Another Attempt to Reform Brazil’s Intergovernmental Financing Arrangements: Preliminary Results and Future Prospects

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Since the mid-1990s, Brazil has struggled, with limited success, to reform its intergovernmental financing arrangements. Every four years, the electoral cycle brings promises of much needed reforms. Recently, Brazil had an unusual window of opportunity to promote such reforms, brought about not by another electoral cycle, but by Supreme Court rulings and changes to its oil exploration regime. This note takes stock of the proposed and realized reforms and simulates their impact for state governments in Brazil.

In contrast to most Latin American countries, the extent of revenue decentralization in Brazil is comparable to Organisation for Economic Co-operation and Development (OECD) levels. However, Brazil’s subnational finances are fraught with complexity, inefficiency, and intrafederative conflicts, leading to several reform attempts over the years that have been incomplete or unsuccessful. Inefficiencies include an overly complex state-level value-added tax (VAT) that favors a “race to the bottom” in the granting of tax incentives by states; a rigid intergovernmental transfer system; and political pressures to revisit the subnational borrowing framework that has helped support the country’s fiscal sustainability prospects. Such weaknesses have constrained the country’s long-term growth prospects.

External factors are forcing changes in the current subnational fiscal framework. Recent Supreme Court (STF) rulings affected both intergovernmental transfers and ICMS (Imposto sobre Circulação de Mercadorias e Serviços, VAT), prompting Congress and states to respond. The debate on the new oil exploration regime also impelled the legislative branch to change the oil royalties–sharing scheme. Finally, states and municipalities have been lobbying continuously for a renegotiation of the terms of their debt to the federal government.

Key Issues in Brazil’s Subnational Fiscal Framework

The main deficiencies of the Brazilian fiscal federalism framework manifest in different forms. They can take the form of: a “fiscal war” among states in the federation; ample heterogeneity in terms of vertical imbalances at the subnational level; and the tensions in establishing limits to and controls on subnational borrowing.

Indirect taxation

ICMS poses myriad problems. While it retains VAT-like features, the ICMS differs from similar arrangements in other countries in that its revenues are collected and administered by state governments. The legislative framework is set by a federal law, but states can issue local regulations within the broad federal rules. While states have autonomy to set internal rates, the Senate is responsible for setting interstate tax rates. The ICMS operates under a mixed origin-destination system in which the interstate tax rate is used to split the revenues of interstate transactions between the producing (origin) state and the consuming (destination) state.

The sizable differences in the interstate tax rates provide ample space for poorer states to implement tax incentives to...
attract investors, fueling the so-called fiscal war. These fiscal incentives are irregularly awarded tax breaks aimed at persuading firms to choose to operate in the grantor state—with- out the approval of the collegiate body, the National Council of Fiscal Policy, as required by law. Because of the mixed origin-destination principle, tax incentives given by the produc- ing state have to be honored by the consuming state, therefore diminishing its revenues. As a result, the spatial allocation of resources is distorted, the competitiveness of richer states is reduced, and the ICMS revenues from manufacturing (the most affected sector) are diminished.

Intergovernmental transfers
The States’ Participation Fund (FPE, Fundo de Participação dos Estados)—the main revenue-sharing unconditional transfer from the federal government to the states—has also been at the center of the subnational fiscal policy debate. The FPE operates through fixed coefficients, adopted in 1989, which were only supposed to be temporary, as law 62/1989 envisaged their replacement by new variable coefficients through another bill. While the FPE remains broadly redistributive, the continuing use of fixed coefficients overlooks significant changes in regional development during the past two decades. In particular, the current calibration does not take into account the fact that the Center-West Region and some north- eastern states have significantly developed over the past decades, suggesting that their respective coefficients may be biased upward.

While a new law on the FPE had not been voted on in Congress until recently, the old FPE sharing criteria were ruled unconstitutional by the STF on February 24, 2010. The STF then required that new rules be put in place by end June of 2013.

Oil and mining royalties comprise another type of transfer to states that is undergoing reform. The distribution of resources from petroleum—especially royalties—also suffers from significant asymmetry, but of a different kind: high concentration in producing states. As for the mining royalties (CFEM), the recent commodity boom and the large amount of oil royalties collected opened the government’s eyes to the need to reform outdated mining regulations and to increase currently low revenues from mining royalties.

Subnational debt
Subnational debt distress in the late 1980s and 1990s led to three rounds of renegotiations between states and the federal government to restore subnational debt sustainability. The first two rounds occurred in 1989 and 1993. The last and largest renegotiation for states took place from 1997 to 1999, leading to the restructuring of nearly 12 percent of the national debt stock. This restructuring was the most comprehensive, including subnational bonds, and was conditioned upon states’ compliance with medium-term fiscal adjustment and structural reform programs agreed upon with the Na-
changed. From 2016 onward, each state will receive the same value as per the previous year, adjusted for inflation (IPCA), plus 75 percent of Brazil’s GDP growth rate. If the total amount of the FPE envelope is higher than the sum of the adjusted FPE values, then the surplus would be distributed in direct proportion to the share of population of each state and in inverse proportion to their per capita household income. The population shares have a lower bound of 1.2 percent and an upper bound of 7 percent, benefiting the least populated states.

In turn, while the current proposal to change the distribution of oil royalties has been under discussion for a few years, it remains mired in controversy. Initially, when the government proposed a change in the oil exploration regime in 2009, its intention was not to change the distribution rule. However, Congress amended the law to redistribute all royalties—old and new contracts, concession and production-sharing regime—accruing to SNGs according to the FPE and FPM coefficients. Under this amendment, the federal government would compensate the losing states with its share of the royalties. These changes were vetoed by the president and the original rules set in 1997 were maintained. In 2012, Congress approved another law (12.734/12) that set the royalty rate at 15 percent for the oil-sharing regime, instead of the current 5 to 10 percent rate, but no special participation payment was foreseen. The law also changed the royalty and special participation distribution in favor of nonproducing states in both new and old contracts. These changes were again vetoed by the president, and an Executive Order (MP) established new royalty distribution rules for contracts signed after December 3, 2012.

Lastly, the federal government sent to Congress a draft law to institute a new landmark regulation regarding mining activities. Specifically, the government’s proposal envisages a change in the tax base from net revenues to gross revenues for mining royalties. The tax rates would be set by decree for each ore, respecting the maximum tax rate of 4 percent. The revenue-sharing scheme between government levels was maintained.

The debate on subnational debt focused primarily on changes to the indexation rules and concerns about debt sustainability. The centerpiece of the federal government’s proposal was a change in the interest rates accruing to the renegotiated debt of the states and municipalities. Currently, SNGs pay interest rates of 6 percent, 7.5 percent, or 9 percent on top of the adjustment by the General Price Index (IGP-DI). The proposal aimed to reduce this interest rate from January 2013 onward to 4 percent on top of IPCA or simple SELIC interest rate accrual, whichever is lower. However, it did not change the debt service ceiling, which varies from jurisdictions, ranging from 12–15 percent of net real revenues (NRR).

The Senate committees modified the proposal to make the changes in the indexation clauses and interest rate retroactive to the beginning of the contract, but only for those SNGs whose accrued interest was higher than the accumulated SELIC for the same period.

The Outcome of the Reforms

Out of the five reforms discussed, only one—FPE—was implemented. Senate amendments to the government proposal created a stalemate in the ICMS reform. The changes in the subnational debt terms were approved in Congress, but stalled in the Senate due to the retroactivity clause introduced.

Regarding the oil royalties, the presidential vetoes were overturned by Congress, and the MP expired. After that, the state of Rio de Janeiro appealed to the Supreme Court to declare both the law and the MP unconstitutional. Currently, the changes are suspended due to an injunction issued by the Supreme Court in response to an appeal from oil-producing states.

Lastly, even though the government has not withdrawn its proposal to change the landmark mining regulation, this proposal is no longer a priority for the government.

Conclusion

What if all five reforms had been implemented? The following simulation demonstrates the estimated net results for each state, and was conducted under the following scenario: FPE as approved by Congress, royalties paid as foreseen by the new (albeit suspended) legislation, tax rates doubled for CFEM, ICMS reformed as in the Senate proposal, and debt price index and interest rates reduced with no retroactivity. Figure 1 displays the estimated loss for each state in 2020 as a share of NRR.

The main winners are non-oil-producing small states that have a moderate debt level and low GDP and household income per capita, and as such they are benefitting from the FPE change as well. This is the case for Piauí, Amapá, Alagoas, Acre, and Maranhão. These five states presented not only the largest gains, but all benefitted by the proposed changes. For example, Amapá would see its transfers boosted by 16 percent of NRR in 2020, and its ICMS revenues increase by 2.2 percent. The change in debt rules would represent a gain of less than 0.1 percent due to its low debt level. The main losers, on the other hand, are large oil-producing states, such as Rio de Janeiro and Espírito Santo, and states strongly engaged in the ICMS fiscal war.

The main drivers of the results are the changes in royalties and ICMS. This is because the changes in FPE are very gradual—the total amount of mining royalties collected is very small, and because the debt for the most indebted states will represent mostly a long-term gain, rather than budget savings in the short term. On the other hand, ICMS is the largest tax in Brazil in terms of revenue generation: oil royalties distributed in 2012 amounted to 3.6 percent of GDP.
Regarding the new royalties rules, the losers and winners from this possible change are clear. The major losers would be the two largest oil-producing states in Brazil, namely Rio de Janeiro and Espírito Santo. Rio de Janeiro, the largest producer, would lose revenues worth of 18.8 percent of its NRR in 2020. Espírito Santo would suffer a loss of 11.5 percent of NRR. The major winners in the royalties redistribution are small and less-developed states such as Acre, Amapá, and Roraima. Acre would see an increase in revenue of 12.5 percent of NRR.

However, there is a caveat regarding the methodology used for the ICMS simulation exercises that influences the way the results are interpreted. The methodology uses the electronic fiscal invoice database, which has limitations imposed by the data. The two main limitations are: (i) it does not capture the changes in ICMS revenues brought about by the Senate resolution that unified the interstate tax rate on imported goods, since it became effective only in 2013, and therefore it does not accurately reflect the current scenario; and (ii) it does not distinguish between taxes that were effectively collected from those that were just registered and not paid due to fiscal war benefits. This is paramount because it tends to overestimate the loss of the most active states in the fiscal war. Therefore, these estimates must be read as the maximum estimated gain or loss to the state, and not as a midpoint.

The main losers, as expected, would be the net-exporting states. São Paulo would have a loss of 2.6 percent of NRR in 2014, increasing to a loss of 4.5 percent in 2020. It also would show the largest loss in absolute terms: R$8.3 billion, accounting for 37 percent of the total loss in 2020. However, states that have developed their industrial sectors, largely thanks to tax benefits granted in the 1980s and 1990s, and that have become net exporters in recent years, such as Bahia and Góias, would also lose revenues. Bahia would lose 2.3 percent of its NRR, while Góias would lose 13.8 of its NRR. Lastly, the states of Santa Catarina, Mato Grosso do Sul and Espírito Santo, which appear to be the main losers, with losses of 15, 20.6 and 21 percent of NRR, have their losses overestimated due to the limitations of the methodology, as explained above. Therefore, even though they are losers due to the proposed ICMS changes, it is hard to sustain that they would be the major losers.

On the winning side, there are the less-developed and net-importer states such as Maranhão, Rio Grande do Norte, and Piauí. These three states would enjoy a revenue gain worth of 8.3, 8, and 7.3 percent, respectively, of their NRR in 2020. They do not have relevant industrial production, especially for products sold outside their boundaries, and most of the goods consumed come from factories outside the state.

In contrast to the changes in the FPE and ICMS, the proposed changes in the debt would benefit all states—at the expense of the federal government. However, for some states, the reduction in interest would represent an immediate relief to their cash flow, while for others the gain would be in long-run debt sustainability, since they would still pay a debt service that is lower than the actual installment due to the debt service cap foreseen in the debt renegotiation contract. Four states—Minas Gerais, Rio de Janeiro, Rio Grande do Sul, and São Paulo—are in this situation. Thus,
for these states, the reduction in interest rate would translate in accelerated amortization and smaller residuals at the end of the contract.

The proposed changes do not cancel each other out in the majority of states. That is, the losses stemming from one reform are not fully compensated by the gains coming from other reforms—there is no endogenous compensation or zero-sum game. Therefore, to avoid losses that could jeopardize fiscal sustainability at the subnational level, an external source or funding, probably the federal government, would need to step in to soften the losses and make the reform viable.

However, a few changes in the reforms would increase the space for internal compensation and reduce the need for external resources from the federal government. The royalty redistribution imposes considerable losses on the two largest oil-producing states. A more balanced rule would help, especially since the slow transition rule of the FPE reduces the requirements of windfall gains from royalties to compensate for those losses. Lastly, a refinement in the ICMS methodology would reduce the uncertainty of estimates and thus make states more willing to commit to the reform.

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Notes

1. The “fiscal war” is defined as “the competition among states of the federation for the installation of enterprises in their territories through the granting of tax exemptions or benefits.”
2. The “fiscal invoice tour” (passeio de nota fiscal) refers to a situation in which companies send only the fiscal invoice and not the actual goods to a state where the interstate tax rate is 12 percent. In this state, the company normally has a tax incentive wherein it pays only 3 percent, but receives a tax credit worth of 12 percent. The company then sells the product back to its original state, where the good is claiming a tax credit of 12 percent against a tax debit of 6 percent (the difference between the interstate and the state tax rate), ending up with a net tax credit of 3 percent.
3. For instance, the Rio de Janeiro Secretariat of Finance reported an increase of 38 percent on the value of the goods imported through its ports in the first two months of 2013.

Reference