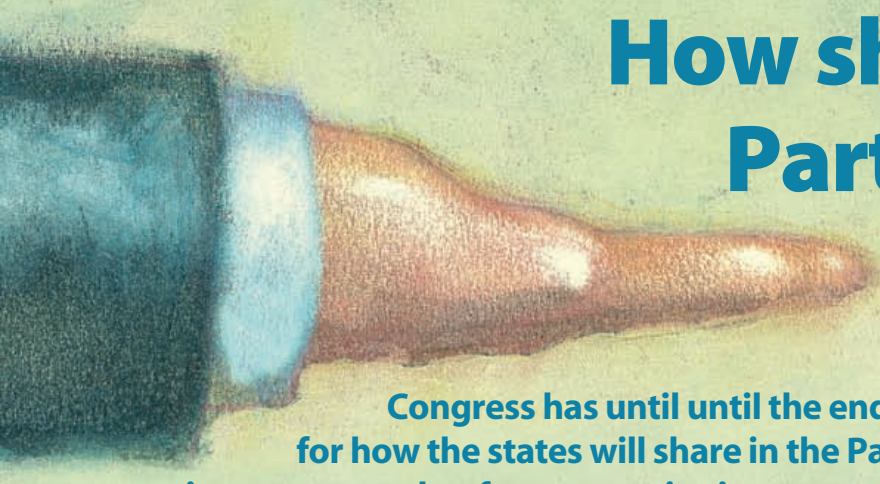


How should the State Participation Fund be shared?

Congress has until until the end of the year to set new criteria for how the states will share in the Participation Fund. Because the options suggested so far antagonize interests, Congress is far from consensus.

Claudio Accioli , *Rio de Janeiro*

It is not difficult to understand why Congress has not yet formalized the review of the State Participation Fund (FPE) the Supreme Court mandated last February. The states of Goias, Mato Grosso, Mato Grosso do Sul, and Rio Grande do Sul had filed a suit charging that the current allocation is unconstitutional, and the court ruled that the shares of the 27 states in FPE resources do not meet the constitutional principle of promoting social and economic balance between states and therefore compromised the federative pact.

What should be a theoretical debate about redistributive principles has been contaminated by state financial agendas. The R$50 billion in the FPE consists of 21.5% of what the federal government collects in income tax (IR) and excise tax (IPI). In the fight for shares, however, the states' demands do not add up realistically.

Several draft supplementary laws on the matter are pending in Congress, and on March 16 the Senate created a special committee to review not only new FPE share criteria but also the federative pact and the tax system more generally. Notably absent from the discussions is the Rousseff administration. Without effective coordination, and with elections scheduled for October, it is unlikely that the dispute over FPE shares can be resolved by January 2013, the deadline the Supreme Court set.

EQUALIZATION

When the constitutional reform of 1965 established the FPE, its resources were to be shared on dynamic distribution criteria, geared to reflect socioeconomic changes between states over time. The original formula to share the resources, which then consisted of just 10% of federal IR and IPI tax collection, allocated resources based on state area, population, and an inverse of state per capita income. Some limits were imposed to protect less populated and developed states, but the important point

was that the allocation would always vary to accomplish the desired equalization.

For the states, the 1965 constitution made two major changes: it introduced both the ICM (a state value-added tax) and the FPE. They were intended to complement each other—the FPE sought to compensate for inequality in ICM collections, which at the time were much more concentrated in the southeastern states, explains economist Fernando Rezende of the Brazilian School of Public and Business Administration, Getulio Vargas Foundation.

José Roberto Afonso, a Unicamp economist specializing in public finance and a consultant to the Senate, adds that the system obeyed the logic of transferring income from richer to poorer states and municipalities in order to reduce disparities between regions.

A PERMANENT TEMPORARY FIX

With few changes, the 1965 FPE criteria remained valid until 1988, when a new constitution was approved. The 1988 constitution expanded the amount of funds in the FPE to 21.5% of IR and IPI collections. It also mandated that a law defining new criteria for sharing resources be voted on within one year. However, since there was no consensus on new sharing parameters, Congress, based on a study of the National Board of Finance Policy(Confaz), in December 1989 created a table with fixed coefficients for the 27 states; it was established that 85% of FPE resources would be allocated to the North, Northeast and Midwest, and 15% to the South and Southeast—São Paulo received a meager 1% and Rio de Janeiro just 1.5%.

Unicamp economist Sergio Prado points out that the states and Congress never revisited the sharing criteria, so there was an agreement that in effect replaced what should be a mechanism to promote equality among states for a system of fixed ratios for sharing taxes. "It was to be reviewed in two years," he says, "but it has remained in place."

No discussion of tax reform in Brazil since 1988 has addressed the federal equity issue, yet in the last 20 years, the profile of the population has changed radically in economic, demographic, and social terms. Rezende points out that "Regions that were poorly developed, like the Midwest, have gained tremendously from the growth of agriculture. However, because the sharing coefficients remained static, there has been a huge disparity in fund transfers among states."

Afonso notes that in 1985, according to the Brazilian Institute of Geography and Statistics, only the South and Southeast

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regions; the states of São Paulo, Rio de Janeiro, Rio Grande do Sul, Santa Catarina, and Amazonas; and the Federal District had GDP per capita above the national level. By 2007, income per capita in the Midwest was also above the national average, while in the Northeast it was far below.

SHARING OPTIONS

Most bills that the House and Senate are considering propose that FPE resources be shared according to such parameters as income per capita, gross domestic product (GDP), Human Development Index (HDI) status, population numbers, land area, and more specific indicators, such as share of houses with access to safe water and sewerage.

The resources at stake are significant. According to Afonso, the net amount of the FPE is equivalent to 1.4% of GDP, 13% of state tax revenues, and 22% of ICM.

There are two obvious alternatives for addressing income equalization: go back to the original model, which prevailed in the tax code, or create a new mechanism that could incorporate into the system of income equalization parametric criteria such as those used by federations like Germany, Australia, and Canada. "The parametric model has been the tradition in Brazil, but it does not take into account how much revenue each state itself takes in. It simply applies the parameters and distributes resources. If the state is poor, for example, it receives more. Equalization of revenue, which is unknown in Brazil, takes into account a state's direct tax collection and shares resources according to state per capita expenditure. This is a more modern system, which deserves our attention because it reflects the states' funding capacity," Prado says.

Whatever the sharing formula, experts warn that there will be difficulties in moving toward a concrete solution for the problem. Changes in the distribution of the FPE could reduce state resources by up to 15% or 20%, which could be catastrophic.

WHOLISTIC CHANGE?

FPE reform offers a good opportunity for discussion of other federation issues, in particular the tax exemption war between the states, the sharing of oil royalties, and the restructuring of state debts. However, in the opinion of Afonso, although there is a consensus among planners and policy makers on the desirability of analyzing the issues together, the federal government has no sympathy for the idea. "The Executive argues for a case-by-case assessment," he

says. "There is a lack of rationality, of strategic vision." Reform of the FPE could be a tool for adjusting other disputes between states.

Realizing that its decision has consequences for state budgets, and because it is a case of partial omission—there is a law, but it does not meet constitutional standards—the Supreme Court in declaring unconstitutional the criteria for distribution of the FPE also held that the current law should still apply for the next two financial years until a new sharing formula is issued. Given the lack of consensus on the issue, however, this may not be enough time. Small states like Rondônia, Roraima, Acre, and Alagoas cannot survive without FPE resources. This problem needs to be resolved before January 2013; otherwise the Supreme Court will have a substantial 'hot potato' on its hands. The hope, according to Afonso, is that the federal government will come forward to arbitrate the issue, even if only in its own self-interest.

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