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**COMPLIANCE
AND SUSTAINABILITY**

**BRAZILIAN AND
PORTUGUESE PERSPECTIVES**

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II

SPECIAL PART

STRATEGIES AND PUBLIC AND
PRIVATE COMPLIANCE
INSTRUMENTS

1.

COMPLIANCE AUDITS IN THE PUBLIC SECTOR WHERE ARE WE GOING?

MATILDE LAVOURAS

Abstract: This article aims to appreciate the contribution of auditing in the public sector to compliance, emphasizing the analysis of public policies and the regulation and control of public expenditure. It also states the importance of compliance in the public sector and of achieving a high level of compliance at all levels.

Keywords: compliance, audit, public sector

1. Introduction

The study of the compliance audit in the public sector is not recent, but only in recent decades has it become central in economic studies. The main reasons for this increased attention are the relationship with state activity, the current recognition of the importance of the quality of the auditing

control of public funds and the relationship with the effective implementation of public policies. We will refer here to just one of those aspects: the compliance audit in the public sector.

Therefore, it is mandatory to take into account the relation of this concern to the increase in public spending as a percentage of GDP from the 1930s onwards, above all in the decade that is considered the *golden age of public expenditure*: the 1980s. The design and implementation of public policies have not always taken into account the harmful effects of these policies in various economic and social sectors. In other words, both the design and the implementation of public policies have not always considered all the benefits and all the negative (or positive) implications of certain policies. In some cases, this happened — and still happens today — because some of the economic and social effects were not known or, if known, could not be internalized. In other cases, the effects were not knowable, and in the remaining cases, economic valuations were not properly performed.

From the 1960s onwards, it is possible to observe the accentuation of new ideas related to economic growth, especially those that identified economic stagnation and decline, and an increase in the number of those defending the need to take into account economic and social goals in several sectors and even the non-monetary effects caused by public policies¹. Public policies would no longer be designed in a restricted or sectoral way and would to some extent take into account the effects in several areas, stressing the importance of sustainable growth. This idea — sustainability — is now well established in the millennial development goals from 2005 onwards and in the sustainable development goals (SDG) of

¹ Technological evolution supported by changes in the ways of measuring the cost-benefit ratio has contributed to a greater degree of internalization of both positive and negative externalities. See Paul SAMUELSON / William NORDHAUS, *Economics*, 19.^a ed., McGraw-Hill, 2010, 34 s.

2030, revealing a growing concern with environmental issues and with social and sociological factors that influences the effects of public policies.

This aim cannot be achieved without establishing levels, guidelines and measures to take advantage of the opportunities that arise during the implementation of projects and, therefore, to optimize the results. On the other hand, risk management is important throughout the process, and although risk and uncertainty are dissimilar, it is very important to obtain the proper attention from the various actors involved in the design and implementation of public policies. However, all these possibilities and the softness of the policies allow greater discretion at the moment of implementation. This greater discretion may obstruct compliance, particularly at the financial level.

The actual diversity of public policies, aggregated to the diversity of public entities' performances and to the diversity of effects, strongly suggests the impossibility of a closed definition of the forms of public action. However, the benefits linked to the variety of actuations are well known and very relevant, and the effects are more visible in situations in which a given behaviour is expected to generate negative global externalities. It is possible to find many examples in environmental policy and in financial market actuations².

Our intent in this short summary of the evolution of public expenditure³ is, on the one hand, to diffuse the idea

² We refer to only two broad areas in which the existence of global public goods is very visible and in which the consumption or supply of those goods leads inexorably to the production of (very strong) global positive and/or negative externalities. It is not possible in most cases — we venture to say in any case — to circumscribe these effects to a particular geographical territory.

³ Regarding the evolution of public expenditure, see Vito TANZI / Ludger SCHUKNECHT, "Reforming Public Expenditure in industrialised countries are there trade-offs?", *Working Paper Series (BCE)* 435 (fevereiro de 2005), disponível em <<https://www.ecb.europa.eu/pub/pdf/scpwps/ec->

of paradigm change in the design of public policies and, on the other hand, to note the existence of increasing pressure by citizens — persons and legal entities or other equivalent entities — because they are able to recognize the economic and non-economic effects of a given policy or, during a policy change, require some control over the allocation of public revenues. It has become important to design a public policy that assures the maximization of the outcomes expected by public decision-makers and, at the same time, maximizes the benefits to the managed ones.

It is especially important at an early stage of the implementation of this method of investigating public policies to benefit from a model of normative public policies to the detriment of models of positive public policies. Additionally, policy design should permit, at any moment, the implementation of a public spending monitoring and control platform. In models of self-control and external state control — political, administrative or jurisdictional — it is necessary to take into account the scrutiny of society.

2. How can the public sector contribute to high compliance levels in public spending?

One of the usual ways to contain non-compliant behaviours and limit the negative effects of these behaviours is precisely regulation: if standards are adopted that make the economic effects of deviant conduct more visible, the agent can more easily make the necessary adjustments. Those adjustments are needed because the agent is lacking the consciousness of the impacts of a certain behaviour on the level of income, deriving

from the ‘lack of visibility’ of the economic effects, and this deficiency can lead to inappropriate conduct.

These rules may, on the one hand, establish exclusions or limit the licit options for action — in a Hobbesian, paternalistic state — or may reward conduct, actions, or results. However, the effectiveness of these regulations is guaranteed only if they are able to shape behaviours to make them more “conductive” to compliance.

Frequently, the choice of a simple and understandable standards design with clear procedures for multiple decisions, but interconnected and not disproportionately bureaucratic, is the most effective model because it is easy to internalize and to fulfil.

Another model is based on the evidence, that is, showing the advantages derived from the adoption of behaviours conforming to the established rules. In addition, if the regulatory norms and sanctioning rules do not always have the expected effects, it is through disclosure and compliance policies that the desired results are achieved, and it is not uncommon for such policies to enable the achievement of much higher compliance levels than initially expected.

3. Auditing as an important contribution to the individual’s benefits maximization

From the economic point of view, the regulation referred to above tends to establish measures that minimize risks, deal with uncertainty and maximize positive results. In addition, the benefits occur not only in the individual (personal) sphere but also at the collective level⁴. Evidence-based influence serves to make the advantages of minimizing risk knowable.

⁴ It is precisely at this point that we find substantial differences in effects: while individualized performance is based on the benefits and the losses that it may cause in the personal sphere, the performance indicated by the state will also allow us to arrive at optimized situations, at least in terms of Pareto’s second best.

The maximization of results depends mainly on the ability of a given action to result in global benefits or avoid global losses that were not taken into account in the decision. It would then be sufficient for those subject to the regulatory behavioural standards to comply with them.

It has been confirmed that breaches of the rules typically occur for two reasons: the impossibility of compliance and deliberate noncompliance. In the first case, classified as a 'myopic economics agent', entities are prevented, for various reasons, from knowing the real effects of their actions. The second case includes situations in which, knowing the rules, despite the sanctioning and economic effects of a non-compliant approach, the entity chooses not to conform to the rules.

Within these two forms of action, there are also different forms of attempting to impose compliance (*enforcement*) through policies that, while minimizing costs, lead to voluntary compliance with the purpose of the norms. In such policies, the state or government plays the role of a good giant that maximizes the collective welfare, which is compatible with non-compliant conduct if the established purpose is fulfilled, albeit in a different way⁵. Occasionally, this possibility of (non-)compliance results from the use of elusive or even fraudulent mechanisms, leading to corruption and rewarding acts that should be repudiated. Although such measures are highly efficient from the collective point of view, in areas such as environmental law, allowing the *maximum benefit at minimum overall cost* should be avoided⁶.

⁵ The first type of action is adopted in countries with more open political regimes, while the second is usually used in countries with totalitarian political regimes or in situations in which it is necessary to achieve almost immediate adherence to the norms.

⁶ It is expected that in these cases, the agents will be able to obtain some economic benefits as well as non-economic advantages that may be useful to them in future situations, such as the support of a certain po-

In contrast, standards may be established that invite management models that maximize the economic benefits of compliance. These norms, which are naturally complex in their *formulae* or in the conduct to be adopted, may, however, generate an excessive expenditure of resources. The adoption of a stance of strict compliance with standards in an attempt to maximize the gains from this fulfilment — budget-maximizing behaviour — implies an expenditure of resources that is excessive from not only the individual but also the collective point of view.

Finally, the option of imposing norms of maximization of benefits in compliance with the standards remains. This maximization occurs not by increasing the yield generated by compliance with the standards but rather by imposing very high pecuniary penalties for non-compliance. In this case, only a few — very few — will be in a position to fail. The sanction for non-compliance is assumed here to be a sort of compulsory pecuniary sanction.

These considerations are fully valid for the implementation of audit policies that can be used both in the public sector and in the private sector. The state should assume a leading role in the design of the rules for public expenditure control and the behaviour of public managers (*lato sensu*). Among these measures, those that stand out are internal control and audit mechanisms and other procedures that not only allow the control of the legality and cost-effectiveness of expenditure but can also be used for the early detection and denunciation of management risks and irregularities.

litical party or entities that we can generically designate as influencers or creators of public opinion. However, the community is not necessarily impaired, and in some situations, the objective that is not fulfilled is compensated for, even in economic terms, by another with the same economic weight (higher pollution index, more jobs).

However, the definition of rules and procedures is not sufficient; it is also necessary to enforce them. It is therefore imperative to detect and define the risks of non-compliance and to create ways to respond to nonconformities and to avoid the so-called non-compliance costs⁷, thus creating conditions for compliance⁸.

Precisely because of the need for more effective control, compliance systems were designed to avoid or at least reduce the occurrences of misconduct or white-collar crime⁹.

In Portugal, even though there still a long way to go in terms of compliance in the public sector, much has been done. The role played by the auditing bodies for management acts should be highlighted, as these bodies having enabled an increased number of identified budget implementation flaws. However, we must also mention the lack of regulation: the current system is based on the personal responsibility of managers, although in some cases with a right of return from the agent. This condition is seen as an incentive either for the internal adoption of compliance measures and increased surveillance in response to slight or early signs of inappropriate behaviour or for the adoption of risk prevention plans, including plans addressing the risk of corruption¹⁰.

⁷ Damage resulting from non-compliance or inadequate compliance may jeopardize efficient resource allocation.

⁸ Compliance allows for a better relationship with the controllers (auditors) and the recipients of the activity, reducing inconsistencies and increasing productivity.

⁹ We can also consider to be included in this type of rules those intended to reduce the actions of employees or agents that are contrary to the guidelines of the entities or to the public interest, leading to the violation of rules of budget execution.

¹⁰ It should be noted, however, that according to an OECD study, we have witnessed the increasing implementation of measures to eliminate or reduce corruption in the public sector. However, it is also possible to

Once again, it becomes important to choose the appropriate design of the internal compliance policy. In addition, the suitable model of control will be founded on the definition of the duties of supervision and control, on the establishment of mechanisms that allow the verification of (non-)compliance and on the stratification of who is involved in each procedure. What is required is that everything be controlled, but since it is very difficult to concentrate control in only one person, it is also important to stratify this task in such a way that it does not allow someone to use another person as an excuse for non-compliance.

It should be pointed out that in Portugal, in the public administration, compliance systems were created long ago in anticipation of international developments. This *desideratum* contributed greatly to the creation of the Council for Prevention of Corruption on September 4, 2008, of which the main purpose is, precisely, “prevention of corruption and related offenses.”¹¹ The implementation of a system of control based on high standards of integrity within the public administration can serve as an example for practices to be implemented not only within the sector but also outside it, generating a kind of contagious effect.

It should be noted that these two trajectories have proven to be essential to prevent situations of corruption in public expenditure, either at the stage of choosing the expenditure or the private contractor or at later stages of the procedure, such as liquidation and payment.

verify that the application of sanctions in cases of non-compliance is relatively low. Cfr. OECD, *Foreign bribery enforcement: What happens to the public officials on the receiving end?*, (2018), OECD Publishing. The same organization estimates that, for example, between 10% and 30% of public expenditure on works are costs attributable to mismanagement or corruption. OECD, *OECD Recommendation of the Council on Public Integrity*, OECD Publishers, available at <<http://www.oecd.org/gov/ethics/OECD-Recommendation-Public-Integrity.pdf>>.

¹¹ Article nr. 1, Regulation nr. 54/2008, September 4th.

The OECD Council on Integrity in Public Administration Recommendation of January 26, 2017,¹² emphasizes the need for an integrated strategy for public management, based on the idea of public integrity, within the public sector. Such a strategy requires a connection with many other areas, with particular emphasis on a culture of integrity, an effective control system and an accountability system, as well as many other areas.



Figure 1 Source: OECD

¹² Available at <<http://www.oecd.org/gov/ethics/recommendation-public-integrity/>>. The Council for the Prevention of Corruption published a note on this recommendation on May 2, 2018, explaining its “manifest adherence” to the content of the mentioned recommendation. <http://www.cpc.tcontas.pt/documentos/recomendacoes_int/nota_recomendacao_OECD.PDF>. This OECD recommendation is the first to refer specifically and exclusively to public integrity, although some references to these matters can be found in earlier recommendations by the same entity: (a) Recommendation of the Council to improve the quality of State Regulation [C (95) 21 / FINAL], (b) Council Recommendation on OECD Guidelines for the Management of Conflicts of Interest in the Public Sector [C (2003) 107], (c) Council Recommendation on Principles for the Participation of the Infrastructure [C (2003) 23 / FINAL], (d) Council Recommendation on Combating Bribery of Foreign Public Officials in International Business Transactions [C (2009) 159 / REV1 / FINAL], Principles of Transparency and Integrity in Lobbying [C (2019) 16], (f) Council Recommendation on Regulatory Policy and Governance [C (2012) 37], (g) Council Recommendation on Governance (C / MIN (2004) 8 / FINAL), available at <<http://www.oecd.org/>>.

In the European Union countries, there is no uniformity of compliance rules for the public administration, but the compliance audit is carried out by the same entities that audit the public accounts — the so-called Supreme Audit Institutions (SAI), which, in addition to financial audits and performance audits, can perform a compliance audit¹³. Even in cases where there is no independent audit area for compliance, it will eventually be considered to be covered by other forms of audit.

The Portuguese regulation does not provide legal autonomy of this function, but it does not mean that an audit cannot be performed. In addition, the Council for Prevention of Corruption, through Recommendation No. 1/2009 of July 1, 2009¹⁴, recommended to all “maximum governing bodies of the entities managing public money, assets or properties, whatsoever their nature”, the adoption, until December 31, 2009, of a risk management plan for corruption and related offenses and, by 2015, the adoption of plans for the prevention of corruption and related offenses, making clear the need to implement management entities. The Law on Organization and Procedure at the Court of Auditors (LOPTC) does not eliminate but rather reinforces the possibility of verifying compliance with legal regulations, not only those of a formal and/or materially financial nature¹⁵.

¹³ Although Supreme Audit Entities are independent bodies, this does not mean that there is no relationship with the representative bodies (Parliaments). On the diversity of audit bodies in the European Union and the diversity of their functions, see EUROPEAN COURTS OF AUDITORS, *Public Audit in the European Union — The Handbook on Supreme Audit Institutions in the EU and its Member States*, 2019 Edition, EU Publications Office; and Milagros GARCIA CRESPO, ed., *Public Expenditure Control in Europe: coordinating Audit Function in the European Union*, Edward Elgar Publishing, 2005.

¹⁴ <http://www.cpc.tcontas.pt/documentos/recomendacoes/recomendacao_cpc_20090701.pdf>. The initial deadline was 90 days.

¹⁵ As an example, see the norms of the articles 40th and ff. from LOPTC approved by Regulation nr. 98/97, August 26, in its current draft.

4. **Conclusion**

Public accounts auditing plays an important role in assisting compliance with standards in Portugal and in other European Union countries. In combination with other mechanisms to support risk prevention and management of public money, assets and properties, management entities are an essential tool for the implementation of compliance practices in the public financial area. Notwithstanding the changes that may occur in the way the audits are carried out, and even if the auditors are replaced by mathematical formulae, the adoption of compliance rules in the management of public money will always be of undeniable utility — and in cases of non-compliance even more so.