

Constitutional Revenue Earmarking For Regional Financing: At Odds With Fiscal Efficiency

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Abstract:

Background: *The Constitutional Financing Funds for the North, Northeast and Centre-West (FNO, FNE and FCO), created by the 1988 Federal Constitution and regulated by Law No. 7,827/1989, allocate 3% of income tax and excise tax (IPI) revenues to subsidised credit programmes administered by regional financial institutions. These incentives aim to offer companies in less developed regions cheaper financing. This article assesses whether the constitutional financing model functions as an effective regional policy. It is argued that the constitutional earmarking of revenues, although conceived to reduce regional inequalities, weakens the federal budget as an instrument of fiscal planning, violates the principle of budget unity, creates parallel budgetary structures and reduces fiscal discipline, as pointed out by Tanzi (1996), von Hagen and Harden (1996), and Nunes and Nunes (2000). The literature on investment subsidies presents heterogeneous evidence regarding their impact on firms' capital structure and profitability, with indications of inefficiencies, dependency and moral hazard. Moreover, the Public Choice School emphasises that state actions are subject to government failures. The article argues that the explicit inclusion of these subsidies in the general budget would allow for greater transparency, prioritisation and control, bringing Brazil closer to international practices that favour improvements in the business environment rather than subsidised transfers. It is concluded that the current model, characterised by automatic transfers and regional discretion in allocation, has contributed little to reducing regional inequalities and may run counter to regional policy principles. Since subsidies require higher tax revenue from sectors that are not favoured, they reallocate resources from some segments of the private sector to others, and for such intervention to be justified, its benefits must outweigh its opportunity costs. However, such a policy is not carried out at the national level.*

Key Word: *Constitutional Funds; Revenue Earmarking; Regional Inequalities; Fiscal Discipline; Credit Subsidies; Moral Hazard.*

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I. Introduction

The present study analyses the use of the Constitutional Financing Funds as an instrument for reducing regional inequalities. It also discusses the implications of these Funds for fiscal discipline and, above all, for the efficiency of the resource allocation process. The efficiency of this form of state intervention in the economy is typically emphasised in heterodox approaches. According to these authors, state action is indispensable not only to promote economic growth but also to accelerate it. However, such state intervention is often questioned in mainstream (orthodox) frameworks. In this view, government action is subject to government failures, which may compromise the success of policy (Nunes, 2025).

Notwithstanding the academic controversy surrounding state intervention in the economy, the provision of subsidised credit to foster productive investment in less-developed regions finds constitutional grounding in Articles 3 (III) and 174 of the 1988 Federal Constitution. Article 3 establishes, among the fundamental objectives of the Republic, the reduction of social and regional inequalities, whereas Article 174 assigns to the State the incentives in relation to economic activity. Furthermore, the persistence of the Constitutional Funds model may be partly explained by the over-representation of the beneficiary states in the National Congress.

This study assesses the extent to which subsidised credit provided through Brazil's Constitutional Financing Funds raises income and productivity in less-developed regions, and whether such gains exceed the opportunity costs arising from resource reallocation and possible crowding-out elsewhere. To achieve this aim, the study pursues the following specific objectives:

- (i) To estimate the impact of Fund-supported credit on income growth in beneficiary regions.
- (ii) To estimate the impact of Fund-supported credit on productivity (and/or employment and investment) in beneficiary regions.
- (iii) To test for displacement effects, including potential crowding-out of private credit or economic activity in non-beneficiary regions and sectors.

(iv) To compare estimated benefits with the fiscal costs of subsidised finance (e.g., the implicit subsidy) in order to assess net efficiency implications.

That said, it falls to the Executive to draft the budget and to Congress to approve it, pursuing an economic policy that delivers the greatest return of wealth to the country as a whole, irrespective of region. The analysis should therefore provide the elements of judgement required, first, to assess the extent to which a given expenditure—such as subsidies for firms in less-developed regions—is necessary; and second, to establish a hierarchy of priorities for determining what the Government ought to do as a matter of greatest importance.

The explicit incorporation of these subsidies into the general budget, subject to annual debate by the Executive and the National Congress, would provide the basis needed to assess the genuine necessity of each item of expenditure and to establish a clear hierarchy of priorities. It would be important for voters to understand that the proposal to be chosen should be the one that brings the greatest benefits to the nation. In terms of efficiency, the project's expected benefit should exceed its opportunity cost, since gains generated in one region tend to have repercussions across the whole country, given the economic interdependence. It would thus address fundamental questions: where should resources be spent and what objectives should be achieved?

The analysis takes an institutional and legal perspective. It examines how the Government allocates resources to promote growth in regions with lower per capita GDP. The intervention is financed by tax revenues, and Article 14 of the Fiscal Responsibility Law (*Lei de Responsabilidade Fiscal*) requires the Federal Government to compensate any foregone revenue. There are clear trade offs. Subsidies to lower profitability firms impose costs on more profitable firms. An incentive for one group often implies a disincentive for another. As Friedman put it, 'there is no such thing as a free lunch'. This point is often missing from public debate, where government spending is sometimes treated as if it could expand without constraint.

Applying Barro (1991) to the Brazilian context suggests that automatic fiscal transfers, such as disbursements from the Constitutional Funds that benefit relatively less developed regions, may crowd out local efforts to create incentives for firms and to mobilise resources for electoral spending. From the perspective of the Public Choice school, this effect constitutes a potential government failure insofar as it alters political incentives and may encourage opportunistic behaviour.

Orthodox authors typically recommend allowing the market itself to reduce regional inequalities. The equalisation of regional per capita income could occur through the relocation of firms from higher income areas to less-developed regions over time, attracted by lower labour and land costs and, in some cases, by proximity to suppliers. Such movement could raise income and employment in those regions through regional convergence (Nunes 2005). This hypothesis is supported by the literature on endogenous growth and human capital externalities (see Lucas, 1988).

In this setting, the present study aims to assess whether investment subsidies affect firms' capital structure and performance and, in particular, whether such effects are positive and statistically significant in the medium term.

The study adopts a qualitative and theoretical normative approach, based on a literature review (authors such as Tanzi, von Hagen and Harden), an analysis of legal provisions (CF/1988, Law No. 7,827/1989, etc.), and an examination of secondary historical evidence (Lavinias et al., 1997; Barros, 1997).

II. Theoretical Framework

The Constitutional Financing Funds for the North, Northeast and Centre-West (FNO, FNE and FCO) were created by Law No 7,827 of 27 September 1989, subsequently amended by Law No 9,126 of 10 November 1995. This law regulated the provision set out in Article 159, section I, subparagraph "c" of the 1988 Federal Constitution, which established the transfer of 3 per cent of revenue from the Income Tax and the Tax on Industrialised Products for application in financing programmes for the productive sector of these regions, through regional financial institutions, which came to have the function of providing subsidised credit for regional development. Through fiscal measures that wholly or partially forgo tax revenue, as occurs with the subsidised interest rates applied by these funds, the Central Government seeks to stimulate economic expansion in the North, Northeast and Centre-West, encouraging productive investment in sectors regarded as priorities for reducing regional inequalities.

Law No. 7,827/1989 was responsible not only for establishing the Constitutional Funds but also for determining the distribution of the corresponding percentage among the regions and for identifying the regional financial institutions charged with implementing those resources, institutions that had already been designated in Article 34 of the Transitional Constitutional Provisions. The creation of these Funds, which possess both financial and budgetary characteristics, was a constitutional requirement set out in Article 167, item IX, of the Federal Constitution.

It should be noted that this transfer of resources, as it constitutes a constitutional earmarking of revenues, is not subject to the restrictions set out in the Fiscal Responsibility Law. Consequently, there is no

requirement to comply with Article 14 of that Law, which demands the identification of the source of funds intended to offset the revenue foregone through the granting of subsidised interest.

This resource transfer linked to the Constitutional Funds (FNO, FNE and FCO) constitutes one of the elements that underpin the budgetary rigidity of public accounts. Such an allocation of funds tied to specific revenue sources tends to generate various inefficiencies in the formulation and execution of the public budget. As corroborated by Nunes (2024), the primary cause of this inefficiency lies in the allocative distortion arising from the ossification of priorities defined in the past, which constrains budgetary execution and prevents the fulfilment of current demands. In this manner, the mechanism deprives the government of the flexibility required to recalibrate priorities and to target public expenditure in accordance with the emerging needs of each period.

This form of budgetary earmarking, similar to other mechanisms contained in Brazilian legislation, has diminished the Federal Budget's ability to serve as an instrument of fiscal policy planning. The reasons are several. Budgetary decentralisation, in itself, weakens fiscal discipline because it hampers coordination across economic policies (Tanzi, 1996; Ter-Minassian, 1997; von Hagen and Harden, 1996). In practice, except where they act in concert with the federal government, subnational governments do not assign to their budgets the functions of contributing to price stabilisation or of pursuing full employment, output growth and external balance; rather, they tend to press for higher expenditure. Extending the argument hypothetically, fiscal discipline would be maintained only where subnational entities acted in a coordinated manner, one in which all of them placed national welfare above local interests. This possibility runs counter to what is predicted by Public Choice Theory.

The earmarking of funds fragments resources and reduces the scope for managing the public budget, depriving the Government of the capacity to establish priorities according to the needs of each period. Moreover, the use of funds results in a multiplicity of genuine "parallel budgets" alongside the Fiscal Budget, such that these practices ultimately contravene the Principle of Budgetary Unity.

The weak control over the level of public expenditure within the scope of the Constitutional Funds originates, in part, from the fact that the subsidies granted are implicit within the budgetary transfers. Law No. 9,126/1995 establishes the application of the Long-Term Interest Rate (TJLP)¹ to loans granted using resources from the Constitutional Funds, plus a *del credere* of up to 6 per cent per year, compatible with the risks assumed by the financing operations and appropriate to the social function of each type of operation. In operations contracted with small rural producers, financial charges are subject to an additional reduction of up to 5 per cent, and, in the financing of investment for the production of manufactured and semi-manufactured goods intended exclusively for export, remuneration is based on the London Interbank Offered Rate (LIBOR)², plus a *del credere* defined by the banks administering the respective Funds according to credit risk. The subsidies also include, pursuant to Article 8 of Law No. 7,827/1989, exemption from any tax or contribution on results, income and financing operations.

The control of public expenditure tends to be considerably more stringent when resources are disbursed in cash than when the subsidy arises from a differential in interest rates. In the latter case, the fiscal consequence is the transfer, to future generations, of the financing burden associated with such expenditure through an increase in public debt, which remains continually subject to pressures for extensions and renegotiations. This behaviour makes it almost impossible to ascertain the subsidies *a priori*, as becomes evident when the fiscal position of the Funds and the repayment capacity of borrowers, particularly those in the rural credit sector, are assessed on a recurrent basis. Articles 5 and 7 of Law No. 9,138 of 29 November 1995, for instance, authorised the extension of debts arising from rural credit operations contracted up to 20 June 1995, using resources from the Funds, including those already renegotiated, with the cost of the equalisation borne by the respective Fund. Consequently, these operations are carried out without the requisite transparency, in contravention of the provisions of the Fiscal Responsibility Law.

This is the way in which the budget is prepared, namely the traditional incremental budgeting model, in which existing expenditures are automatically accepted as a necessary baseline, and justification is required only for the additional amounts requested. In this approach, the sectoral units submit the draft budget proposal using the previous year's amounts and budget headings as the reference point, with values that may be increased or reduced. In this sense, as Pyhrr (1981, p. 1) notes:

¹ Law No. 9,126/1995 establishes that, as of 1 July 1995, financing granted using resources from the Constitutional Financing Funds shall have as basic cost the Long-Term Interest Rate (TJLP), and the administering banks may charge a *del credere* of up to 6 per cent per year, in addition to the costs provided for in the main provision.

² Note. LIBOR has permanently ceased. USD overnight and 12month settings ended on 30 June 2023; the last synthetic 1, 3 and 6month USD LIBOR settings ceased on 30 September 2024. References to LIBOR in this paragraph reflect the historical legal framework; current practice uses riskfree rates (e.g., SOFR for USD; SONIA for GBP).

“Customarily, the employees in charge of an established program only need to justify the increase they are requesting in relation to the appropriation from the previous year. In other words, what they are already spending is generally accepted as necessary, without examination. Substantial economies could undoubtedly be made if every public agency were required to justify the entire appropriation requested every year, exactly as if its program or programs were entirely new.” (Pyhrr, 1981, p. 1).

This historical budget tends to drive budget growth because it carries forward residual public spending linked to past social or political priorities that may no longer be relevant in the current year. Although these legacy priorities sometimes face small reductions in their allocations, they are rarely removed altogether, which keeps resources tied up that could be reassigned to more urgent present needs. Constitutional revenue earmarking, such as rules that guarantee automatic transfers to the Constitutional Funds, worsens this by keeping certain expenditures in place even when the original objectives are no longer fully justified.

However, addressing this situation depends on legislators including the expenditure in the Annual Budget Law and on the existence of revenue sources to finance the spending. Given the budget constraint, there is competition for public goods in amounts greater than needs, in order to secure the desired levels. Thus, the problem is characterised by limited revenue and unlimited demands.

In a context of inherent scarcity of public resources and limited government revenues, there is competition for budgetary resources in order to secure the desired amounts. It should be noted that, for those who benefit from the budget, it is seen as a good that belongs to everyone. Coase (1960) refers to such a good as one without an owner. Because claimants do not bear the cost of the public good supplied, demand exceeds the socially optimal point and groups compete with one another for budgetary resources. This nature creates pressure to spend, including inefficient spending, thereby wasting opportunities to maximise social welfare.

Such practice directly contradicts the principle of efficiency in Public Administration, and maintaining inefficient structures is socially undesirable. In this sense, Mello (2010, p. 53) emphasises that efficiency constitutes, by definition, the “nuclear commandment of an administrative system”. These implications are grave in Brazil, one of the most centralised federations in the world (Shah, 1997), where budget rigidity further undermines the capacity for a coordinated response to national and regional demands.

In this setting, one of the main aims of the subsidies channelled through the Constitutional Funds is to reduce firms’ cost of capital. Such spending should deliver a rate of return above the opportunity cost of the resources involved. As Ziesemer (2021) notes, it ought to generate medium term returns that can be measured, both in productivity and in profitability. Even if one would expect beneficiary firms’ operating performance to improve consistently, the empirical literature points to marked heterogeneity: some studies find positive effects (Maffioli et al., 2017), but many report weak or statistically insignificant impacts (Bergström, 2000), nil effects (Vozárová et al., 2020; Harris and Robinson, 2004), or even adverse outcomes, such as transmission failures in subsidised credit markets (Ornelas et al., 2019). It is worth recalling that promoting development to balance regions facing different economic conditions is also one of the Budget’s functions. In that sense, the difference between investing in a region through a Fund and appropriating that expenditure directly in the Budget is that, in the latter case, it is easier to set priorities, avoid duplication, and pursue greater efficiency and control over spending.

On the contrary, these same objectives — promoting the economic growth of the North, Northeast and Centre-West regions — could be achieved more efficiently through annual budgetary appropriations in the Annual Budget Law (Lei Orçamentária Anual, LOA). Allocating expenditure via the budget would enable: (i) periodic evaluation of results and targeting of spending; (ii) adjustment to emerging priorities in each period; (iii) greater parliamentary and social oversight of allocation; and (iv) the release of fiscal space should the need diminish or more urgent demands arise. Constitutional earmarking, by “freezing” resources for specific purposes irrespective of their current effectiveness, ultimately privileges inertia over responsiveness and administrative efficiency.

However, if the social situation and the guidelines of economic policy indicate the need to grant subsidies to a sector or a region, why not include such expenditure in the Budget? In the interest of expenditure control, it is always preferable to recognise in advance and to make as explicit as possible the subsidy character of loans, separating the pure lending component from the subsidy component. Loans should be grounded in credit analysis, whereas subsidies, as the outcome of an economic policy decision endorsed by society, should be included in the Budget, avoiding, as far as possible, recourse to less transparent mechanisms (interest-rate equalisation, the issuance of securities, etc.).

On the basis of econometric studies, von Hagen and Harden (1996, p. 2) even proposed centralising the budget process as a way of reducing the public deficit: “Spending and deficits can be reduced by introducing elements of centralization in the budget process.” They add that “Our empirical results show a strong correlation between our index of centralization and fiscal discipline.”

With regard to the allocation and efficiency of spending, it is known that greater decentralisation does not necessarily imply a reduction in regional inequalities. Lavinás et al. (1997) show that, between 1985 and

1994, there was an increase in the variance of GDP per capita and in the concentration of regional income: whereas in 1985 seven states held two thirds of the country's wealth, in 1994 this share rose to 77.3%. These data indicate that, although transfers to the Constitutional Funds remained at high levels (0.15% of GDP in the 1997 budget reprogramming and 0.16% of GDP in the 1998 Draft Budget Bill), inter-regional imbalances increased, breaking with the pattern of the 1970s, a period in which budget centralisation was precisely greater. Barros (1997) also agrees with this proposition, noting that Brazil had been able to reduce regional disparities in the period 1947–1988 and, nonetheless, with the increase in budget decentralisation after 1988, the success of this policy ceased to exist. For the author, the reduction in regional disparities is due to a fall in real wages in the more prosperous regions, which made the Northeast less competitive in Brazil.

The explanation for this apparent paradox, namely the persistence or even the worsening of regional inequalities despite substantial transfers, lies to a large extent in the inefficiency of the current model of regional development, which is anchored in automatic transfers and subsidised loans. In the absence of a broad and rigorous assessment of economic viability, the administering banks may channel resources into inefficient or low-return projects, thereby encouraging overinvestment in activities with low marginal productivity. This distorts the allocation of capital at the national level, fosters dependence on chronic subsidies, and reduces the economy's aggregate productivity, as evidenced by studies indicating limited or heterogeneous effects of these funds on capital structures and on the performance of beneficiary firms (e.g., Instituto de Pesquisa Econômica Aplicada, 2024).

In general, as Nunes (2024) points out, earmarked budgetary allocations merely create automatisms that ossify past priorities and reduce the scope for expenditure programming. Yet, in this particular case, there is an additional reason why the allocation of resources from the Funds may not be the most efficient. Once the transfers have been made, the priorities for lending and the financial charges are defined, at the discretion of the responsible financial institutions. Under the law, the reduction of financial charges, relating to interest and monetary correction, is conditioned solely on the activities being deemed priorities and of significant relevance to the economic and social development of the regions. Thus, it is of little use that the same law prohibits the use of resources on a non-repayable basis and establishes, as a guideline, their prudent use and an adequate collateral policy, if the granting of credit remains subject to regional political pressures.

There is, from a technical standpoint, no justification for the exclusivity granted to the regional federal financial institutions by Law No. 7,827/1989. On the contrary, the exclusive support for banks identified as governmental introduces a moral hazard component, as borrowers feel more protected and tend to take on greater debt in the expectation of renegotiations or cancellations in the event of difficulty, as observed in the successive restructuring laws and recent extensions (Law No. 14,554/2023, which extended the deadline to April 2024; Law No. 14,995/2024, which reopened the deadlines; and Decree No. 12,445/2025, which regulated formalisation until 29 April 2028, with the possibility of instalments until 2032).

Furthermore, the concentration of credit granting in regional federal financial institutions, by exposing them to political pressures, tends to reduce the efficiency of lending. Naturally, these institutions also benefit directly, inasmuch as they are entitled to an administration fee of up to 3% per year, calculated on the net assets of the respective Fund and appropriated monthly.

III. Conclusion

The Constitutional Financing Funds (FNO, FNE and FCO), established by the 1988 Constitution as an instrument to reduce regional inequalities through subsidised credit, appear, in light of the analysis presented, to constitute a model of regional policy marked by significant inefficiencies. The constitutional earmarking of revenues, by creating budgetary automatisms and “parallel budgets”, violates the principle of budget unity, weakens fiscal discipline, and ossifies priorities set in the past, as noted by authors such as Tanzi (1996), von Hagen and Harden (1996) and Nunes (2024). This rigidity undermines the flexibility required to recalibrate policy in response to emerging needs and contributes to the persistence of implicit subsidies, with limited control and transparency.

Moreover, the empirical literature on investment subsidies reports ambiguous results, with substantial heterogeneity in estimated effects on firms' capital structure and profitability. Historical evidence from Brazil corroborates this ineffectiveness: despite substantial transfers to the Funds, regional inequalities increased after 1988 (Lavinhas et al., 1997; Barros, 1997), reversing the convergence pattern observed during periods of greater budget centralisation. Discretion in credit allocation by regional financial institutions, which are exposed to political pressures, combined with moral hazard and institutional incentives such as administration fees, further exacerbates the inefficient allocation of resources.

In sum, the current model, grounded in rigid earmarking and automatic subsidies, contributes little to the effective reduction of regional disparities and runs counter to good practice in fiscal management. A more efficient alternative would be to incorporate these subsidies explicitly into the Annual Budget Law (Lei Orçamentária Anual, LOA), enabling periodic evaluation of results, parliamentary prioritisation, greater

transparency, and adjustment to contemporary demands, (see Nunes et al., 2024). Such a reform would align Brazilian regional policy with principles of administrative efficiency and fiscal responsibility, thereby maximising social welfare in a context of scarce public resources.

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