

**THE GEORGE  
WASHINGTON  
UNIVERSITY**

WASHINGTON, DC

**The George Washington University**  
**School of Business and Public Management**  
The Center for Latin America Issues  
Minerva Program – Fall 2015  
Washington-DC

**PROPER MANAGEMENT OF THE PUBLIC GOOD: PROMOTING EFFICIENCY  
AND EFFECTIVENESS OF PUBLIC SPENDING**

**Author: Giovana dos Santos Itaborai**  
**Advisor: David Brunori**

December 2015

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## Summary

This study aims to analyze the management and quality of public spending willing to introduce possibilities of optimization of the public sector and its organizations to ensure the effectiveness and efficiency of public spending and policies. Clearly the public budget has enormous potential to promote this qualitative transformation, both macro and micro scope. The earmarking of revenues to specific expenditures and the existence of a set of compulsory expenditure on which the government has little or no control, associated with budgetary rigidity are reflected as limiting to the public manager performance, resulting in reduction of free resources, which are essential to achieve the priority projects of any government and the mitigation of allocative flexibility of fiscal policy.

In Brazil, specifically, there are rules for the minimum amount of spending in some areas, such as education and health. A state or municipality may be required to spend more on education because the revenue increased, regardless the number of school children, that can even reduce. Another huge cause of loss in the quality of public spending is the publication of unrealistic budgets in which revenue is overestimated, causing their subsequent contingency.

Thus, it is important to mention that our legislation about public expenditure management system is extremely complex and strict willing to ensure fairness in public administration; however, they impose too much restrictions and tethers for public managers. We can say that, today, in Brazil, the measure of success of a public manager is the accomplished expenditure. A visionary manager can rarely be distinguished from a mere spender manager and an efficient manager who achieves results with lower costs can be even punished with a cut in its budget the following year.

The bad quality of Brazil's public spending can also reflect our low level of investment, if compared to other countries in Latin America. According to OECD, the level of investment, public and private, in Brazil is less than 20% of GDP. Another reason for that is our relatively low domestic saving. Therefore, investment has also been trending down due to policy uncertainties and lack of confidence, especially because of economic crisis that has affected numerous sectors and corruption allegations surrounding national companies, like Petrobras.

Efficiency gains mean increasing the quantity and quality of public services, reaching the intended results, using the same amount of expenditure. Brazil has very high tax burden, of approximately 40% of GDP, and a low return to society with poor quality of public services. It is possible to do more using a lot less.

## **I - Introduction**

In a democratic country, the budget process should reflect, in the best possible way, the choices of individuals, through public managers, with respect to the form of financing and composition of public expenditure. However, as a direct consequence of its democratic character and its function to distribute public resources among the many potential beneficiaries, public budget in our times is the cause of distributive conflict between the various groups in society.

Agents who work in the budget process are driven by different interests, especially regarding the allocation of expenditure. In Brazil, the level of budgetary rigidity is so high, with excess of mandatory and earmarked spending, that in some ways, new expenses can only be financed by new revenues. However, the creation of a new tax depends, to some extent, on the approval of society, and it is only achieved with strong arguments that its creation will be directly linked to the expected benefits to the population.

Thus, the analysis of allocative flexibility of budgetary resources has great importance to evaluate the ability of the government to manage public resources. Such flexibility in the budget of the Federal Government is affected by the excessive degree of revenue earmarking and the high level of constitutional and legally compulsory expenditure.

The first constraint refers to the volume of revenue causing rigidity of the budget in the sense that they cannot be used to finance different expenses than those for which they were created. The expenditure financed by these revenues can be either enforceable in the exercise of their collection or have non-mandatory execution at that period. In the latter case, the funds are raised and allocated in the organ whose revenues are linked, not being used for any other purpose other than that for which they are creation.

The second restriction concerns the continued growth of constitutional implementation costs and/or legally binding, which affect the flexibility of the fiscal policy. These restrictions reduce allocative flexibility of fiscal policy to meet demands of society.

## **II - An analysis of the Public Budget and tax structure in Brazil: An outlook on tax structure in Brazil and the rigidity of the public budget; an overview on law 4320/1964 and law 101/2000.**

### **II.a- Tax Structure in Brazil**

In Brazil, the list of tax competence or constitutional rules establishing criteria for the creation of other rules, in the development of legislative processes, express the ability to create legal rules that directly or indirectly provide for the institution, collection or enforcement of taxes.

The taxing power cannot be delegated, nor be confused with the ability to raise taxes, designated as active tax capacity, that can be delegated, as the forecasting of article 7 of Brazilian National Tax Code. In Brazil, the establishment of tax powers is rigid, segregating the fields of activity of the Federal Government, States and Municipalities<sup>1</sup>. But the tax capacity is malleable, allowing the sharing of collections through joint actions. When it comes to financing, Brazil's Federal Constitution, besides establishing exhaustively taxing power, based the share of revenues also by dividing what has been collected.

As a result, there is a mixed system, which besides granting exclusive tax power, also provides parts of tax revenues from other entities, in order to ensure that the poorest federal units receive enough resources to prevent the expansion of existing disparities<sup>2</sup>. Thus, they seek to overcome inequalities by financial mechanisms with asymmetrical transfer of funds benefiting the poorest.

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<sup>1</sup> SOUZA, Hamilton Dias de. *A competência tributária e seu exercício: a racionalidade como limitação ao poder de tributar*. Revista Tributária e de Finanças Públicas, São Paulo, v. 5, out. 1993.

<sup>2</sup> FERREIRA FILHO, Manoel Gonçalves. *Curso de direito constitucional*. São Paulo: Saraiva, 2001.

The solidarity federalism requires such cooperation. The technique of redistribution of revenues collected by taxation, in order to strengthen, above all, the financial resources of the poorest States and Municipalities is part of the dynamic field of intergovernmental relations of cooperative federalism.

Nevertheless, the participative tonic expressed in the Federal Constitution of 1988, based on financial arrangements to reduce socio-economic imbalances, shows a centralizing force of the Federal Government, responsible for revenue sharing and control of subnational spending which has mitigated the potential for effective participation of States and Municipalities. In parallel to the expansion of federal tax bases that are not subject to distribution, like the special and social contributions provided for in Articles 149, 149-A and 195<sup>3</sup> of the Federal Constitution, the dependence of many subnational entities in relation to the constitutional transfers has increased, especially those provided for in art. 159<sup>4</sup> of FC, generating permanent situations of vulnerability, given the fluctuating cycles these transfers face whose amount can vary from time to time.

The Brazilian federation is currently strongly centered on the Federal Government<sup>5</sup>, which plays a role of tutor of states and municipalities in the financial domain. This centralizing force, shown in the distribution of tax revenues system, obstructs the active voice capacity of subnational entities in the field of public finances, creating a fiscal federalism of passive participation and often conflicting, contrary to the ideal of federal cooperation sedimented in

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<sup>3</sup> These articles talk about social contributions, as well as contribution of intervention on economic activity, professional or economic categories and over public lightning service. The contribution for social security englobes health, pension and social assistance. Despite the fact that revenues from special contributions, in general, are not submitted to distribution, the resources from contribution of intervention in the economic domain on the activities of importation or negotiation of oil and oil products, natural gas and its derivatives and alcohol are supposed to be shared with States and the Federal District and they share with municipalities, according to art. 159,III of the Federal Constitution and art. 1-B of Law 10.336/2001.

<sup>4</sup> This article shows the distribution of income taxes, industrialized products tax, and contribution of intervention on economic activity.

<sup>5</sup> SCAFF, Fernando Facury. Aspectos financeiros do sistema de organização territorial do Brasil. 2005.

equality plans. This distortion in the allocation of tax revenues system has threatened the health of federal relations, making the current fiscal federalism a distortion.

Before specifying the types of taxes it is important to show the concept of them in Brazil. According to Article 3 of the Brazilian National Tax Code, Tax means "all cash benefits, compulsory, in cash or the value of which it can be expressed, which does not constitute an act of sanction, established by law and charged by administrative activity."

In other words, the tax is an obligation of the citizen to the state, which should be established by law and resulting from lawful acts (i.e. excludes criminal acts, which are subject to other penalties - fines, imprisonment, etc.). Nowadays, in Brazil, there are five types of taxes:

- Imposto
- Taxa
- Contribuição de Melhoria
- Contribuição Especial
- Empréstimo Compulsório

We call imposto the taxes people must pay regardless any specific state activity. Impostos are characterized by having compulsory collection and for not giving a return to the taxpayer of the taxable event or property. For example, a tax on car ownership will not necessarily be reversed into improvements on the conditions of urban highways or roads.

Taxa or a fee is the type of tax over specific service that can be shared or measured by each payer, related to a public service provided or made available. It is also related to the power of police administration, encompassing inspections and licensing in general. Not necessarily by



paying the fee, contributor will use the service, it only has to be available. A good example is the fee over garbage collection.

Contribuição de melhoria or contribution of improvement is the tax whose generating fact is the added value over real state as a result of public works. It is charged only in the region benefited from the work. The key to the taxable event is the benefit arising from public works. Thus, the general limit of charging is the cost of the work and individual limit, the added value to each property.

Contribuição especial or special contribution is set out in articles 149 and 149-A of the Federal Constitution and they can be: social, intervention in the economic domain, professional categories and to fund the public lighting service<sup>6</sup>. These contributions have specific purpose and destination, as defined in their establishing law. The contribution for social security is depicted in article 195 of the Federal Constitution which shows its tax event.

Empréstimo Compulsório, or compulsory loan. According to Article 148 of the Federal Constitution, the Federal Government may establish, by a supplementary law, compulsory loans, to meet extraordinary expenses resulting from public calamity, foreign war or the imminence of one; in the case of public investment of an urgent nature and relevant national interest.

The Federal Government (Union) also has two other possibilities for creating taxes:

a) Residual jurisdiction allows the Union to create other taxes, since they are non-cumulative and do not have a taxable event or an assessment basis of discrimination in the Constitution.

This type of tax, once created, should be shared by 20% with the States and federal District;

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<sup>6</sup> The tax power to collect the contribution to fund public lightning service belongs to municipalities and federal district and not the Union.

b) In the imminence or in the event of foreign war, extraordinary taxes can be created, which will be gradually abolished once ceased the causes of their creation.

## **II.b- Rigidity of the Public Budget: earmarking of revenues and mandatory expenditures;**

### **A summary of the main linkages of federal revenues**

After the Federal Constitution of 1988, the Brazilian budget was led to a significant reduction process on the degree of discretion of allocating resources. This movement has been linked to several restrictions on the use of revenues, such as earmarking and constitutional transfers that summed to personnel expenditures, pension, debt, among others, made the allocation of resources extremely rigid, making it harder to adjust them according to the current needs and priorities of society. Around 90% of Brazilian's Federal Budget is composed by mandatory expenditure. In 2015, around 42% was destined to debt, legal and constitutional transfers, 26% to pension, 5% for health and education (each), social welfare 4%, labor 3% and 15% to other expenditures like national defense, agriculture, transportation.

It is important to mention that in 1994 the FSE (Fundo Social de Emergência - Emergency Social Fund) was created in order to make parts of the revenue excluded from the excessive earmarking and allow the application of resources according to the real demands of society. Nowadays the FSE<sup>7</sup> has become the DRU (Desvinculação de Receitas da União – Utying Union Revenues) and the percentage is 20% of federal taxes revenue. There is a project of amendment to the article 76 of the Act of the Transitional Constitutional Provisions though, PEC (Proposta de Emenda à Constituição – Constitutional Amendment Proposal) 87/2015, expected to be voted by the Brazilian Congress, that it will valid the DRU until December 31, 2023<sup>8</sup> and raise the current percentage of 20% to 30% of federal tax free from earmarking. It excludes revenues

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<sup>7</sup> After FSE it became FEF (Fundo de Estabilização Fiscal – Stabilization Fiscal Fund)

<sup>8</sup> The last time DRU was extended it was determined that it would end on December 31, 2015.

from IPI (Imposto sobre Produtos Industrializados – tax over industrialized products) and IR (Imposto de Renda – income tax) from its cover.

The Committee on Constitution and Justice of Citizenship (CCJ) of the House of Representatives has already approved, on November 4<sup>th</sup>, 2015, the admissibility of the extension of the DRU.

With the approval, the three proposed amendments to the Constitution (PECs 4, 87, and 112, all from 2015) extending the DRU in different ways were admitted and may now be considered by a special commission. If passed, it will go to the House plenary, which will have to be voted in two readings.

PEC 87/2015 determines untying 30% of Union's revenues referring to social contribution, but not affecting the payment of expenses of Public Pension of the General Statute; contribution of intervention on public domain; fees and financial compensation for mineral and water exploration to generate power and electricity. The social contribution of education salary, funding programs to the productive sector of the North, Northeast and Midwest of Brazil, financial compensation for oil or natural gas, transfers to States, Federal District and Municipalities concerning education and health and revenues from *impostos* are not included in the untying revenues.

Turning resources free from earmarking allows public managers to adjust them into Brazilian reality and guarantees that the budget will implement priority projects.

The excessive earmarking of revenues can cause distortions in public choices; inadequacy to the dynamics of budget process where spending decisions will not adjust to priorities; loss of tax system quality; excess of resources in certain budget items and shortages in others; generating tax revenue asymmetry between the various organs of government; restrictive effects on public

savings; disincentives to obtain quality public spending by protected sectors; decrease on investments that are generally discretionary spending.

In order to show the size of earmarking of revenues in Brazil, it must be explained also the importance of transfers, not only at federal level, but also to municipalities and states. Transfers of federal funds to municipalities and states are made by three forms: constitutional transfers, voluntary transfers and legal transfers. Constitutional transfers correspond to the resources raised by Federal government and passed to municipalities and states through commandment force established in the Federal Constitution.

The main transfers provided by federal government to the states and Federal District and from states to the municipalities, are the FPE (Fundo de Participação dos Estados - Participation Fund of the States and the Federal District), FPM (Fundo de Participação dos Municípios - Participation Fund of the Municipalities), distribution of revenue of IPI-exportação<sup>9</sup> (Imposto sobre Produtos Industrializados – export of industrialized products tax), FUNDEB (Fundo de Manutenção e Desenvolvimento da Educação Básica e de Valorização dos Profissionais da Educação - Maintenance and Development of Basic Education and Teacher Appreciation Fund), IOF Ouro (imposto sobre operações relativas ao metal ouro como ativo financeiro - tax on transactions relating to gold metal as a financial asset) and ITR (Imposto sobre a Propriedade Territorial Rural - Tax on Rural Property) , financial compensation related on article 20 of the Federal Constitution, according to mineral and water resources exploration.

To summarize the constitutional transfers, we can notice the following:

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<sup>9</sup> The transfer of part of the collection of the IPI-exportação for state, Federal District and municipalities was determined by the 1988 Constitution (Art . 159, item II and §§ 2 and 3 ) and by Complementary Law n. 61/1989 and Complementary Law 65/1991. The Federal Constitution set a 10% transfer of the collection of the tax, in the proportion to the value of their exports of industrialized products. Of this amount, 75% are destined to the states and Federal District and 25% of States to its municipalities.

- Income tax over payroll of States and Municipalities' public employees will be 100% destined to the employer entity;
- 20% of residual tax that can be charged by the Federal Government, as we have previously observed, will be shared with States;
- 29% of the CIDE (Contribuição de Intervenção no Domínio Econômico incidente sobre a importação e a comercialização de petróleo e seus derivados, gás natural e seus derivados, e álcool etílico combustível - contribution of intervention in the economic domain on the activities of import or negotiation of oil and oil products, natural gas and its derivatives and alcohol) will be shared with states, and from what states receive, 25% should be shared with municipalities;
- 50% of ITR (Imposto sobre a Propriedade Territorial Rural - tax on rural property) will be destined to the municipality where the property is located. If the municipality is in charge of supervision and collection of the ITR, it may retain 100 % of the revenues;
- 10% of IPI – exportação (Imposto sobre Produtos Industrializados/exportação – export of industrialized products tax) will be shared with states in proportion to the export value. From this amount, states will share 25% with its municipalities;
- 30 % of IOF – Gold (imposto sobre operações relativas ao metal ouro como ativo financeiro - tax on transactions relating to gold metal as a financial asset) is allocated to the origin state and 70 % to the corresponding municipality;
- 49 % of the sum of IR and IPI are shared as follows: 21.5% to the Participation Fund of the States and the Federal District; 22.5% to the Participation Fund of the Municipalities; 3% for the Financing Program of the productive sector of the North, Northeast and Midwest and 1% to the Participation Fund of Municipalities , which will be delivered in

the first ten days of December of each year and 1% to the Participation Fund of Municipalities which will be delivered in the first ten days of July<sup>10</sup>;

- 50 % of IPVA (Imposto sobre Propriedade de Veículos Automotores - tax on ownership of motor vehicles), which competence is from the state, will be shared with the municipalities where the vehicles are enrolled;
- 25% of ICMS (Imposto sobre Operações relativas à Circulação de Mercadorias e Prestação de Serviços de Transporte Interestadual e Intermunicipal e de Comunicação - Tax on the Circulation of Goods and Interstate and Intermunicipal Transportation as well as Services Delivery and Communications), which competence is from the state, will be shared with municipalities.

Voluntary transfers, on the other hand, are defined on article 25 of Complementary Law No. 101/2000 (Fiscal Responsibility Law - FRL) as the delivery of current or capital resources to another member of the Federation, for cooperation, financial aid or assistance, which is not due to constitutional or legal determination, neither intended for System Health. There are two instruments for the operationalization of voluntary transfers, convênio or agreement, and contrato de repasse or transfer agreement.

Legal transfers are regulated in specific laws. They are parts of federal revenues collected by the federal government and transferred to states, the Federal District and the municipalities. These laws determine the form of license, transfer, investment of funds and should take place as their accountability. The main legal transfers from the federal Government to the states, the Federal District and the municipalities are: PNAE (Programa Nacional de Alimentação Escolar - National School Feeding Program), PNATE (Programa Nacional de Apoio ao Transporte

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<sup>10</sup> IR revenue shall be deducted from the amount received by the states, Federal District and Municipalities, levied at payroll employees.

Escolar - National Support Program for School Transport), PDDE (Programa Dinheiro Direto na Escola - Money Program direct to the School), the Program of Support to Education Systems for Service to Youth and Adult Education, etc.

The FUNDEB (Fundo de Manutenção e Desenvolvimento da Educação Básica e de Valorização dos Profissionais da Educação - Fund for Maintenance and Development of Basic Education and Enhancement of Education Professionals) was created by Constitutional Amendment No. 53/2006 and regulated by Law No. 11,494/2007 and Decree No. 6,253/2007, replacing the Fund for Development of Basic Education and Teacher Appreciation - Fundef, which lasted 1998-2006.

It is a special fund, of an accounting nature and state level (one fund per state and the Federal District, a total of twenty-seven funds), formed almost entirely by resources from taxes and transfers from the states, Federal District and municipalities linked to education pursuant to art. 212 of the Constitution. In addition to these resources, still makes up the Fundeb, as a complement, a portion of federal resources where, within each state, its value per student does not reach the nationally set minimum.

Over the last years, we can see that a great number of laws have been passed to increase the earmarking of revenues and mandatory expenditures, especially to welfare purposes. A good example is Law n. 12.858/2013 that allocates 75% to education and 25% to health of all revenues coming from oil exploration over contracts celebrated after December 3<sup>rd</sup> 2012<sup>11</sup>. It also allocates to education 50% of the resources from the Social Fund, a fund that receives resources obtained from the exploration of oil on the pre-salt layer.

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<sup>11</sup> The resources referred in the law involve Federal Government, States and municipalities’.

This linkage and earmarking might seem fair but it hides a very problematic definition of priorities to public spending in Brazil. A growing number of mandatory expenses to certain categories without a complete discussion about how other expenses will be affected. Some expenditure are already being paid with this resources, so how are they going to be affected when the full revenues get to be designated only to education and health? Studies show that increases in municipal spending on education very often show no connection to improving its education system. The educational achievement of municipalities that produce oil which benefited from large increases in royalties revenues in the last decade and that have promoted an increase in spending on education around 15 % higher than the neighboring cities of the Brazilian coast, have not improved educational indicators. Instead, indicators such as the number of schools for young people and percentage of students dropping school show that the oil-producing municipalities had a worse performance in comparison with other municipalities.

Other cases can be mentioned. Through Federal Constitution amendment n. 29/2000, 12% of net revenue from taxes (imposto) of states should be designated to health. On municipalities, this percentage is even higher, 15%. Besides that, expenditures related to health should be annually adjusted based on GDP growth. Another similar law, n. 11.494/2007, establishes that at least 70% of the transfers from federal Government to FUNDEB must be paid with additional resources to constitutional earmarking of 18% of taxes (imposto).

The excessive linkage of revenues to specific purposes makes the public budget more rigid each day, therefore, it will be harder for future public managers to define priorities to society. Outlining the use of oil exploration resources just to education and health precludes the analysis of the needs in other sectors like infrastructure or public safety that could be financed with these funds.



Also, the Constitution Amendment Proposal of the imposing budget (PEC 358/13) has been approved and it establishes the mandatory implementation of the parliamentary amendments to the budget up to 1.2 % of net current revenue (RCL) held on the previous year. Individual parliamentary amendments in the budget are resources that every congressman and senator is entitled. They direct the money of the amendments to works such as building bridges and health centers, generally in their constituencies. According to the PEC, half the value of these amendments should be applied to health, including the funding of SUS, but may not serve for the payment of personal or social charges.

So it is not hard to realize that the part of the budget that could be used in investments or other sectors that don't receive such earmarked revenues is very limited. Brazil's tax burden is almost 40% and the allocation in federal public investments is, nowadays, less than 2% of its GDP.

### **II.c - The Federal Constitution of 1988 and its mandatory minimum limits on some sectors such as health and education**

Besides the transfers and mandatory expenditure previously observed, article 212 of the Federal Constitution establishes that the Federal Government should apply, annually, never less than 18% and States, the Federal District and the municipalities 25%, minimum, over the resulting tax revenues, included the ones originated from transfers, over maintenance and development of education. The share of tax revenues transferred by the Federal Government to States, Federal District and Municipalities, or by the States to respective municipalities, is not considered revenue from the entity that transfer it.

Public elementary education will have as an additional source of financing the social contribution of education salary, collected from companies. State and local dimensions of the

collection of education salary will be distributed in proportion to the number of students enrolled in basic education in their public networks education.

It is important to mention here again the FUNDEB and its structure. FUNDEB has a complex composition according to article 3 from law n. 11.494/2007, since it receives 20% of a lot of different revenues, like the FPE, FPM, ITCMD (Imposto sobre a Transmissão Causa Mortis e Doações de quaisquer bens ou direitos - tax over transmission causa mortis and donation) that belongs to state power; ICMS; IPVA; portion of ITR; and IPI – exportação. The application of 60% of FUNDEB resources to the remuneration of teachers, provided for in Article 22 of Law n. 11,494/07 is intended to ensure the enhancement of the career of teachers. The Federal Government shall supplement the resources of FUNDEB whenever, in the Federal District and in each state, the amount per student does not reach the nationally set minimum.

When it comes to health, the Federal Constitution, Article 198, paragraph 1<sup>st</sup>, determined that the SUS (Sistema Único de Saúde - National Health System) should be financed by the Federal Government budget, the States, the Federal District and municipalities, as well as other sources. The financial responsibility is shared by the three levels of management in order to guarantee the population their fundamental right to health as well as to ensure the universality and gratuitousness of this system, like foreseen in Brazilian Federal Constitution.

In September of 2000, a constitutional amendment was passed, number 29, which aimed to ensure the minimum resources to finance actions and public health services, and linked the revenues of the three spheres of government to the SUS by setting minimum percentages of resources for the Federal Governments, States and municipalities should invest in this area by amending Articles 34, 35, 156, 160, 167 and 198 of the FC.

With the changes promoted by the Constitutional amendment n. 29, health became part of the actions of public policy for which there should be invested a minimum percentage of funds by federal entities. Otherwise, the non-application of these resources for maintenance actions and public health services would enable the Federal Government intervention in member states, Federal District and municipalities located in federal territories<sup>12</sup>, and states in their municipalities.

States should spend the minimum limit of 12% of the tax revenue the product of numerous taxes such as ITCMD, ICMS and IPVA<sup>13</sup>. Municipalities, on the other hand, should invest at least 15% from the collection of several taxes such as IPTU (Imposto sobre Propriedade Territorial Urbana - real property tax on urban land), ITBI (Imposto sobre Transmissão de Bens Imóveis *inter vivos* – real estate transfer *inter vivos*), ISS (Imposto sobre serviços de qualquer natureza – tax on services of any kind), among others.

After this short brief, it is possible to see how revenues are strongly earmarked through public budget in Brazil, which doesn't give much space for the public manager to adequate priorities in public spending every year. In addition, the budget rigidity phenomenon can be associated with problems to conduct stabilization policies, because there is a delay between the recognition of the economic shock and the implementation of policy actions in response to it, given the slow pace of legislative process. Another common criticism of earmarking is that they're permanent. The links should be constantly reviewed, but they are so intermingled in the financial structure of the public sector that they are not made with the same frequency as conditions change.

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<sup>12</sup> Nowadays Brazil doesn't have any federal territory.

<sup>13</sup> See article 198 of FC and articles 8 and 9 from Complementary Law 141/2012.

## **II.d – An overview over the Law 4,320/1964 and Law 101/2000**

The Law n. 4,320, published in 1964, defines general rules of finance to set the control over the public budget and accounting balance of public entities. It is the basic law applicable to Governmental Accounting, adjusted to the Federal Constitution of 1988. It stipulates general rules of Financial Law to prepare and control budgets and balance sheets of the Union, the States, the Federal District and municipalities. In other words, it establishes procedures that must be obeyed by public managers to deal with public resources. With this law, Brazil adopted the program budget defining also a very advanced classifying system to expenditures at the time that combines different aspects: institutional, in terms of budget units, economic, functional, by program and by object to the level of elements, making it possible to go to the sub-element level and item.

The Fiscal Responsibility Law, FRL, n. 101/2000, focuses on the responsibility over fiscal management in order to improve its quality and avoid damage to public resources as well as to help control mandatory expenditures.

Regarding the experiences of other countries, the FRL incorporates some principles and rules that were taken as a reference like the International Monetary Fund, of which Brazil is a member country, and has edited and distributed some public management standards in different countries; New Zealand, through the Fiscal Responsibility Act, 1994; the European Economic Community, from the Maastricht Treaty; and the United States, whose discipline standards and central government spending control led to the edition of the Budget Enforcement Act, coupled with the principle of "accountability".

The FRL was published to regulate some articles of the Federal Constitution of 1988 like 163. It mentions that a complementary Law will establish rules of Public finances, foreign and domestic

public debt, including foundations and other entities controlled by the Government, granting of guarantees by government entities, issuance and redemption of government bonds; supervision of financial institutions.

It becomes another tool to determine necessary guidelines for a proper execution of the public resources. It did not come as a savior law to remedy all the problems in the execution of public administration, but it has complemented existing laws like n. 4,320/64, which regulates public finances in Brazil. The Law n. 101 seeks for the efficiency in Brazilian public management and fiscal balance in public accounts, bringing some important advances in economic and social terms, requiring a concentration of efforts of all segments involved in the management of public resources.

In this context, despite the remaining big path of improvement, the law is a key tool to emphasize the evaluation of public resources over quality and not quantity, because it establishes limits of expenditure, adequate balance of public accounts, proper use of funds, costs involved and transparency.

The Law brought innovations to the public sector by strengthening control mechanisms and transparency in the use of funds, giving administrators the responsibility for an accurate fiscal management. The responsibility for fiscal management requires planned actions and transparency that aims to prevent risks and correct deviations that could affect the balance of public accounts, through fulfillment of goals, obedience to limits, conditions for revenue resignation and generation of staff expenditure, debt, among others. The same law attributed to the Audit Courts the supervision of the introduced standards. Indeed, Complementary Law n. 101/00 provides regulation for government revenues and expenditures in order to balance these two factors.

Therefore, the Fiscal Responsibility Law draws an integrated system to the three levels of government, individualizing responsibilities of each power and its holders, or replacements in the course of administration of various auxiliary organizations, both direct and indirect public administration. LRF brought a very important contribution to the transparency of fiscal management by defining that tax reports should be widely disseminated, including by ensuring the participation of society in the discussion of PPA (Plano Plurianual - Multi-Year Plan), LDO (Lei de Diretrizes Orçamentárias - Budget Guidelines Law) and LOA (Lei Orçamentária Anual - Annual Budget Law).

It must be mentioned that the Brazilian Federal Senate has been analyzing project law n. 229/09, which presents measures aimed to impact the quality of fiscal management and that should replace Law 4,320/64.

This Supplementary Law is in compliance with article n. 165, § 9 of the Federal Constitution and lays down general rules on planning, controlling and managing public accounting and budget. It establishes responsibilities in the budget process and financial management and also amends provisions of Complementary Law No. 101 of 4 May 2000 (LRF) to strengthen fiscal management.

Currently there are three important projects (PLS 229, 175 and 248 of 2009) in the Senate who intend to revoke Law N. 4320/64 and change the financial administration of public agencies. If approved, they will generate the Law of Fiscal Quality. The new law reinforces and supplements LRF and it does not affect the austerity that LFR deployed in the country. The project seeks to stimulate long-term vision of the budget to reshape the Attachment of Fiscal Goals, a part of LDO. Current legislation only requires such documents for a horizon of two years. The new text

expands it to four years and determines the progressive breakdown of the budget fiscal space, with the aggregation of project costs - both under way and future projects.

When it comes to the budget, the substitute innovates when establishes that the Multi-Year Plan (PPA) of a government should coincide with the candidate's elected government plan as presented in the campaign. The PPA will be a political document because it will reflect the government plan of the elected candidate.

Congress raises the estimated revenues to include the parliamentary amendments and the Executive agrees in order to be able to make discretionary contingency. This mischaracterizes the nature of the budget legislative process, since the Executive shall choose what to fund, ignoring the predictions made in the budget laws.

The purpose of the PLS 229 is that the revenue estimative is made on LDO, which predates the LOA and conditions its formulation. Thus, Congress would be required to confirm the LOA, as provided for in LDO revenues, excluding the possibility of overestimation. The Executive therefore would be unable to practice contingency expenses so expansively.

This law is intended to provide equal treatment of the three spheres of government when it comes to the quality of spending. A major focus will be the requirement to submit an administrative report traction; the government will have to explain what was done, how it was done and why, making room for evaluation and control. It is now being evaluated by the CAE, (Comissão de Assuntos Econômicos - economic affairs comission).

### **III - The creation of special contributions**

Special contributions are defined as qualified taxes. Each contribution represents the specific revenue to fund activities related to the particular field determined by the Federal Constitution.

According to article 149 of the Constitution, there are several special contributions like social, intervention on economic domain, professional and economic categories and service public lighting. Each of them should pay their related activities. It is forbidden to direct their revenues to any activity that is not related to their specific hypothesis.

The Budget is composed of three categories, fiscal budget, Investment and Social Security. Contributions will be distributed according to this model, following its constitutional and legal purposes. The fiscal budget includes all the necessary values the Federal Government needs to maintain its activities, personal and material structure, as well as any funds and organs. This budget receives the revenue of contributions of intervention in the economic domain. These revenues have specific expenses, related to their economic branch of intervention, either through works, programs, infrastructure or even a specific fund.

The investment budget shall include all of investments in companies in which the Federal Government has corporate holding, either for its expansion, or to increase equity. This budget is not appropriate to apply to the collection of special contributions. This understanding is based on the fact that state action in this sector, through public enterprises and joint stock companies, set up direct state intervention in the economy, in order to obtain positive results in competition with the private sector, and there is not, in the constitutional text, provision for special contributions to such allocation. The lack of this forecast results in impossibility of allocation of revenues from other special contributions in this budget, which would set diversion of tax revenue purpose.

Finally, the social security budget comprises all Federal Governments expenses related to social security, represented by health activities, social assistance and welfare, according to social



security provided in article 195 of the Federal Constitution. In this budget all of the revenues from social contributions will be related.

According to article 167, XI of the Federal Constitution, the specific revenues from social security contributions levied on remuneration paid by the employer and on the income of workers and other insured must be designed specifically for the funding of the social security system. Corporate contributions, on the other hand, don't even enter the Union budget. They will be collected and managed by entities that have active tax capacity, delegated by the Federal Government. Finally, contributions to fund the public lighting service, being municipal and district competence, don't belong in the budget of the Federal Government. However, in the budget of the competent entities such revenue should be mandatory for the maintenance of such activity.

We can notice as well that the federal government has been increasing special contributions whose resources are not shared with states and municipalities. Over the years, the federal government began to increase the rates of such contributions like CSLL (Contribuição Social sobre o Lucro Líquido – Social Contribution on Net Profit), COFINS (Contribuição para o Financiamento da Seguridade Social - Contribution to Social Security Financing), PIS/Pasep (Programa de Integração social/Programa de Formação do Patrimônio do Servidor Público - Social integration Program/Public Employee Asset Formation Program) at the same time decreased rates of some federal taxes, such as IPI and income tax, whose revenues will be shared with states, municipalities and the Federal District.

#### **IV – The Public Manager**

In the public sector, the manager has the role to organize and administrate human and material resources that will satisfy wills and desires of the population as well as accomplish and guarantee adequate public policies. The Federal Constitution of 1988 also establishes the behavior of managers in accordance with the constitutional principles of public administration (Art. 37): the principle of legality, impersonality, morality, publicity, efficiency.

It is expected that the manager directs the activity and the effectiveness of public services with impartiality, neutrality, transparency and provides the approach of the population to public services. In this regard, the public manager's role is to promote efficiency and effectiveness in service delivery, adding new values to public administration in support of quality public services.

Although government has a different structure of private sector, there have been many changes in recent decades, requiring very similar quality services to the private sector. The role of public manager in decision-making has fundamental importance to the efficiency and effectiveness of the services provided. Social, economic and political transformations in the contemporary world, combined with the recurrence of sharp criticism and chronic inefficiency in public administration, accentuated pressures for greater efficiency of the public sector.

##### **IV.a – The limited activity of public manager dealing with public resources**

Although Government raises money by charging taxes, these revenues cannot be spent discretionarily. There are some mandatory expenses required, which the government cannot help doing like payment of the public debt, the salaries of public employees, pensions, benefits such as maternity grants and transfers that the Constitution or Law sets among other bindings.

When these compulsory expenditures greatly increase, there is little to cover other expenses that are also important to the country's development, such as improving education, funding of scientific research, road construction, modernization of hospitals and other types of investments. These expenditures are important, but not mandatory, and so they are called discretionary spending.

Such high compulsory spending leaves little room for other expenses, which are those where government can decide what to do. To cover all of this, government either seeks to ensure the efficient use of funds left over or have to collect more tax. The last option is quite doubtful since Brazil already has a high tax burden.

It is important to mention that not all of the money the government collects comes from taxes. Part of it comes from the provision of services such as issuing passports; the sale of a public asset such as land, buildings and vehicles; the receipt of rents; or even by selling bonds that the government puts on the market.

But the government cannot spend all of these resources freely. Besides mandatory expenditure, that we have seen previously, and should be aimed, in part, to certain expenditures as defined in the Constitution or legislation, there are some stamped revenues that can only be used for certain purposes, as defined in legislation. One example is the education salary, a contribution paid by companies to the Federal Government and that can only be used to cover expenditure on primary education.

All of these revenues, which already have allocation defined by the Constitution or law, are earmarked revenues. These revenues guarantee money for a specific area, but end up tying the manager in choosing what actions should be prioritized at any given time.

#### **IV.b – Public Investment in Brazil**

In the complex path taken by public money, a small party of the budget is directed towards investments that can translate into economic growth and improve social indicators. Mandatory expenditures require account for most of what is budgeted by Federal Government, around 90%. Four major items are: the public debt service, social security and welfare benefits, transfers to states and municipalities and expenditures on personnel and social charges.

The government is free to define how to spend only about 10% of the budget, as discretionary spending. Part of this amount is meant by public investment, which will result in the expansion health, education, infrastructure, science and technology etc, like the well-known PAC (Programa de Aceleração do Crescimento - Growth Acceleration Program) whose mission is to account for investments in infrastructure such as the construction of railways, roads, dredging of harbors etc.

Some rules that require further spending in the coming years were also adopted. Spending on health has been linked to 15% of RCL (Receita Corrente Líquida - Net Current Revenue of the Union)<sup>14</sup>, while the PNE (Plano Nacional de Educação - National Education Plan) provides that spending in the area should increase to 10% of GDP until 2024.

Alyzing the behavior of public investment in Brazil from 1995 to 2010<sup>15</sup>, data from IPEA shows that the lowest ratio was in 2003, around 1,5% of GDP and grew up to 2,9% of GDP in the end of 2010. According to government data, including public companies, in 2010 the public

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<sup>14</sup> Constitutional Amendment n. 86/2015.

<sup>15</sup> There are different ways of calculating this rate. For IPEA (Instituto de Pesquisa Econômica e Aplicada – Institute of Economic Research), public investment rate is the ratio of the total gross fixed capital formation of public administration - federal, state and local government - to gross domestic product (GDP) . It is important to note that it does not include investments of state companies, such as Petrobras, or those financed with public banks resources, such as Banco Nacional de Desenvolvimento Econômico e Social (National Bank of Economic and Social Development), Banco do Brasil and Caixa Econômica Federal.

investment, considering Union, States and Municipalities reached 4,8% of GDP. However, following this criteria, public investment shrank to 4,1% in 2011 and stayed the same around 4,4% from 2012 to 2013.<sup>16</sup> Considering just the Federal Government the ratio is about 1,1% of GDP in 2014.

According to IBGE (Instituto Brasileiro de Geografia e Estatística – Brazilian Institute of Geography and Statistics) the total percentage of investment in 2014, public and private, was 19,7% when it was 20,6% five years ago. The launch of the PAC in 2007 increased public and private investment on the three following years, helping to collect of taxes as well.

The need to promote a great fiscal and budget adequacy in order to avoid the contention of expenditure centered in public investment makes it clear that the reduction of public expenditure, notably the current spending, is essential. The size of public expenditure in Brazil has serious macroeconomic implications. It creates funding problems, either by the pressure on public debt, or by taxes level nonstandard for developing countries, resulting in distortions and allocative inefficiency.

There are, though, several legal and political limitations that make it difficult to implement significant changes in public spending in the short term. It is important that every program of public expenditure reduction shall be implemented gradually. The most viable alternative as several authors argue is to get spending growth less than the growth of nominal GDP. This requires reduction of the excessive earmarking and charges of minimum expenditure, without which it is impossible to reduce the future expenditures, and promoting a change on the growth trend of certain expenditures. In Brazil, as we know, the main area where the pressure for increased future spending is already contracted is the area of public pension.

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<sup>16</sup> Until 2013, the MCMV (Minha Casa Minha Vida – My House my life) was classified as current expenditure and after 2013 it started being considered as a public investment.

For all these reasons, the focus of fiscal policy discussion today passes through the sparing use of public expenditure, which should concentrate on the absolutely key areas and should be replaced, where possible and appropriate, for private expenditures. The search for greater efficiency in public spending, not only through programs that allow the reduction of cost, but also for greater budgetary flexibility, enabling the rationalization and reduction of public spending no longer focus exclusively on public investments.

#### **IV.c – Data on Education and Health**

A quick view over Brazil's expenditures with education can show how much has been designed for this area, with rates that are similar to developed countries. But these resources seem to be mismanaged. More important than high expenditures is the result on what the student is learning. On math for example, 67% of Brazilian students is below level 2 of PISA (Programme for International Student Assessment)<sup>17</sup> on a scale of 1 to 6.

After eight years of continuing expansion over education spending, Brazil has reached high national income level of expenditure considering world parameters. But the official goal is even higher. It has been 6,6% of GDP in 2013 which is higher than the rate of 5,6% average between OECD (Organization for Economic Co-operation and Development) countries, most of them rich. The goal for 2024 is to reach 10% of GDP on education. In 2010, when Brazil spent 5,8% of its GDP with education, Japan had spent 3,8% and Norway 6,5%<sup>18</sup>. Comparing the ratio of spending on education over GDP of some countries and the score on PISA evaluation it becomes pretty obvious that higher spending does not always lead to an improvement on quality. Colombia: invests 4,9% of GDP, Costa Rica 6,8% Japan 3,8% and United States 5,2%.

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<sup>17</sup> The assessment made by the Organization for Economic Cooperation and Development (OECD) is applied to on 15 year olds teenagers every three years. The survey measures student performance in three areas of knowledge: reading, mathematics and science. On the last evaluation, among 65 countries, Brazil ranked 58th.

<sup>18</sup> Unesco Institute of Statistics

PISA score in 2012 shows: Brazil 391 points, Colombia 376, Costa Rica 407, Japan 536 and United States 481. From 2003 to 2013 annual spending between federal government, states and municipalities jumped from R\$ 2.213 to R\$ 6.203 per student<sup>19</sup>. It must be mentioned, though, that Brazil has a lot of students, especially on elementary and high school<sup>20</sup>, and when we analyze overall spending over total amount of students, Brazil reaches second to last place.

We can see that the fundamental approach is based on the quality of the public spending with education, and not only establishing goals to reach higher and higher levels of expenditure on this area that is already really high. South Korea, for example, a country with the best performance (in individual terms) in mathematics in OECD, spends per student, far less than the average. The world is no longer divided between the rich and well-educated countries and poor and badly educated countries. Success in education systems no longer depends on how much money is spent, but rather how the money is spent.

In Brazil, studies show that some municipalities that invested more in education over the past decade managed to increase the expectation of years of education and reduce school backwardness and illiteracy rate among young people<sup>21</sup>. However, transforming these investments and the increase in time in school to real learning improvement is a much greater challenge. Estimates show that, on average, municipalities have not yet found a recipe for turning largest resources in better learning.

It is a lot easier to implement policies that increase school attendance and study time than improving the quality of teaching. The relative poor performance on municipalities that produce petroleum indicates that municipalities do not apply extraordinary resources resulting from the

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<sup>19</sup> Inep/MEC and OECD

<sup>20</sup> Elementary and high school have 84,5% of total students in Brazil but only 75% of education expenditure is destined to them.

<sup>21</sup> MONTEIRO, Joana. *Gasto Público em educação e Desempenho escolar*. FGV. 2014.

petroleum activity to improve their education systems. It is not simple to make the transition from basic education system that teaches basics Portuguese and mathematics paragraph into more complex cognitive ability.

When it comes to health, Brazilian government has increased its expenditure over this sector in high proportions. From 2000 to 2012, the average amount per patient rose from US\$ 107 to US\$ 512. Despite this growth, specialists affirm that there should be higher spending since still half of the bill is paid by the patient<sup>22</sup> and the world average is about US\$ 615. As we know, Brazil has established the SUS in order to provide health care to all of its citizen, which can be quite expensive and hard to manage. In developed countries like Japan the average spending per patient is US\$ 3,900. The total amount from GDP destined to health was 9,7% in 2014 and 4,7% corresponds to public expenditure.

These data can show how Brazil has strengthened health and education spending in a progressive growth every year. However, earmarking several revenues to these purposes only, without analyzing the real social demands in a certain period of time or either developing better indicators and monitoring systems can make it really hard for the government to accomplish real improvements in these areas. Society changes, priority changes, average age change, and by making all revenues stuck we can leave a bad legacy to generations to come.

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<sup>22</sup> The rate is estimated on 47,5% of health spending paid by public sector and 52,5% paid by the citizen.



## **V - A parallel with United States**

Considering the current analysis, it is important to expose some structural and operational differences between Brazil and the United States when defining priorities over public spending. These variances are influenced by many factors but especially by budget criteria and tax structure which can define the leading policies of a country, as well as the rules to deal with public revenues and corresponding expenditures.

### **V.a – Fiscal Federalism**

Etymologically, federalism is a system of government in which a Federal State shares the constitutional powers with the sovereign member states, each retaining their own domain of competence. This model of organization allows the exercise of the power in large territories, usually with great cultural, economic and social diversity through the administrative division of the Governments in sub-units: states, provinces, counties, municipalities, cities, districts, reporting to a central sovereign government. This mechanism requires a negotiation between the administrative spheres to establish the division of government functions to be met by each of them, as well as the distribution of necessary resources for the performance of their duties while preserving the autonomy between the parties. This political organization aims to make more efficient the distribution of responsibilities and resources between the different levels of power, in order to reconcile citizens' preferences in with the supply of goods and public services according to available resources.

The federal system of government has the possibility to allow the nation to accommodate a wide range of individual preferences. In the United States, the differentiation of spending and taxation between units may cause a certain competition between jurisdictions with great influence on the policies of revenues and expenditures of state and local governments. The intergovernmental

competition for people and companies shows the influence of the allocative efficiency of resources.

This permits different jurisdictions to compete for residents, both firms and individuals. Federalism induces subnational jurisdictions to attract residents by offering a preferred public good. Competition can maximize preference satisfaction as individuals migrate to jurisdictions that offer the public goods that they desire. A corollary of these characteristics of federalism is that interjurisdictional competition simultaneously acts as a safeguard against strong centralized governments. Allowing potential residents to migrate to jurisdictions that offer goods and services is market-preserving where decentralized governments retain substantial autonomy over the economy within their sphere.<sup>23</sup>

Basically, federal and decentralized political systems vary in the extent to which these governments can decide policy authority, political independence and taxation powers. It characterizes the fiscal relation between central and lower levels of government which is the financial aspect of the development of authority from the national to the regional and local governments. We can say that the first area of competence is the decision making about public expenditure and revenue between different levels of government. Another one is the degree of freedom of decision making covered by state and municipal authorities in the assessment of local taxes and the way they will be used.

The authority enjoyed by local government<sup>24</sup> depends on the range of public services they finance, the sufficiency of the revenues that will finance public services as well as the extent of

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<sup>23</sup> R. Weingast, Barry. *The Economic Role of Political Institutions: Market Preserving Federalism and Economic Development*, 11 J.L. ECON. & ORG. 1, 3 (1995);

<sup>24</sup> In the US, local governments generally include two tiers: counties and municipalities, or cities/towns. In some states, counties are divided into townships. Municipalities can be structured in many ways, as defined by state constitutions, and are called, variously, townships, villages, boroughs, cities, or towns. Various kinds of

the authority that these governments have in the allocation of budgetary resources and the extent of authority in determining the rates of local taxes.

Brazil<sup>25</sup> and the US differ a lot when it comes to the structure of its state and local autonomy.<sup>26</sup>

In the United States, the pattern of federal relations was redrawn from Roosevelt, since his New Deal caused losses of power from state level, with the increase of federal help to States, building the pillars of So-called "new federalism", of more cooperative character. Shortly after Richard Nixon took office in 1969, he proposed an intense restructuring of American government. Nixon believed that federal bureaucracies suppressed creative entrepreneurship and implemented dependency on donations. He called for a New Federalism, a system which directed money and power away from the federal bureaucracy and toward states and municipalities. Nixon considered that this system could respond more efficiently to the needs of the people.

The New Federalism proposed by other president, Ronald Reagan, destined to restore the role of states and local governments to "dynamic laboratories of change in a creative society", through: (i) transfer of important programs undertaken by the federal to state governments; (ii) replacement of "categorical grants", granted for purposes defined and specific conditions to "block grants", which have less restrictions.<sup>27</sup> Local governments, for instance, are pretty valued in the US and their strength has contributed to social and economic development of the country.

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districts also provide functions in local government outside county or municipal boundaries, such as school districts or fire protection districts.

<sup>25</sup> In Brazil, the structure of public entities is constituted by Union, States (also federal District) and Municipalities

<sup>26</sup> Under the Tenth Amendment to the U.S. Constitution, all powers not granted to the federal government are reserved for the states and the people. All state governments are modeled after the federal government and consist of three branches: executive, legislative, and judicial.

<sup>27</sup> SCHWARTZ, Bernard. *O Federalismo Norte-Americano atual. Translated by: Elcio Cerqueira*. Rio de Janeiro: Forense Universitária, 1984. p. 65.

So, in order to provide public services in an efficiently way, they need to be able to raise revenues with minimal interference from higher levels of government<sup>28</sup>.

The US dualist model of federalism structure is currently based on infra-constitutional legislation and judicial interpretation, since there is no provision on composition of revenues and intergovernmental transfers in the Federal Constitution<sup>29</sup>, which is quite objective and synthetic. Each government entity administers its own laws through its own civil service. Thus, it's easier to promote dynamic adjustments according to the cyclical needs of society.

Making a parallel with Brazil, the fiscal federalism there has been altering of centralization and federal decentralization of higher and lower rates of cooperation with different intensities and direct impact on the degree of concentration of financial resources in the figure of the Federal Government. Marked by a dualism of conflicting trends and transition crisis, the Brazilian fiscal federalism is currently expressed within a democratic order and ideally cooperative, brought by the Federal Constitution of 1988.

The Federative Republic of Brazil is constituted by indissoluble union of states, municipalities and Federal District, not fitting on it any possibility of modification<sup>30</sup>. Compared to the previous model, the new constitutional order established in 1988 operated, with respect to the breakdown of tax powers, considerable decentralization, based on increasing the number of state and local taxes, with fortified economic basis. The fiscal decentralization undertaken at the revenue side, was due to the subnational pressure for greater participation of tax revenues.<sup>31</sup>

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<sup>28</sup> BRUNORI, David. *Local Tax Policy, a Federalist Perspective*. The Urban Institute Press. 2003 p. 26.

<sup>29</sup> Each state has its own written constitution, and these documents are often far more elaborate than their federal counterpart.

<sup>30</sup> The US Federal Constitution allows the union of two or more states, or parts of them as long as there is authorization of the legislative of the states as well as Congress authorization.

<sup>31</sup> ANDRADE FILHO, Luiz Marques de; SANTOS, Reginaldo Souza. *O federalismo fiscal e as finanças públicas no Brasil dos anos noventa*. Revista de Desenvolvimento Econômico, Salvador, v. 2, n. 3, jan. 2000.

## **V.b – Tax Structure**

The US Tax System is depicted in the Constitution of the Country, especially in the 16th amendment, which in 1913 authorized the establishment of the income tax; in the Internal Revenue Code, that is the code income tax; and in the Treasury Regulations, which are regulations issued by the Treasury, which interprets the Internal Revenue Code. There are also the Revenues Rules that contains more specific guidance emanating from the financial administration and direct guidance to taxpayers (Private Letter Rulings). Also understood as a source of tax law are the precedents and the parliamentary discussions preceding the institution of tax rules. It is up to the tax authorities, also based on the business concept purpose, disregard transactions that only minimize the load tax the taxpayer with no real business intention.

US tax system is marked by the voluntary compliance idea, where it is expected that taxpayers report all winnings to be taxed on behalf of the common good. The United States of America adopts the demarcation criteria of international taxing power nationality, consisting of taxing the income of citizen no matter the residence or where income was earned. The critic that arises from this model is that it opposes to the idea of justice taxing individuals who do not benefit from the services that the state provides. It is, however, augmented that Government protects the national offers abroad.

The biggest part of the revenues comes from income tax, whose hypothesis of implications for the individual is the realization of capital income and remuneration for work. For legal entities, sales and services are taxed, and discounts in operating costs and expenses are allowed. There is federal tax on the payroll (payroll tax) whose allocation is social security. In federal level, individual income tax is the major source of revenues, followed closely by Social Security and

other payroll taxes. As a revenue source, the corporate income tax is in third place<sup>32</sup>. Other taxes contribute to smaller portions of federal revenue such as custom duties, levied on imports, and excise taxes as well.

Sales and use taxes are among the most important sources of state revenue<sup>33</sup>. Sales tax is state competence that focuses on the consumer. It is the main source of revenue for American States. Almost all of the 50 states (45) have instituted some type of general sales tax. In 10 of these states, sales tax accounts for more than 40% of tax revenue and the rates vary from 2.9% to 7 per cent. The values are separated from the product price. There are though, forty-one states and the District of Columbia, which impose a broad-based personal income tax which account for about one-third of total state tax revenue in the US<sup>34</sup>. Most of the states impose low rates, around 7%, and for Americans who itemize their federal tax returns, state personal income tax is deductible.

Many economists affirm that sales tax should be applied to consumer services as well, yet they are exempt in most states imposing sales tax which results in considerable loss of revenue for the states. Still on State competence there is property tax on three types of property: real property, tangible personal property and business property<sup>35</sup>. The corporate income tax is levied by forty seven states and also franchise taxes are levied by some states like Delaware and charged to certain business organizations such as corporations and partnerships with a connection in the state. They represent a very small part of states' revenues, around 2% of tax and non-tax revenues. Besides those, altogether states administer hundreds of different types of

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<sup>32</sup> In 2015 individual income taxes accounts for about 47% of federal tax revenue, followed by payroll taxes, 33% and corporate income taxes, around 11%.

<sup>33</sup> BRUNORI, David. *State Tax Policy, a Polititcal Perspective*. The Urban Institute Press. Second Edition. 2005. P. 53.

<sup>34</sup> BRUNORI, David. *State Tax Policy: A political perspective*. The Urban Institute press. 2005. Second Edition. P. 71.

<sup>35</sup> BRUNORI, David. *State Tax Policy: A political perspective*. The Urban Institute press. 2005. Second Edition. P. 107.

taxes whose most important categories include excise<sup>36</sup>, severance<sup>37</sup>, wealth transfer and property taxes.

Property taxes are usually paid to a local government, a school district or a county government. It is imposed by counties in 45 states, municipalities in 49 states, townships in 24 states, school districts in 42 states and special districts in 20 states<sup>38</sup>. However, continuing efforts to limit property taxes have forced local governments to focus on alternative taxes like local-option sales taxes and excise taxes which generate billions of dollars in revenues. 33 of the 45 states imposing a sales tax allow their local governments to impose similar taxes. There are some differences between sales tax and excise tax since the first are ad valorem and have general applicability and the other is imposed on a per unit basis and is imposed only on designated items. Besides consumption taxes, many local governments impose levies on personal income and wages as well as business activities, but they are not very common.

Grants are also taxed (gift taxes<sup>39</sup>) as well as the transfers of assets (estate taxes<sup>40</sup>) which are both transfer taxes. However, more than half of the revenue collected by local governments comes from sources other than taxes which are intergovernmental aid (especially from states); user fee and charges and the operation of utilities. The Municipalities can charge a municipal income tax. Since States and Districts federation may also establish and charge income tax (typical example is the case of New York City) the taxpayer is entitled to deduct the federal level of the amounts already paid to states and districts.

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<sup>36</sup> Excise tax is also called special sales tax and they are imposed over products like alcohol, fuel, tobacco, hotel rooms, car rentals, telecommunications among other products and services.

<sup>37</sup> Severance taxes are levied on nonrenewable natural resources extracted from lands and water.

<sup>38</sup> BRUNORI, David. *State Tax Policy: A political perspective*. The Urban Institute press. 2005. Second Edition. P. 46.

<sup>39</sup> If you give someone money or property during your life, you may be subject to federal gift tax.

<sup>40</sup> The estate tax is a tax on your right to transfer property at your death.

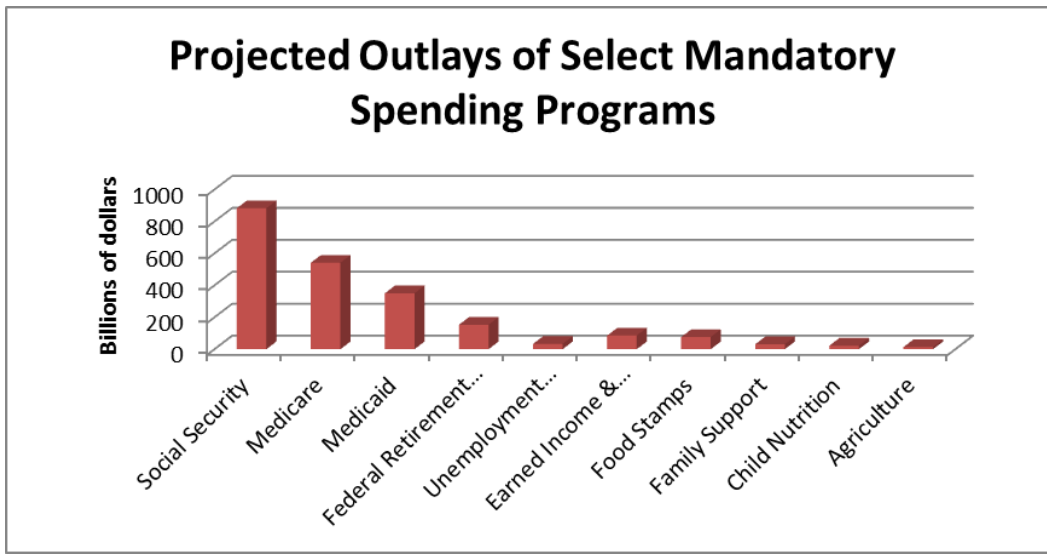
## **V.c – Mandatory and Discretionary Expenditures**

There are three groups of spending in federal government: mandatory spending, discretionary spending and interest on debt. According to the Congressional Budget Office, mandatory spending accounts for more than 60% of the federal budget in 2015. The graph below shows the projected amount, in billions of dollars, spent on select mandatory programs like Social Security, Medicare, and Medicaid. Mandatory spending is federal spending that is spent based on existing laws rather than the budgeting process. This spending is mainly comprised of entitlement programs, such as Social Security and Medicare whose spending criteria is determined by who is eligible to apply for benefits and not by Congress. Discretionary spending, on the other hand, is the portion of the budget that the president requests and Congress appropriates every year through legislation. For 2015 the estimate of US\$ 2.38 Trillion mandatory Spending and US\$ 1.05 trillion of discretionary spending like national defense, education, unemployment and labor, international affairs, energy and environment, housing and community, among others.

Federal outlays in 2015 will equal 20.3 percent of GDP, CBO estimates, which is the same as last year's percentage and only slightly higher than the 20.1 percent that such spending has averaged over the past 50 years. But the mix of that spending has changed noticeably over time. Mandatory spending is expected to equal 12.5 percent of GDP in 2015, whereas over the 1965–2014 period, it averaged 9.3 percent. Meanwhile, the other major components of federal spending have declined relative to GDP: Discretionary spending is anticipated to equal 6.5 percent of GDP this year, down from its 8.8 percent average over the past 50 years, and net outlays for interest are expected to be 1.3 percent of GDP, down from the 50-year average of 2.0 percent (see Figure 3-1 on page 62). Discretionary expenditure includes most federal spending on research, education, training and infrastructure (though not highways). Most of US Federal



Government's contribution to the nation's productive capital is discretionary and vulnerable to changes. At the same time, mandatory programs, which don't need annual authorization and include most of the social safety net, will increase to 14.1% of GDP by 2025 from 10.1% in 2007, according to the CBO.



Source: Congressional Budget Office

Many mandatory programs' spending levels are determined by eligibility rules. For example, Congress decides to create a program like Social Security. It then sets criteria for determining who is eligible to receive benefits from the program, and benefit levels for people who are eligible. The amount of money spent on Social Security each year is then determined by how many people are eligible and apply for benefits.

Congress therefore does not decide each year to increase or decrease the budget for Social Security or other earned benefit programs. Instead, it periodically reviews the eligibility rules and may change them in order to exclude or include more people, or offer more or less generous benefits to those who are eligible, and therefore change the amount spent on the program.

Mandatory spending makes up nearly two-thirds of the total federal budget. Social Security alone comprises more than a third of mandatory spending and around 23% of the total federal budget and 4.9% of GDP. Medicare makes up an additional 28% of mandatory spending and 3.5% of GDP.

#### **V.d – Federal Budget Process**

The U.S. Constitution designates the "power of the purse" as a function of Congress. That includes the authority to create and collect taxes and spend public money for the national government. However, the Constitution does not specify how Congress should exercise these powers or how the federal budget process should work. Thus, the budget process has changed over time. Congress passed laws over the last decades that shaped the budgeting process into what it is today, and formed federal agencies like the Office of Management and Budget, the Government Accountability Office, and the Congressional Budget Office.

The budget process begins when the President submits a budget request to Congress. The President's budget is formulated over a period of months with the assistance of the Office of Management and Budget, the largest office within the Executive Office of the President. The budget request includes funding requests for all federal executive departments and independent agencies. Budget documents include supporting documents and historical budget data and contain detailed information on spending and revenue proposals, as well as policy proposals and initiatives with significant budgetary implications. The President's budget request constitutes an extensive proposal of the administration's intended revenue and spending plans for the following fiscal year.

In March, the CBO publishes an analysis of the President's budget proposals (budget report). CBO computes a current-law baseline budget projection that is intended to estimate what federal

spending and revenues would be in the absence of new legislation for the current fiscal year and for the coming ten fiscal years. Considering the CBO budget report, the budget committees consider the President's budget proposals, and each committee submits a budget resolution to its house by April 1. The House and Senate each consider these budget resolutions and are expected to pass them, possibly with amendments, by April 15.

Congress creates a new budget every year. This annual congressional budget process is also called the appropriations process.

Appropriations bill specify the amount of money destined to specific federal government departments, agencies, and programs. The money provides funding for operations, personnel, equipment, and activities. Regular appropriations bills are passed annually, with the funding they provide covering one fiscal year<sup>41</sup>. Appropriations bills are under the jurisdiction of the United States House Committee on Appropriations and the United States Senate Committee on Appropriations. Both Committees have twelve matching subcommittees, each tasked with working on one of the twelve annual regular appropriations bills.

Congress must also pass legislation that provides the federal government the legal authority to actually spend the money which is called authorization bills or authorizations. Authorization bills often cover multiple years, so authorizing legislation does not need to pass Congress every year the way appropriations bills do. Authorizations also serve another purpose. There are some types of spending that are not subject to the appropriations process like the mandatory spending.

There are three types of appropriations bills: regular appropriations bills, continuing resolutions, and supplemental appropriations bills. Regular appropriations bills are the twelve standard bills that cover the funding for the federal government for one fiscal year and that are supposed to be

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<sup>41</sup> The fiscal year is the accounting period of the federal government, which runs from October 1<sup>st</sup> to September 30th of the following year.

passed into law by October 1. If the budget process is not complete by Oct. 1, Congress may pass a continuing resolution so that agencies continue receiving funding until the full budget is in place. Such resolution will provide temporary funding for federal agencies until new appropriations bills become law. If Congress does not pass a continuing resolution by October 1, there can be a government shutdown, as in 2013. Finally, third type of appropriations bills are supplemental appropriations bills, which add additional funding above and beyond what was originally appropriated at the beginning of the fiscal year. Supplemental appropriations bills can be used for things like disaster relief. Sometimes government has to respond to unexpected circumstances for which there is no funding, such as natural disasters. In such cases, government must allocate additional resources.

Appropriation bills are part of the complex budget process that is preceded by the president's budget proposal and Congressional budget resolutions. Thus, the main steps in the federal budget process involves the President submitting a budget request to Congress; the House and Senate writing and voting their budget resolutions; House and Senate Appropriations subcommittees determining the precise levels of budget authority, or allowed spending, for all discretionary programs; The House and Senate voting on appropriations bills from each of the 12 subcommittees; The President signing each appropriations bill and the budget finally becoming law.

According to the U.S. Constitution, allocation of all funds from the U.S. Treasury (e.g., tax revenue) must be outlined within a piece(s) of legislation and ratified. Article I, Section 9, Clause 7 imposes accountability on Congressional spending:



*No money shall be drawn from the Treasury, but in Consequence of Appropriations made by Law; and a regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time.*

That means that Congress must have appropriated by law the funds to be spent before they can be released from the Treasury. It serves as a powerful check of the legislature on the executive branch and as a constitutional check and balance on the administration itself.

When Congress can't agree on 12 separate appropriations bills, it will often resort to an omnibus bill - a single funding bill that encompasses all 12 funding areas. The fiscal year 2015 budget was the result of a combined omnibus and continuing resolution enacted by Congress in December of 2014.

### **V.e – Tax Earmarking**

Earmarking is the budgeting practice of dedicating tax or other revenues to a specific program or purpose. Such practice usually involves depositing tax or other revenues into a special account from which the legislature appropriates money for the designated purpose. In general, the funding received by the recipient earmarked tax revenue is limited to those tax revenues. There are cases though, where earmarked tax recipients will have additional funds from the general budget allocated to it, for example, schools are usually funded by property taxes, but failing inner-city schools will often receive additional federal aid. Additionally, taxes on gasoline are generally used to pay for highway construction, lottery profits at state level are commonly earmarked to education as well. The average earmarked share of state tax collections has remained near 23%.

In the context of federal budgeting, the term 'earmark' is used in two distinct ways. First, it may refer to expenditure, paid from the general fund that has been specified to apply to a particular

local project, usually within the congressional district of the provision's author<sup>42</sup>. Second, an earmark may refer to the dedication of a discrete revenue to a particular program within the federal budget, regardless of whether that program is local or national in scope<sup>43</sup>. Earmarked revenues are used to fund programs of various sizes, ranging from Social Security and Medicare to conservation projects funded from General Service Administration property sales. Earmarked revenues may fund programs that relate directly to the source of the funding or programs that bear little relation to the source of the funding<sup>44</sup>.

Among US specialists the critics to earmarking revenues are very similar the ones observed in Brazil's case. While increasing the visibility of cost-sharing arrangements and ensuring a minimum level of programmatic funding, the Government Accountability Office argues that earmarked revenues diminish the capacity to annually adjust program priorities, lengthen the time it takes to make necessary modifications in an individual program's funding level, increase the probability of over-funding certain programs (since a decrease in programmatic needs is not directly linked to the associated revenue formula), and impair deficit reduction efforts by guaranteeing minimum spending levels. Others suggest that the increasing practice of earmarked revenues is part of a broader "new outlook" on budgeting that tends to limit the flexibility of future budget makers as they realize that past decisions have already committed resources to particular goals and projects<sup>45</sup>.

Another common problem in the US earmarking for specific projects is called "orphan" earmarks. There are cases in which not a single dollar has gone toward its intended purpose,

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<sup>42</sup> PORTER, Rob; WALSH Sam. *Earmarks in the Federal Budget Process*. Briefing paper 16. Harvard Law school. Federal Budget Policy Seminar.

<sup>43</sup> Earmarked appropriations include many projects that are typically referred to as "pork".

<sup>44</sup> GAO Fact Sheet, *Budget Issues: Earmarking in the Federal Government* 3-5 (1990).

<sup>45</sup> MEYER, Annette E. *Evolution of United States Budgeting*. 2002.

sometimes because of basic typographical and procedural errors. Lawmakers may include the wrong name of the project or direct money to projects that cannot be built.

However, in Congress, since 2011 earmarking has been banned as a republican initiative prohibiting the pork barrel spending. For conservatives, it is considered as symbol of wasteful federal spending, typically referred to items inserted by member of Congress into bills directing dollars to specific projects back home. Earmarks had been, admittedly, abused. They had increased in number and size through the 1990s and 2000s, and some House and Senate members used them to direct funds anonymously to questionable projects, a few of which weren't remotely close to their districts.

## **VI – Conclusion**

The frequent budget deficits that happen in Brazil, as well as in many other countries, are due to several reasons but especially to the disconnection between taxing and spending decisions or expenditures and revenue policies. Despite being made separately, they are directly interconnected. Larger deficits today will lead to larger debts, as well as an increase on tax cuts if there is not simultaneous cut on spending. Thus, the tax side of the budget must be in equilibrium with the spending part. Policymakers should be able to reduce budgets in the same way they have increased them. But they are not. Without the ability to significantly reduce or eliminate individual spending programs it is quite hard to imagine that policymakers can promote budget cuts. Worried about being elected, politicians avoid being criticized by public opinion by cutting spending for example, since it will always affect some groups in society, or a lot of them.

Besides that, we have seen how rigid federal budget in Brazil has become, so not all areas of the budget are equally susceptible to cuts. The Federal Constitution of 1988 caused an

immobilization of fiscal policy in Brazil, due to a considerable increase in compulsory expenditure especially in the social area, a greater share of federal government revenues with the subnational entities and the "protection" of some areas such as education and health, characterized by the minimum requirement for implementing resource annually. In order to finance such expenditures, the federal government chose to increase the tax burden which occurred especially through contributions, particularly those linked to social security, that are not shared with states and municipalities. The combination of these factors led to a rigid budget at federal level, significantly covering its fiscal policy, characterized by shortage of free resources for priority areas, especially for investments. As a result, the government made use of some decoupling mechanisms revenues, starting in 1994, as the FSE/FSF/DRU.

In addition to this increase in the earmarking of revenues, there was also significant growth in mandatory expenses such as pension, personal, social welfare and health. The effort to untie revenues was accompanied by increased allocation of resources to the Social Security and mandatory expenditure. These factors show that DRU is an important temporary facility, but it does not solve the issue of flexibility of the fiscal policy.

A major step was given with FRL n. 101 which defines criteria for the creation and expanding of expenditure. However, a lot of structural changes are necessary to increase the flexibility of fiscal policy and hence the government's ability to meet other demands of society. In order to enable public managers to better organize their budgets, directing public spending to take care of more persistent demands, it is necessary, unquestionably, to review the current legislation and promote a tax reform. Such reform must be accompanied by changes in the distribution criteria of constitutional and legal transfers and the earmarking of revenues.



Some might say that in developing countries, governed by weak democracies, earmarked taxes revenue provide the public greater assurance that the public managers aren't simply wasting tax revenues on personal extravagances. Assuming that the tax is placed on a fairly stable source, earmarked taxes allow beneficiaries to plan useful long-term projects based on a projected annual income. It might also provide protection for priority programs against shifting majorities, inefficiency and corruption.

However, skepticism about earmarking is justified because in general it hasn't worked very well. It is really difficult to set up taxation arrangements that lead to an appropriate allocation of services. There are a lot to consider before setting an earmarking scheme such as analyzing the essentiality of earmarking to ensure service quality; also analyzing if the revenue arrangement will automatically lead to the appropriate levels of the service; if there is a competent agency to carry out the program or direction of specific revenue to be used in a certain purpose and appropriate accounting and auditing to protect against any abuse; if there is a cutoff date for deciding whether the earmarking arrangements should be continued or they will be *ad eternum* promoted even if there is a reduction of related calculation base like the number of students in the education case in Brazil for example?

It is noticeable that earmarking leads to a misallocation of resources, with too much being given to earmarked activities and not enough to others. It makes budgetary control harder, infringes on the powers and discretion of public managers, and imparts inflexibility into budgets, it makes changes come with a lag and earmarking systems continue after their usefulness has been served. The resulting expenditures may not have to meet the same rigorous evaluation as other budgetary expenditures and thus funds may be diverted to low priority projects or used in needless spending.

It is hard to find guidance about the ideal performance criteria earmarking should have to be considered satisfactory. Little is said about how earmarking might be implemented or whether it is suitable or not. Most practical literature evaluating earmarking in several countries and sectors consider it to be negative.

There have been cases of successful earmarking such as revenue sharing between national and subnational levels and social security revenues applied to social security beneficiaries, however, requiring specific taxes or revenues to finance certain narrow government expenditure program has not been successful. Besides, earmarking appears to work more successfully in local governments where the correspondence of beneficiaries and taxpayers is closer.

It does not mean that a budget should be a 100% free. There has been, however, exponential growth in earmarked revenues and mandatory spending in Brazil. Around only 10% of Brazil's budget is composed by discretionary expenditure and mandatory spending continues to increase. It is suggested that earmarking scheme should meet a series of prerequisites to make sure that it in fact represents an improvement. Naming a few, evaluating if there is a strong link between beneficiaries and tax payers; assessing if earmarking is necessary to ensure certain level of the service; if the source of revenue arrangements for the correspondent expenditure will lead to appropriate level of resources and meet the expected demand; if the revenue arrangement will have distortionary effects on the allocation of revenues like inflation or deadweight losses; if there is an appropriate investment program and a clear set of rules for decision to administrative overheads; if there is a strong set of controls to prevent the misuse of funds; if there is an agency in charge of planning and evaluating results; and finally, like previously mentioned, if there is a cutoff date to decide whether earmarking arrangements should be continued or not.

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