulsory transfers, based on constitutional provisions; and *(iii)* a multiplicity of instruments for voluntary cooperation between the three

levels of government, anchored on conditional agreements, with defined goals and with or without matching resources from the subnational entities.

After some time, boosted by the principle of federative solidarity in the education and health areas, both backed by the Constitution itself, the instruments for automatic cooperation among the three levels of government multiplied (resources delivered to subnational entities to fulfil specific goals, but without the support of conditional agreements), as exemplified by the FNDE transfers.

Nevertheless, circumstantial factors stimulated the emergence of ad hoc transfers. Provisional Law n. 82/2002, for example, transferred several federal roads to the states. As a compensation, the latter received R$ 130,000 per kilometer transferred. It was a response to the financial difficulties they faced at that moment, not a strategic decentralization decision. In order to mitigate the atypical character of this transfer, it was presented as a counterpart for the assets passed along. Later, it ended up giving rise to the annual transfer of part of CIDE-Combustíveis[55] and the asset exchange was dispensed.

Subsequently, as already pointed out, FEX was created. Its goal was to supplement the funds provided by the compensation for the effects of the Kandir Law, but without observing the fixed apportionment of the latter. At the same time, it was a way of circumventing the challenge of approving a specific law regulating this compensation. In reality, it was simply another instrument of fiscal rescue. This time, in place of the asset transfer, the support sought was the constitutional provision for the compensation of ICMS exemption of exports of primary and semi-elaborated products, even though the legal form adopted was not appropriate, as pointed out by TCU.

As a consequence of the policies combating the 2008 financial crisis, a new level of discretionary transfers was achieved: unconditional ones unsupported by constitutional provision and not preceded by conditional agreements. It was the financial support to states and municipalities, paid sporadically between 2009 and 2018.

[55] EC n. 42/2003.

The most recent example of this tendency of capture of federal revenues is the transformation of fractions of Funpen and FNSP budget appropriations in compulsory transfers to the subnational entities. Now it is even being discussed the redistribution of the signature bonus[56] and the yields of the Social Fund[57], both associated with the exploitation of oil and natural gas. This subject has been constitutionalized[58] not because of the transfers themselves, but as a result of the need to exclude the two transfers of the spending ceiling of the federal government stipulated by the New Fiscal Regime. If not for this restriction, the new apportionment could be defined by law.

The risk is a generalization of the problems observed in the public security area (excessive dispersion and hoarding of scarce resources), impairing the ability of the federal government to coordinate the decentralized implementation of national public policies.

The proliferation of ad hoc solutions for federative issues has been accompanied by a strong judicialization of the disputes. Only in the field of intergovernmental transfers there were, recently, the STF decisions on FPE and the compensation for the effects of the Kandir Law as well as the injunction about the apportionment of the compensation for the exploitation of oil and natural gas. The first decision and the injunction placed state against state. In the first case, the solution was to change the apportionment rules the least possible. The second decision, in turn, places the Union against the states. Its solution remains pending, with significant fiscal risk for the National Treasury. The same can be said about the injunction granted.

The Brazilian federal pact has been going through a non-planned revision, whose consequences on efficiency and intertemporal sustainability of public policies are not yet fully understood. Perhaps the best expression of this revision is the weakening of the federal executive branch role as the main guarantor of the obligations and rights of the Union vis-à-vis the subnational entities. In the case of the recent refinancing of state and municipal debts, for example, Complementary Law n. 148/2014 had a facultative character. So, the Ministry of Finance had some leverage to discuss the terms of the debt

[56] Bill (PL) n. 1.538/2019.

[57] Senate Bill (PLS) n. 264/2017.

[58] Proposed Constitutional Amendment (PEC) n. 78/2019.

recomposition. Nevertheless, this leverage ended up being curtailed by a new law[59] approved, contrary to the established practice, by parliamentary initiative. This understanding was later embraced by the STF in April 27, 2016, in spite of the vote to the contrary by the rapporteur.[60]

In light of the new constraints affecting the functioning of the Brazilian Federation, the chances of a successful program directed to the improvement and rationalization of intergovernmental transfers are quite uncertain. However, it does not make such a program any less urgent.

[59] Complementary Law n. 151/2015.

[60] Writs of Mandamus (MS) n. 34,023, n. 34,110 and n. 34,122 (see article "STF Prorroga por 60 Dias Liminares sobre Dívida dos Estados", available at: http://portal.stf.jus.br/noticias/verNoticiaDetalhe.asp?idConteudo=315388.

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