BANCO INTERAMERICANO DE DESARROLLO
DEPARTAMENTO DE INTEGRACIÓN Y PROGRAMAS REGIONALES
DIVISIÓN DE INTEGRACIÓN, COMERCIO Y ASUNTOS HEMISFÉRICOS
INSTITUTO PARA LA INTEGRACIÓN DE AMÉRICA LATINA Y EL CARIBE

TAX REFORM IN BRAZIL: THE LONG PROCESS IN PROGRESS

RICARDO VARSANO*
CONSULTANT

APRIL 2003

* The author was the Tax Studies Coordinator at IPEA – Institute of Applied Economic Research, Rio de Janeiro, Brazil, and became Regional Director of the institution while writing this paper.

1. Introduction

The tax system in force at a given time is the result of an evolution process that, in general, is continuous. Almost everyday, at least one of the many legal and administrative taxation norms is modified, either to improve the system or in response to changes in the relevant circumstances. Provided its basic structure is adequately set, the tax system is able to endure for a long period.

The ability of the tax system to adapt to new circumstances is, nonetheless, limited. And it tends to decline with time, due to deterioration of its components as a result of the cumulation of changes in norms. Senescence of the tax system or major changes in the economic environment where it operates may require adjustments which transcend the flexibility of the basic tax structure. Once in a while, a full revamp of the system is in order. Though taxation undergoes daily revisions, usage reserved the expression “tax reform” to refer to these discontinuities in the evolution process.

Brazilian experience shows very well that, despite being a discontinuity, tax reform is far from an instantaneous event. Rather, it is a process that involves time-consuming discussions, negotiations and legislative procedures before implementation. Time elapsed from the initial discussions and propositions to completion of the reform is usually very long. Furthermore, resistance to change stemming from economic agents — prominent among them tax administrations of the three levels of government — brings about a tendency to recondition preexistent taxes instead of replacing them by better quality ones.

The consequence is that the tax system in force is never a creature of its own time. Many of its components have remote origin, resulting from a pile of changes made over decades. As such, they inherit many characteristics and deficiencies of their precursors. The consequence is that tax reform, when finally takes place, is insufficient, what makes its discussion recurrent.

The other side of the coin, the good one, is that the behavior of the economic agents creates a protective barrier. Sudden changes in relative prices and tax revenues, which could be brought in by more radical reforms and might jeopardize economic performance, are prevented.

A tax reform process is now in course in Brazil. It started in 1995, when the President of the Republic presented to the National Congress a proposal to amend the chapter on the tax system of the Brazilian Federal Constitution (PEC 175/95). During the more than seven years of stop-and-go discussion, the process provided only two practical results: the so-called Kandir Law that modified the chief state tax — on the circulation of merchandises and on communication and interstate and intermunicipal transportation services (ICMS) —, but which effects have been partially postponed by subsequent laws; and a recent law, which has mitigated the cascading of a social contribution.[1] Discussion of the constitutional amendment, which was interrupted in the first quarter of 2000, is expected to resume in 2003.

This paper discusses the tax reform process in course. The next section deals with the present tax structure. Though some of its components, like the income tax, date back to the early 20th century or even earlier, like the import and export taxes, the major reform that took place in the sixties is considered here as the origin of the system now in force. A brief discussion of the reform of the sixties and of the evolution of the tax system since then is provided. Section 3 considers the chief motivations of the present reform effort, which are found, mainly, in the economic transformations that the country has undergone since the beginning of the nineties. Given the core motives for carrying on a reform — enhance economic efficiency and competitiveness —, Section 4 discusses the main shortcomings of Brazilian taxes and present some reform proposals. The final section describes the reform process in progress since 1995 up to its present stage and maps the difficulties that will probably be faced to conclude successfully the reform. A list of abbreviations used along the text is provided after the final section.

It should be stressed from the outset that the present tax reform effort is intended to mitigate the malefic effects of taxation on productivity and competitiveness of the Brazilian production sector. These effects are considered an important factor hampering economic growth, which minimization is urgent. On the other hand, intergovernmental fiscal relations, despite the importance of the issue for future discussion, are not contemplated as

[1] Social contribution is a denomination given in Brazil to a set of taxes that are earmarked to social security activities. The Constitution defines social security as comprising health, social assistance and social insurance.

a target for the present process of reform. This is the reason why most of the text that follows concentrates on the taxes, with little attention provided to federative issues.

2. The Set of Taxes in Force: Origin, Evolution and Current Features

The National Constituent Assembly in charge of the elaboration of the 1988 Constitution promoted a reform of the Brazilian tax system. But, despite the elimination of some federal taxes, which bases joined that of the main state tax — the tax on the circulation of merchandises (ICM) — to give rise to the ICMS, the 1988 changes were concentrated in federative relations. More specifically, the distribution of tax revenue among units of the three levels of government was the main issue. The backbone of the tax system remained practically intact. More important for practical purposes was the fast growing importance of cascading taxes during the nineties, which added several percentage points to the tax burden. Except for these facts, the basic structure of present Brazilian taxation is, in essence, the one built during the substantial reform of the sixties.

2.1. Origin

On the outset of the sixties, the aggravation of federal government fiscal conditions was calling for an urgent improvement in its tax collection. In fact, Brazilian total tax burden had plunged from a high of 18.7% of gross domestic product (GDP) in 1958 to 15.8% of GDP in 1962. The reform started in 1962, but an institutional crisis erupted and the process was interrupted before it could offer any result. Only after the 1964 military takeover, the process was set in motion again. A new tax system was gradually put into effect between 1964 and 1967.

Priority was conferred to changes that either could contribute immediately to the rehabilitation of federal finances or might provide some fiscal relief to the entrepreneurial sector, which made up the political basis of the military regime. Constitutional Amendment

18/65, which, with few adjustments, became the text on taxation of the 1967 Constitution, and the National Tax Code are the legal documents that synthesizes that reform.[2]

The income tax (IR), which has existed in Brazil since 1922, underwent an in-depth reformulation, beginning in 1962 and ending in 1965. The purpose was to increase the tax yield, by expanding the base and improving evasion controls, both to contribute for the reduction of the fiscal deficit and to enable tax renounces as incentives to capital accumulation. Requirement to present an annual statement of assets attached to the tax return, expansion of the withholding tax regime, elimination of exemptions previously allowed to some professional categories, and the reformulation of marginal rates structure are some of the improvements introduced at that occasion. On the other hand, the new legislation provided tax exemptions or reductions to some types of capital income and incentives for several modalities of investment.[3]

The result of the income tax reform was a steep increase in its yield. Despite tax renounces, real net revenue grew more than 60% between 1962 and 1966. The bad news was, of course, the inequity of a tax which base was expanded primarily by assessing labor income.

The reform of the sixties substituted value-added taxation (VAT) for the two turnover taxes that had been the main sources of revenue for the Union and the states. The tax on industrialized products (IPI), federal, took the place of the consumption tax in 1964; and the ICM replaced the tax on sales and consignations, collected by the states, in 1967.

Both the IPI and the ICM were partial VAT. The IPI, still in force, taxes only the industrialization stages of the production and distribution course. The ICM, succeeded by the ICMS in 1989, reached all stages up to retail sales, but its base did not include minerals, fuels and lubricants, electric energy and services. The first three continued to be subject exclusively to federal excise taxes, the so-called single taxes (IUM, IUCL and IUEE, respectively). Transportation services, except those rendered within the bounds of a municipality, and communication services constituted the base of two other federal taxes,

---

[2] Constitutional Amendment 18, December 1, 1965; Constitution of the Federative Republic of Brazil of 1967, January 30, 1967; Law 5,172 (National Tax Code), October 25, 1966.

[3] On the reform of the income tax in the first half of the sixties, see F.G.V., Comissão de Reforma do Ministério da Fazenda (1967) and E. Lezan e R. Varsano (1981).

while other non-financial services were — and still are — assessed by the municipal tax on services of any nature (ISS).

The reform of the sixties, besides its success in the rehabilitation of Brazilian public finances — tax burden grew to 25% by the end of the decade, despite the generous concession of fiscal incentives —, was quite advanced for the time it took place. Specifically, Brazil was a pioneer in the use of VAT, now adopted in more than 120 countries,[4] preceding the European countries but France. Furthermore, Brazil was the first country — and until recently, the only one — to use VAT as a source of own revenue for state governments. [5]

Pioneers have the disadvantage that they cannot count on previous experience. Brazilian VAT was modeled on the only paradigm available by the mid sixties, the French tax enacted on 1948. Soon after Brazilian reform, in 1968, this tax was reformulated, becoming more inclusive, and the French service tax was extinguished. At that point, the IPI and the ICM were already fully implemented, not including services in their bases and with several imperfections, some corrected along time and many still persisting.

The ICM — and its substitute, the ICMS — most important shortcomings are related to the rules for assessment of interstate trade, for which no model and poor technical literature existed at the time of its institution. One exception was the so-called Neumark Report, which treated the similar problem of taxation of trade among European Economic Community (EEC) countries.[6] It proposed that EEC countries treated trade with third countries according to the destination principle and that they applied the origin principle to intra-community trade. This scheme, known afterward as the restricted origin principle, would have the advantage of eliminating fiscal barriers at intra-community borders.

The Report did not explore the economic consequences of the adoption of the restricted origin principle; but suggested that, in order to avoid economic distortions and intricate administrative procedures, tax rates should be the same (or, at least, very close) in

[4] See Ebrill et al. (2001).

[5] This assertion does not ignore the fact that Germany adopted a VAT, collected by the *landers*, in 1968. However, from an economic standpoint, the German tax is not, in fact, a subnational tax. Although collected by the *landers*, the tax is centrally legislated, its rate is the same in all units, and the global amount collected is allotted among them according to rules based on the equalization principle.

[6] International Bureau of Fiscal Documentation (1963).

all EEC countries. This severe restriction on fiscal sovereignty is probably the main reason for the reiterated postponements of the adoption of the scheme, not yet in practice in the European Union (EU) and that, probably, will never be.

In Brazil, the restricted origin principle was adopted for the ICM with a flaw, which is, in fact, a concession to tax tradition: immunity for exports to other countries was granted only to industrialized products, so that states were allowed to impose the tax on their exports of primary goods. And, as supposedly necessary, state autonomy to fix their rates was restrained. Uniform rates were required within each geo-economic region of the country; and ceiling rates were imposed, estimated to approximately replicate state revenues just previous to reform. Together, these conditions implied almost uniform rates nationally. Due to the initially high revenue produced by the new tax and to the authoritarian environment, the need for restrictions remained unquestioned and political reaction to autonomy loss was minor.

Instead, the central theme of debates had been the distribution of revenue among states. Since the restricted origin principle privileges net exporters in interstate trade — which, in Brazil, are the more developed states —, poorer units reacted to what, in their view, was an unfair revenue distribution. The adopted solution was to apply a lower tax rate to cross-border trade, so that revenue coming from these transactions is shared between importing and exporting states. The portion allotted to each unit depends on the difference between the rates applied to internal and interstate transactions, which has been increased over time to favor less developed states, without much attention to the aftermath of this practice.

No matter all conceptual deficiencies the ICM presented, it cannot be denied that adoption of a subnational VAT was a major breakthrough, which provided states with a reliable revenue source which effect on efficiency was much milder than that of their previous turnover taxes. Cumulative taxation was not eliminated, but its burden had become much lighter than before.

Unfortunately, while, in the whole world, VAT evolved in the direction of generalization and simplification, in Brazil, especially in the case of the state tax, it followed the path of specificity and complexity. Administration and compliance costs, relatively high with VAT, became excessive; and distortions imposed on the allocation of resources and on competition grew immoderately.

The reform of the sixties marks the beginning of a new stage in Brazilian taxation, in which taxes are viewed not only as revenue sources but also as policy instruments. In fact, the tax system was used as an important instrument of the strategy for accelerated growth conceived by the military government.

According to this strategy, private investment was desired but the federal government should be responsible for the orientation and control of the process, in order to maximize growth obtainable from Brazilian investment rate. This required centralization of economic decisions. The fundamental role of the tax system was to increase society's tax effort so that not only budget equilibrium could be reached but also part of the revenue could be surrendered in favor of capital accumulation. Fiscal incentives had the twofold objective of increasing private investment and canalizing it to activities ranking high in the prioritization of central government strategists. In other words, fiscal incentives were used "to buy" the decision power over private funds. As this power belonged to the wealthy, equity could not be a consideration of the tax reform; and income concentration was a trait of the strategy.

In respect to the public sector, the strategy required centralization of the legislative power on taxes that were primarily economic policy instruments — taxes on imports and exports (II and IE), on financial operations (IOF) and on rural real estate (ITR)[7] — or could interfere with the allocation of resources. But the strategy required as well that subnational units had enough revenue to perform their functions, in order to avoid hindering the growth process.

That explains the choice of a VAT as the main source of own revenue for states and, by means of a transfer of 20% of its proceeds to municipalities, for local units with reasonable economic base. With some restraint on state autonomy to legislate — legitimated by the adoption of the restricted origin principle that, according to the economic literature of that time, required it — ICM could be a very productive tax and, at the same time, almost neutral with respect to resource allocation.

[7] ITR would be — but, in fact, never have been — an instrument for agrarian reform.

The core of subnational governments financing was completed by two municipal taxes — the already mentioned ISS and a tax on urban real estate (IPTU) — and a set of federal grants — States Participation Fund (FPE) and Municipalities Participation Fund (FPM) — to ensure that state and local governments short of tax bases would have revenue enough to adequately perform their functions.[8]

2.2. Evolution and current features

The strategy was very successful for almost a decade. The country experienced very fast economic growth from 1968 to 1976, a period known as the Brazilian miracle. GDP grew at an average rate of 10% during this period, with a peak of 14% in 1973.

Of course, fiscal affairs were not the only reason for the success or for the later collapse of the policy. But they played a role in both situations. The unreasonable proliferation of fiscal incentive concessions stimulated investment while the consequent mushrooming tax renounces eroded federal finances, requiring adjustments in the fiscal model.

The first adjustment came just after the reform was concluded. In 1968, the amount of federal transfers to states and municipalities was drastically reduced; and conditions were imposed on the use of the resources. This includes earmarking to public works complemental to private investment, a clear indication that the optimal balance between private and public investment had been missed. To deal with the problem the government had to cut fiscal incentives. Two laws, of 1970 and 1971, halved the corporate income tax deductions for investment in some chosen sector or in the North and Northeast regions. The other half was earmarked to government investment programs.[9]

To reinforce further its finance — and appease the critics on income distribution —, the federal government created, in 1970, the Social Integration Program (PIS), a compulsory illiquid savings fund, belonging to workers of the private sector, supplied by a

[8] Some taxes were not referred to in the text. They are unimportant both with regard to their yields and for the discussion of the current process of reform. There are also constitutional intergovernmental transfers other than those mentioned in the text, which need not be considered here.

[9] Decree-laws 1,106, of June 16, 1970, and 1,179, of July 6, 1971, created the Program for National Integration (PIN) and the Program of Land Redistribution and Stimulus to Farming in the North and Northeast (PROTERRA).

turnover tax, the first one created after the reform. A similar fund was established soon after, with contributions of public institutions of the three levels of government, in behalf of civil servants (PASEP). The funds were unified in 1976. The 1988 Constitution halted contributions to the fund, preserved the ownership of accumulated assets, and assigned the PIS/PASEP contribution to the financing of the unemployment insurance.[10]

Creation of new incentives ceased in the early seventies, but concession of the already existing continued, at a gradually slower pace, during the eighties and into the nineties. Despite the erosion of tax proceeds due to the incentives, government managed to sustain the country's tax burden at a level around 25% of GDP, by means of incessant changes in tax legislation. Prominent among them was the institution, in 1982, of the contribution to the Social Investment Fund (FINSOCIAL). This was another turnover social contribution that, after the 1991, became the current contribution for the financing of social security (COFINS).[11]

At that time, growth had subsided — growth rates were negative in 1981 and 1983 and barely positive in 1982 —, foreign finance, one of the inputs of the Brazilian miracle, was scarce and interest rates high. Although the tax burden has been sustained at reasonable level, the fiscal crisis that still persists began.

After more than 20 years of both political and fiscal centralism, the chief motivation for the tax reform accomplished by the National Constituent Assembly was decentralization of tax proceeds. In fact, deconcentration had been in course since 1983, both because of the legal increase in the shares of the IPI and the IR yields going into the FPE and FPM and for the boost in voluntary transfers from the Union to the states and municipalities during the transition back to democracy.

[10] Complementary Laws 7 and 8, of September 7 and December 3, 1970, created, respectively, the PIS and the PASEP. The funds were unified, from July 1, 1976 on, by Complementary Law 26, of September 11, 1975. Workers, the owners of the assets, could not draw from the fund, except in special occasions, such as marriage, retirement, and disability. The financial results of the fund were distributed once a year. Art. 239 of the 1988 Constitution, which assigned the PIS/PASEP contribution to the financing of unemployment insurance, determined that employees of PIS/PASEP taxpayers earning a monthly amount up to two minimum wages receive from the fund a sum equal the monthly minimum wage per year.

[11] Finsocial was enacted by Decree-law 1,940, of May 25,1982 and COFINS by Complementary Law 70, of December 30, 1991.

Deficient information about the ongoing decentralization, as well as the existence of influential "municipalist" and "regionalist" groups of constituents, resulted in an excessive increase in the amount of mandatory federal transfers to those units. The subsequent reaction of the federal government was a reduction in voluntary transfer so that the net result was more the consolidation and institutionalization of previous deconcentration than an addition to it.

Local governments had, nonetheless, a very large gain. It was due not only to the larger flow of federal transfers but also to the increase, from 20 to 25%, in the percentage accruing to them of the yield of the principal state tax, which base was expanded. The states, all in all, realized a modest gain, despite the expansion of the base of their main tax. But they recovered their autonomy to set the rates applied to intrastate transaction.

Five federal taxes — the three single taxes and those on transportation and communication services — were extinguished and their bases pooled together with that of the ICM to constitute the ICMS. The objective was twofold. First, following the general mood for decentralization, to enlarge the base — and, thus, the yield — of the state tax. Second, to eliminate excise taxation of production inputs.

It should be noted that fuels, electric energy and communication services are very ease to tap tax bases. States used their autonomy to set selective rates to impose higher ones on these goods. Nowadays, they are responsible for more than a third of ICMS total revenue, what, although a distortion for a VAT, shows that the first part of the objective was plainly attained. On the other hand, its second part was only partially fulfilled because the ICMS (as well as the IPI) paid on inputs gives rise to VAT credits according to the so-called "physical criterion".[12] Albeit the 1996 Kandir Law, which is part of the present process of reform, stipulated the adoption of the "financial criterion", this requirement was not yet put in effect.[13]

[12] This means that the taxpayer may claim credit only for taxes paid on those inputs that are embodied in the product to be sold. For example, a credit cannot be claimed on electric energy used in offices and selling points of an industry. The alternative is the so-called "financial criterion" according to which credit against VAT liabilities are allowed for any tax paid on inputs.

[13] The so-called Kandir Law (Complementary Law 87, of September 13,1996) was followed by Complementary Laws 92 (12/23/97), 99 (12/20/99), 102 (07/11/00), 114 (12/16/02) and 115 (12/26/02), which modified the tax treatment of capital goods and postponed the enforcement of some of its provisions. See page 27 and following, below.

Several proposals intending to improve the quality of subnational taxation were advanced during the parliamentary discussion but few prospered. Most clashed with the strong resistance to any innovation that could imply a reduction of revenues for subnational units, even to those associated to other changes that would more than compensate such losses.

A proposal for inclusion of all other services in the ICMS base — extinguishing the ISS and compensating municipalities with increased participation, from 20 to 25%, in the state tax proceeds — was rejected (though the higher municipal share held).

Another proposal, for the adoption of the destination principle both for international and interstate trade — with collection at the origin and a "clearing house" procedure —, was rejected, except for interstate transactions with fuel and energy, which were zero rated (promoting, in the case of fuel, gross evasion). In all other cases, rules for taxation of interstate trade were not changed. Regarding foreign trade, a move was made in the wrong direction: not only primary exports remained taxable but also immunity for part of the industrialized products, so called "semi-elaborated" (a new category which would be defined by law), was dropped. Moreover, a federal transfer, equivalent to 10% of the IPI revenue, was created like compensation for not collecting taxes on manufactured exports (a rule which was in force since 1967).

Anyway, despite the preponderance of decentralization as objective and the resistance to other changes, the above mentioned extinction of federal taxes shows some concern of the 1988 reform with the effect of taxes on production.

The National Constituent Assembly showed also some interest in the question of equity of taxation, ignored by the previous reform. The Constitution assigned a tax on large fortunes (IGF) — in fact, a politically convenient name for a wealth tax — and a social contribution on net profit (CSLL) to the federal government. A tax on motor vehicle (IPVA) was assigned to the states that share 50% of the proceeds with their respective municipalities. Furthermore, two taxes, one on commercial real estate transfers (ITBI), municipal, and the other on donations and succession (ITCMD), assigned to the states, substituted for the previous tax on real estate transfers. The intention was that the federal and state governments would use their taxes to increase tax system progressiveness.

CSLL has been in force since 1989.[14] The question about it — an old unresolved issue in the public finance literature — is whether it stays put or is shifted to consumers and/or labor. CSLL would be progressive only if the first alternative holds. IGF has not been implemented so far. IPVA was not, in fact, a new assessment; it replaced a previously existent fee. And ITCMD is an ill-administrated flat rate tax. In short, concern about equity had little practical consequences. The only undoubtedly (lightly) progressive tax in Brazil is the individual income tax.

Revenue deconcentration without a concomitant organized and agreed upon process of decentralization of responsibilities — in fact, the Constitution added new duties to the federal list — concentrated the fiscal imbalance in the Union. The reaction was, on the expenditure side, the so-called "dismantlement operation", which consisted of discontinuing unilaterally a large number of programs and activities, even some essential ones, in the hope that states or municipalities would adopt them as their responsibility. On the revenue side, the reaction was to increase taxes that the federal government does not share with subnational governments.

Reasonable quality federal taxes like the IR and the IPI, which yields are shared with subnational governments — according to the Constitution, 44% and 54% of the amount collected, respectively, belong to those units —, deserved little effort to increase the revenue. Bad quality taxes, like the cumulative social contributions, a source of finance exclusive of the Union, were grossly increased during the nineties. PIS/PASEP and COFINS accounted for about 6% of total tax burden of the country by the end of the eighties. Their rates grew in the nineties; and a temporary social contribution on bank debits (CPMF) was created. In 2001, the revenue coming from these three assessments was beyond 18% of Brazilian total tax collection.

As the IR and the IPI levied constitute general-purpose funds while social contributions are earmarked to social security expenditures, the change in the composition of the federal revenue amplified a budgetary problem, namely, rigidity in the allocation of the federal resources. The solution came through a transitory constitutional provision that, among other things, liberated for general use, from March of 1994 to June of 1997, 20% of

[14] Law 7,689, of December 15, 1988.

all earmarked federal revenues. Other constitutional amendments successively extended the period that, according to present rules, will finish at the end of 2003.[15] A new postponement of the final date will probably happen.

Payroll and wage taxes make up another important set of social contributions. They amounted in 2001 to over 13% of GDP, accounting for almost a quarter of total tax revenue (See Table I). They are the main source of finance for the social insurance but are addressed to several other purposes as well. This set of contributions is under severe criticism both because they impair competitiveness of Brazilian production — in fact, they do so only insofar as their burden is heavier than in competing countries — and for the wedge they impose between the wage costs to the firms and the take-home pay of workers. The wedge stimulates informal labor relations that, besides contributing to the precariousness of employments, reduce the payroll tax base.

Other categories of duties composing the Brazilian tax system are the fees, for services and for police power, betterment contribution, compulsory loans, contribution in the interest of professional or economic categories, and contribution for intervention in the economic domain. They were all of minor importance, in terms of revenue, until the beginning of 2002. A contribution for intervention in the economic domain on the importation and commercialization of oil and derivates, natural gas and derivates, and combustible ethylic alcohol (CIDE) has been in force since then.[16] Its expected revenue in 2003 is, approximately, 0.5% of GDP.

Table I presents the most important Brazilian taxes, classified according to their bases and ordered, for each tax base, by their respective revenues in 2001. Its second column shows the level of government that detains the power to enforce the levy. The table shows that taxes on goods and services account for almost half of total revenue. The income and profit taxes group follows in importance the taxes on payroll and wages, which

[15] Constitution Revision Amendment 1, of March 1, 1994, created the so-called Emergency Social Fund (FSE), later extended and renamed as Fiscal Stabilization Fund (FEF) by Constitutional Amendment 10, of March 4, 1996. Constitutional Amendment 17, of November 22, 1997, postponed again its ending date to the 31st of December of 1999. Finally, Constitutional Amendment 27, of March 21, 2000, did not recreate the fund but maintained 20% of earmarked funds liberated up to the end of 2003.
[16] Law 10,336, of December 19, 2001.

account for more than a quarter of total tax proceeds. The state VAT is the most important Brazilian source of revenue.

Table II shows the tax burden and collected and disposable revenues shares of the three level of government for selected years.[17] These were chosen to illustrate the results of the Brazilian tax reforms in terms of centralization/decentralization of tax revenue.

It is clear from the table that the immediate result of the reform of the sixties was a mild concentration of revenue in the central government and redistribution from states to municipalities. Participation of these units in disposable revenue increased sharply in the sixties. A strong revenue concentration process had occurred in the seventies and early eighties, reaching a peak in 1983.

By the time the 1988 Constitution was promulgated, decentralization had been in course for five years. As a result of the tax reform, the process continued up to 1995, despite the reaction of the federal government. Fiscal resources available to municipalities reached an all-time peak in that year. States, however, did not manage to recover the share of total tax revenue that they enjoyed in the sixties.

[17] Disposable revenue is that remaining to the government unit after transfers received from and delivered to other units.

Table I: Brazilian Main Taxes According to Their Tax Bases — 2001

Tax Bases and Taxes	Government Level[a]	Tax Revenue	
		% of GDP[b]	% of Total
• **Goods and Services**		**15.71**	**45.74**
ICMS	State	7.96	23.17
COFINS	Federal (SSB)	3.84	11.17
IPI	Federal (FB)	1.63	4.75
PIS/PASEP	Federal (SSB)	0.94	2.74
II	Federal (FB)	0.77	2.24
ISS	Municipal	0.57	1.67
• **Payroll and wages**		**8.42**	**24.51**
Social Insurance Contribution	Federal (SSB)	5.16	15.01
FGTS[c]	Federal	1.78	5.18
State Servants Social Insur. Contr.[d]	State	0.52	1.50
Federal Servants Social Insur. Contr.[d]	Federal (FB)	0.32	0.94
Contributions to the “Sistema S”[e]	Federal	0.27	0.80
Contrib. to the “Salario-Educação”[f]	Federal (FB)	0.26	0.77
Municipal Servants Soc. Insur. Cont.[d]	Municipal	0.11	0.31
• **Income and Profit**		**6.57**	**19.12**
IR	Federal (FB)	5.81	16.91
CSLL	Federal (SSB)	0.76	2.21
• **Financial Flows**		**1.75**	**5.09**
CPMF	Federal (SSB)	1.45	4.22
IOF	Federal (FB)	0.30	0.87
• **Property and its Transfer**		**1.11**	**3.24**
IPVA	State	0.53	1.55
IPTU	Municipal	0.45	1.32
ITBI	Municipal	0.08	0.24
ITCMD	State	0.03	0.08
ITR	Federal	0.02	0.05
Main Taxes Total		**33.56**	**97.70**
Other Taxes		**0.80**	**2.30**
Total Tax Burden		**34.36**	**100.00**

Source: Santana et al. (2002).

[a] Brazilian federal government has two budgets, one exclusive of the social security (SSB), and other general, referred to as fiscal (FB).

[b] The estimate of GDP for 2001 used in the table, which source was IBGE (the Brazilian statistics bureau), is R$ 1,184.0 millions. According to a more recent IBGE estimate, GDP is R$ 1,200.1 millions, implying a slightly lower tax burden.

[c] FGTS is a compulsory saving fund in name of workers, supplied by an 8% payroll contribution from employers. Workers may draw from the fund upon their dismissal or retirement. Since FGTS resources belong to workers, they are not included in the budget.

[d] Private sector workers and employers contribute to the Social Insurance General Regime. Civil servants of the three levels of government contribute to special regimes.

[e] Set of contributions in the interest of professional categories, collected together with the social insurance contribution, and transferred to the beneficiary institutions. As resources do not belong to government, they are not included in the budget.

[f] Contribution earmarked to education expenditures, collected together with the social insurance contribution and shared by federal (1/3) and state (2/3) governments.

Table II: Brazilian Tax Burden and the Shares of Federal, State and Municipal Governments in Total Revenue for Selected Years

Year	Tax Burden (% of GDP)	Share in total tax collected (%)			Share in disposable revenue (%)		
		Union	States	Local	Union	States	Local
1960	17.41	64.0	31.3	4.7	59.5	34.1	6.4
1970	25.98	66.7	30.6	2.7	60.8	29.2	10.0
1983	26.97	76.5	20.6	2.8	69.8	21.3	8.9
1988	22.43	71.7	25.6	2.7	60.1	26.6	13.3
1995	29.41	66.0	28.6	5.4	56.2	27.2	16.6
2001	34.36	68.7	26.8	4.5	59.3	26.5	14.2

Sources: Santana et al. (2002); and R. Varsano et al. (1998)

As a result of stabilization and of several fiscal measures taken by the federal government, the tax burden raised from around 25% of GDP in the early nineties to the 34% mark registered in 2001. The increase was concentrated in the federal budget. As a result, the decentralization process was reversed. The small gain obtained by the states after 1988 has been wiped out. Municipalities still retain some gain; but their share is only one percentage point above their 1988 slice of the tax cake.

3. The Motivation for the Current Process of Tax Reform

3.1. The usual motivations for tax reforms

Evaluation of the quality of a tax system takes into account a set of characteristics considered desirable, which are associated with the principles of taxation. The absence or deficiency of any of these characteristics provides a motivation for a reform.

One of the usual motivations for a reform is related to neutrality. Ideally, taxes should not affect allocation decisions, except when they are used as policy instruments that intend to change the behavior of economic agents. In practice, taxes are never neutral and the aim of tax reform is to minimize pernicious effects of taxation on the efficiency of the economy and the competitiveness of its production sector.

Search for a more equitable system may be another motivation. Progressivity is a desirable feature of a tax system, particularly in countries like Brazil, where the distribution of income is quite uneven. However, in a world of intense capital mobility, it is unlikely that taxes may have significant redistributive effect without stimulating capital flights. If this is the case, reforms should have the more restricted objective of avoiding regressivity. The burden of redistribution would then rest on the expenditure side of government budget and the role of the tax system would be to provide adequate finance to government policies without imposing important distortions on the economy.

This introduces a third motivation for reform, namely tax productivity. Adequate government financing must be provided without resort to excessively high tax rates, which stimulate evasion. This brings about a preference for broad base taxes and requires avoidance of legislation loopholes and a highly qualified tax administration.

Simplification is another question usually present in the reform agenda. The daily alterations suffered by tax legal and administrative norms, in response to changes in the relevant environment, tend to increase the complexity of the system as time goes by. Complexity creates costs for both the administration and the taxpayers that, like the efficiency costs of taxation, must be minimized.

Despite the essentiality of searching for simplicity, reformers must be aware that, due to the natural complexity of economic relations, good quality taxation is inherently complicate. They must resist the temptation to adopt simple taxes that promise low administration and compliance costs but promote important distortions in the allocation of resources, creating costs for society that, although less obvious than the administration and compliance ones, are far larger.

Finally, a further motivation for reform, pertaining only to federations and fiscally decentralized unitary countries, is to promote a change in the distribution of public resources among government units. This is one of the toughest questions in tax reform, due to the intrinsic conflicts of interests that it entails.

A comprehensive tax reform involves all these questions, even though some may not be explicit in the discussion agenda. But, in each reform, there are chief and secondary motivations as well as some aspects to which hardly any attention is paid.

The Brazilian reform of the sixties had as its main motivation the increase in tax productivity. And, in fact, total tax burden jumped from around 16% of GDP in 1963 to near 25% of GDP in 1969, a 55% increase in only six years. Federative relations were the main issue in the reform of the eighties. And concentration of disposable revenue in the central government fell from a peak of 70% in 1983 to below 60% currently, even after some recentralization that occurred in the nineties.

The effects of taxation on production and international trade are the foremost concern of the tax reform process in progress now. It intends to adequate the tax system to the remarkable changes in the economic environment that Brazilian producers have been facing since the beginning of the nineties.

3.2. Some economic events of the last ten years and the chief motivation for the tax reform now under discussion

The invention of the transistor, in 1947, was the starting point of a technological revolution that gave rise to the so-called information and communication technology. Easy long-distance communication and swift diffusion of information have provoked striking transformations in international relations, summarized by the word globalization.

Globalization of economic relations had been ignored or rejected by Brazilian policy makers, including the National Constituent Assembly, until the end of the eighties.

In the middle of that decade, a national policy had been established aiming the development of a then nonexistent Brazilian informatics and automation industry. It prescribed fiscal incentives to new firms and controls on imports of informatics and automation goods and services in order to reserve the domestic market for Brazilian firms. The results of this policy — based on infant industry and national security arguments — were not only the failure to build a competitive and up-to-date industry but also to hamper the development of the whole Brazilian economy, which could not introduce productivity enhancing innovations.

The 1988 Constitution did not take into account the integration process that was taking place all over the world. It discriminated against foreign capital willing to participate in domestic production and set a ceiling of 12% per annum for the interest rate that could be charged on loans. Implementation of the ceiling required regulation, which should also address other constitutional provisions regarding the financial activities. The pertinent law has not been enacted so far. Therefore, the ceiling has not been enforced, but at the cost of hindering adequate regulation of the Brazilian financial sector.

Except for the surge of exports during part of the Brazilian Miracle period, Brazil had traditionally been a fairly closed economy. Despite the worldwide movement towards openness, the successive governments of the seventies and eighties preferred to keep domestic markets protected from international competition. The country had not faced the difficulties of the globalization but, on the other hand, had not enjoyed the benefits brought by the new situation.

Two prominent macroeconomic changes took place in Brazil in the first half of the nineties. First, in 1990, government promoted a belated — and, maybe for this reason, in the hurry — opening of the economy that it called a “competition shock”. Soon after, regional economic integration started, with the creation of an economic bloc, the Common Market of the South (Mercosur).[18] Second, in 1994, a stabilization plan — Plano Real — managed to pull down inflation, almost instantaneously, from two-digits monthly rates to a one-digit annual percentage.

Openness and stability thoroughly changed the economic environment in which the production sector operates. In this new situation, competitiveness surpasses sound financial administration as the key question for business survival.[19] Unless the Brazilian production system becomes competitive — what requires the creation of suitable conditions— the country will be doomed to stagnation. One of such conditions is good quality taxation and the question is what does this mean in a context of globalization.

Deepening of the process of market globalization and the formation of regional economic blocs — in the case of Brazil, Mercosur in the present and, probably, the Free Trade Area of the Americas (FTAA) in the near future — gave rise worldwide to increased

[18] The Treaty of Assunción, signed by Brazil, Argentina, Paraguay and Uruguay on March 26th, 1991, created the bloc.
[19] Financial gains still are a very important component of profits due to a conjuncture requiring very high interest rates.

concern on the impact of tax policy on the production and investment decisions, which are now based on global rather than national factors. Fiscal harmonization effort has increased and domestic tax policies have become growingly subordinate to international practices, implying very narrow bounds to fiscal sovereignty. Countries cannot disregard these limits if they intend to be participants in the global economy.

Intense and practically instantaneous international capital mobility requires that the tax system of a country take into account the characteristics of the international financial market and do not impose levies on capital flows which intensity differs significantly from that established by countries competing for the funds. The question is particularly relevant in the case of foreign direct investment, which is sensible both to taxation of capital flows and of business. Permanence of assessment rules is another important feature of a tax system, especially for agents that seek medium and long-term low risk investment opportunities, as is the case of pension funds. In all these instances, a country may face considerable damage to its stability and growth if it disregards tax stimuli to international capital flows.

Countries that need to grow fast, as is the case of Brazil, should rule out taxation that impairs investment, both foreign and domestic. Specifically, taxation of capital goods penalizes investment vis-à-vis consumption. Such good will be taxed twice, once upon its acquisition and again, along its lifetime, due to taxation of its products, which price includes the amortization of its cost. Neutrality would require the concession of tax credits along the lifetime of the taxed capital good. However, the simplest practice — adopted by most countries and the most convenient for a developing one — is immediate and full exoneration of the capital good.[20]

Regarding taxation of goods and services, the use of exports as a tax base is practically precluded. Destination principle is the rule in all countries that are important participants in international trade. Therefore, if a country taxes its exports, they would be

[20] Regarding value-added taxation, three types of taxes may be distinguished according the treatment of capital goods: gross product type, which taxes capital goods; net income type, implying taxation and tax credits along lifetime of the good; and consumption type, which does not subject capital goods to the tax. This last type is the one adopted by most countries but not by Brazil.

burdened twice, once in the origin and again in its destination, while its competitors would be assessed only in the destination.

Exports may be taxed only in special cases of notorious competitive advantage derived from natural factors — mostly concerning commodities —, and provided international prices are in a very favorable phase and the tax is viewed as a foreign trade policy instrument — and thus temporary — rather than as a revenue raising device. Notwithstanding, the general rule is to avoid any levy that may affect the competitiveness of domestic production in the international markets.

By the same token, import duties should not be used anymore to make up for competitive disadvantages imposed to the country's production by its domestic taxes. This rule is yet more important for participants of regional blocs. Economic integration leads to the suppression of import taxes for transactions between members of the bloc and to the adoption of common tariffs for trade with third parties. Loss of the autonomy to conduct the commercial policy is one of the costs of integration.

Despite the achievements of Brazilian economic policy during the second half of the nineties and the outset of the present decade, vulnerability of the country is still relatively high. The recent boom of exports and slow down of imports — due, in part, to excessive devaluation of the Brazilian currency and to sluggish economic growth — was not enough to revert the balance of payments deficit, which was around U$ 7.8 billions for 2002.

The excessive devaluation provided space to price increases. Monetary authorities reacted to recrudescence of inflation by raising nominal interest rate. Public debt, most of it indexed to exchange rate, price or interest rate, increased substantially. Net public debt was near 56% of GDP in December of 2002, and interest payments along the year amounted to 8.43% of GDP. In other words, despite the huge fiscal effort that resulted in a 4.06% of GDP primary surplus, the public sector experienced a 4.38% of GDP nominal deficit.[21]

Though an official number is not yet available, total tax burden in 2002 was around 35% of GDP, a level that seems too close to the fiscal capacity of the Brazilian society.

[21] Central Bank data, relative to December of 2002 in the case of the stock of debt, and, concerning all other variables, to the period January to December, evaluated at December prices (deflator: General Price Index (IGP-DI), estimated by Fundação Getúlio Vargas).

Therefore, the practice of the recent past — to produce primary surpluses from tax burden boosts — will not be feasible hereafter.

It seems to be consensual in Brazil that, in the short run, economic policy priority must be to prevent the reinstatement of a chronic inflation process in the country. Nevertheless, there is also a widespread demand for rates of growth higher than the modest ones of the past 20 years. This is not only a desirable objective in itself but also, combined with fiscal austerity, the only perceived way out — save a breach of public debt obligations — of the fiscal crisis that the country has undergone since the beginning of the eighties.

Faster growth cannot happen unless the country overcomes its external restriction, what requires that the capacity to compete of its production sector improve. Under these circumstances, minimization of the perverse effects of the Brazilian tax system on the competitiveness of domestic producers is fundamental for resuming a sustainable growth path. This has been the chief motivation of the tax reform under discussion since 1995.

4. The Main Shortcomings of the Tax System and the Advisable Reforms

In a context of international economic integration, domestic taxation of a country that must sustain fast growth cannot inhibit exports, investment and job creation. It should not interfere, unless intentionally, with competitive conditions in the domestic markets, both among domestic firms and between those and foreign competitors. Interference with choices concerning the location and the method of production should be avoided, for they may induce decisions that increase the social cost of production.[22] Last, domestic taxes should be suitable for harmonization with those of countries that are important commercial partners.

It is practically a consensus that the Brazilian domestic taxation hinders both the insertion of the country in the global economy and economic growth, for:

- It imposes a competitive disadvantage to the Brazilian production sector, in both the international and the domestic markets;

[22] It should be stressed that the text refers only to domestic taxes and does not advocate that free trade is necessarily the best situation. Also, the neutrality of domestic taxes should not preclude their use as instruments of some policies (e.g., regional) that intend to correct distortions.

- It distorts the allocation of resources in detriment of economic efficiency;
- It increases the cost of investment by taxing capital goods;
- It is excessively complex and inappropriate for international harmonization;
- It facilitates or even stimulates evasion, causing inequity and unequal competition; and
- It is suitable for predatory fiscal competition among states, the so-called fiscal war, that brings about conflicts in the federation.

Therefore, a reform is in order to restore the ability of the tax system to serve development. It is a necessary, though not sufficient, condition to lead the country back to a path of sustained and faster economic growth, which would make easier the improvement of fiscal and social conditions.

Tax system contribution to the Brazilian Miracle was accomplished, as already mentioned, through a huge increase in the fiscal effort of the society, which was very low previous to reform. Present situation is quite different. The citizens view current tax burden, around 35% of GDP, as far too high for the Brazilian level of development and income distribution. It is practically impossible to extract from society any additional financing for government activities. Further increases in nominal tax rates would probably result in additional informal economic relations and evasion. In fact, it will be difficult even to sustain the tax burden at its present level for a long period.

On the other hand, despite the recent success in restraining public expenditures growth, evidences are that it would be impossible to compress them much further. High interest on public debt, the need to finance social programs that counteract the tendency of globalization to concentrate income and wealth, and the urgency of public investment both to replace wear out infrastructure and for new public works — required to avoid bottlenecks in the hopefully growing economy — will not allow a reduction in expenditures.

In view of these considerations, the conclusion is that the reform will not increase further the tax burden; but one of its aims must be to prevent reductions until additional revenue derived from economic growth contributes to mitigate the fiscal restriction. A reform is inevitable and urgent because improvement of the quality of taxation, concerning both efficiency and equity aspects, is a sine qua non condition to keep the tax burden at its present level, which will be, yet for a long time, a requirement for fiscal equilibrium.

The main shortcomings of the tax system that plague Brazilian economy are:

- Cumulative taxation
- Evasion
- ICMS rules applying to interstate trade
- Fiscal war
- Excessive payroll taxation
- Excessive taxation of business and relatively low personal tax burden
- Complexity

4.1. Cumulative taxation: improving efficiency and competitiveness

Cumulative taxation is present in tax systems worldwide. Even taxes like VAT, theoretically non-cumulative, and retail sales taxes (RST), ideally a tax on final consumption only, always present imperfections that bring about some cascading. Nonetheless, these are usually minor deficiencies that do not impose any significant damage to production.

Any country that intends to be a relevant participant in the international economy should not tolerate intentional cumulative taxation. Even those which participation in trade is insignificant, like some of the less developed countries of Africa, have already realized that cumulative taxation is harmful and are substituting VAT for the turnover taxes that they inherit from colonial times.

In Brazil, the Constitution of 1967 had eradicated turnover taxation. But, three years later a new turnover contribution was created. Since then, the importance of cascading taxes has grown in several episodes when the federal government was seeking a new source of revenue. In the nineties, federal administration clear preference for easy to collect taxes, especially those not shared with subnational governments, promoted a surge of cascading taxation that significantly deteriorated the quality of the tax system. Nowadays, cumulative taxation accounts for more than 40% of total tax collected by the Federal Revenue Secretariat[23] and for almost ¼ of Brazilian total tax burden, a mark one will hardly find in any other country.

Besides the federal turnover social contributions —COFINS, CPMF and, until the end of 2002, PIS —,[24] ISS is a cascading tax, though only on services, and its interaction with the ICMS and the IPI create further cumulative taxation. Assessment of capital goods by the IPI, adoption of the physical credit criterion for both the IPI and the ICMS, and failure to refund to taxpayers, mainly to exporters, IPI and ICMS accumulated credits are also sources of cumulativeness. Furthermore, at the option of the taxpayer, business income tax and the social contribution on net profit may be charged on the firm's turnover, considered as presumed profit, and small firms may replace a set of federal taxes by the SIMPLES, also a turnover tax.

Cumulative taxation changes relative prices, unintentionally and uncontrollably, distorting decisions on the method of production and creating inefficiencies in the productive system. It burdens capital goods and exports, distorts competition and puts national producers in competitive disadvantage vis-à-vis foreigners. Moreover, it cannot be harmonized with the taxes of commercial partners.

A turnover tax imposed with a uniform nominal rate originates different effective rates on each of the goods produced. The effective rate depends on the number of transactions made along the production and commercialization chain in each case; and, given that there is no such burden on imports, it depends as well on the participation of direct and indirect domestic intermediary goods in the total value of inputs. In the case of Brazil, where exportation is exempt from PIS and COFINS, the burden on a firm increases the larger is the relation between its domestic and total sales.

In short, the cumulative tax produces uncontrollable changes in relative prices that introduce all sorts of distortion in the production sector. A well-known case is that of a firm

[23] The Federal Revenue Secretariat is responsible for the collection of all federal taxes, except social security payroll contributions and some unimportant fees.
[24] Law 10,637, of December 30, 2002, reformed PIS, mitigating its cumulative effect.

that, in the absence of the tax, would decentralize part of its production process. This efficient choice may be replaced by self-production due to the tax on the additional transaction that would exist. In other words, the cascading tax promotes inefficient vertical integration of production.

Cumulative taxation interferes with economic growth through its effect on investment decisions. The tax burdens capital goods, meaning that, for a given aggregate savings rate, investment forthcoming will be lower. In the case of Brazil, savings rates now and at the time of the Brazilian Miracle are similar. Notwithstanding, investment rates are considerably lower now, due to divergence in the cost of investment in the two periods. Cumulative taxation is one of the factors behind the discrepancy.

Considering any product, it is impossible to know the amount of cumulative tax contained in its price. This would require following its production process from the first stages of production of each of its input up to the final sale to a consumer. Moreover, as similar products may be obtained by different production techniques — implying different numbers of commercial transactions and different degrees of nationalization —, two varieties of a, for practical purposes, homogeneous product may be submitted to quite different effective rates of a cumulative tax.

Distortion of competition is, therefore, evident. An efficiently produced good may be unable to compete with a similar good which cost, net of tax, is higher. As the amounts of tax built in the prices are unknown, refunds or tax credits to the efficient producer or imposition of a compensating duty on the inefficient one cannot correctly compensated the distortion. This is particularly important in the case of international trade.

The widespread use of the destination principle for treatment of international trade flows ensures that a non-cumulative internal tax do not affect competition between a domestic and a similar import. And, as the internal tax does not burden exports, they may compete in equal conditions in any market with products of that place or of third countries. This is not the case when cascading taxes exist.

In Brazil, while domestic goods are subject repeatedly to COFINS, CPMF and, till recently, PIS along their whole production and commercialization chain, similar imported goods are taxes only in the commercialization phase or, if they are inputs, after incorporation to the good that they integrate.[25]

Concerning exports, Brazilian practice has been to exempt the act of exporting and, since December of 1996, to allow a presumed tax credit that is compensated, if possible, against IPI liabilities. The credit is equal to 5.37% of the value of inputs, subject to the IPI, used in the production of the export.[26] Of course, only by change the refund will equal the unknown tax born by the inputs. In general, it will be either insufficient or more than sufficient to compensate the burden. In the first case exports become less competitive; in the second, a subsidy exists that may subject the country to retaliations. This was one of the reasons for the replacement of European turnover taxes by VAT in the sixties.

4.2. VATs: complexity, fiscal war, and taxation of interstate trade[27]

ICMS has been in force since March 1989. A complementary law should regulate the new tax. The 1988 Constitution, to prevent a possible legal vacuum, stipulated that, if such law were not enacted until 60 days after its promulgation, states could provisionally make the tax effective by means of a covenant. The law was not enacted and, consequently, ICMS was regulated by norms collectively adapted by states from previous ICM legislation.

In 1995, when a constitutional amendment proposal was presented that, among other objectives, aimed at overhauling the ICMS, the due law had not yet replaced the provisional covenant. The lack of a law gave rise to judicial actions claiming that, without it, the ICMS could not be charged. It was argued that seven years is too large a lapse to be adherent to the concept of provisional. The main source of state revenue was at risk.

To fill this legal gap, federal deputy Antonio Kandir proposed, in the beginning of 1996, a law that would not only regulate the ICMS but also reform some of its features. Soon after, he became the minister of planning. The threat of losing their main source of

[25] In the case of the CPMF, taxation occurs one stage earlier, as a bank account debit is required to pay for the foreign exchange.
[26] Law 9,363, of December 13, 1996. A more recent law (Law 10,276, of September 10, 2001, modified by the art. 6th of Law 10,637, of December 30th, 2002) established an alternative way to compute the presumed credit. Exporters choose which method they will use during the year.
[27] This subsection draws on Varsano (2000), and Mora and Varsano (2001).

revenue forced state governments into the discussion of the complementary law. Thus, Kandir had the opportunity to conduct himself the negotiations — state governments on one side and federal government on the other, with the National Congress acting as the referee — leading to Complementary Law 87, the so-called Kandir Law.

The law is not a mere reproduction of Kandir's original proposal. Its content is based on three different projects of law. It is the result of a couple of months of technical effort, made jointly by federal and state officials, followed by hard political negotiations. These include definition of a scheme for compensation of conceivable revenue losses resulting from the changes in the characteristics of the tax. After months of intensive negotiation, a proposal for regulation of the ICMS passed fast through legislative procedures.

Insofar as quality of the Brazilian subnational VAT is concerned, this law has been the most important piece of legislation enacted in the country. It introduced three economically meaningful alterations that corrected original deficiencies of the ICM. First, all exports to other countries were exonerated from the state tax, marking the end of a dispute that had lasted for over a century, about taxation of exports by the states.[28] Second, investment goods were also freed from the burden, by allowing buyers to credit the tax paid against their tax liabilities. Third, taxpayers were allowed to compensate taxes previously paid on all their inputs — no matter they are physically incorporated to the output or not — with their liabilities.

Unfortunately, due to posterior state governments political pressures, subsequent legislation determined that the tax on capital goods should be compensated along a four-year period instead of immediately; and postponed to 2007 the effects of the stipulations on tax credit for inputs.[29]

Complementary Law 87 reduced the quality gap between the ICMS and similar duties in force in other countries. According to that law, ICMS would be a consumption-type VAT. In view of subsequent legislation, it is now a net income-type VAT and — from

[28] A constitutional provision had attributed to the complementary law the power to exempt exports other than those for which immunity had been therein assured. The law prescribed also the refund of eventual unused credits relative to ICMS paid by exporters on their inputs. Up to now, states have not fully complied with this determination, meaning that residual taxation of exports still exists.
[29] See footnote 14.

a national, though not from a state, viewpoint — a destination-based tax. Yet dissatisfaction persists, and further reform is needed to give the subnational tax the contour of a modern VAT.

A non-exhaustive list of complaints includes:

- Lack of uniformity in tax rules among states;
- Complex and burdensome administration, both to taxpayers and the public sector, with high compliance costs due, among other things, to the existence of two different VATs, a federal and a state one;
- Preservation of some degree of cumulative taxation due to exclusion of services from the tax base;
- Incapacity to raise a reasonable level of revenue to less-industrialized states;
- Undesired redistribution of revenue among states in the cases of exports to other countries and capital goods purchases;
- A high level of evasion, part of which due to the difference between rates applied to intrastate and interstate transactions;
- Vertical inequity; and
- Fiscal war among states competing for new plants, which disturbs state financing, allocation of resources, and harmony in the federation.

Many self-nominated tax experts in Brazil claim that adoption of a VAT would be the best solution for the country, without realizing that the problem is just the opposite: there are 28 different VATs in Brazil—the IPI, one in each of the 26 states, and one in the Federal District. They are unable to identify IPI and ICMS as taxes similar to the modern VATs they see in other countries; and, in some sense, they are right. While VAT evolution in the entire world has pointed to simplification and generalization, Brazilian VATs have become progressively more complex and particularized.

IPI and ICMS are partial taxes, the former on manufactured goods only and the later on all merchandises but not on services, except communication and intermunicipal and interstate transportation. They are highly selective taxes, with many distinct rates applying to different goods; and, in the case of the ICMS, the rate concerning any particular good varies among states while interstate transactions are subject to one out of two different rates, set by the Federal Senate.[30]

The federal and the state taxes are ruled by different legal norms, and distinct bookkeeping for each is required from taxpayers. Notwithstanding the existence of a national law that defines its main characteristics, ICMS norms differ among states in several respects. Firms that have several plants and operate nationally must deal with up to 28 distinct sets of laws and consider up to 30 different rates that apply to each good they sell. Legislation has been changing over time and is now so intricate that it is almost impossible for a taxpayer to know it fully and comply with it. Even tax administrators are confused about their own state norms.

Moreover, a complementary law provides a comprehensive list of services that are liable to the ISS. Its rates are much lower than those of the ICMS; but those rendering services are not allowed credits for taxes paid on either their good or service inputs. In the same way, producers of goods cannot credit the municipal tax paid on their service inputs against their ICMS and IPI liabilities.

Clearly, simplification of the VATs is a compulsory course for reform. As tax administrations and taxpayers have acquired a solid experience in dealing with value-added taxation techniques, it seems that the logical path to follow would be substitution of a dual VAT, with a single national set of legal norms, for both IPI and ICMS. This change would be consistent with smooth transition and low risk for the fiscal adjustment process now in progress, which may not be the case if a state RST substitutes for the ICMS and a set of excises replaces the IPI.

Regarding this conclusion, three important questions must be discussed, all somehow related to the issue of subnational tax autonomy:

[30]The applicable rate is chosen according to the origin and destination of the trade flow. Transactions originating in the South and Southeast Regions, except from the state of Espírito Santo, and bound for the North, Northeast, and Center-West Regions, as well as for Espírito Santo, are taxed at 7 percent; all others, at 12 percent. Moreover, interstate trade with fuel and electric energy are zero-rated; and, for regional policy reasons, exports from anywhere to the Manaus Free Trade Zone and, under certain conditions, to Western Amazon states are also zero-rated.

1. Should the dual VAT be general—i.e., should services, now subject to the municipal ISS, be included in its base?

2. Would states be willing to forgo their current taxing power?

3. Should the destination principle, now fully applied to international trade but only partially to interstate trade,[31] be the general rule for border tax adjustments?

Concerning the first question, there are sound economic reasons for the incorporation of services in the VAT base. The ISS and its interaction with taxes on goods raise several problems, such as:

a) Identification of services by means of a list — what is necessary due to the gray borderline between goods and services — may result in not assessing some of them, particularly if the list is not revised frequently in a world where new types of service often spring up;

b) The ISS is not fully adequate for Brazilian municipalities. Many have hardly any base to tax. And, as changing the fiscal domicile of a service firm is usually inexpensive and barely interferes with its business, even tiny rate differentials between units may affect their location. This stimulates competition among municipal governments to attract taxpayers (rather than their activities), to the detriment of the finances of all;

c) Families in the higher income brackets tend to use a larger fraction of their income to consume services. Therefore, if rates on the final consumption of services are lower than those on the consumption of goods, the tax system becomes more regressive;

d) Intermediary consumption of services, on the contrary, is overtaxed relative to that of goods. Its cost is a component of the price of produced goods and, thus, is subject to the ICMS and the IPI, besides the ISS. As services rendered and

[31] A constitutional provision demands that rates applied to intrastate transactions be higher than those set by the Senate for interstate trade. It follows that part of the tax proceeds derived from cross-border flows belongs to the state originating the flow — 7 or 12 percent of the value of the traded good, depending on which is the relevant rate (see footnote 30) — and the remainder to the state of its destination — the difference between the rate applied by the state receiving the good and the interstate rate.

used inside the same production unit are not taxed, inefficient vertical integration of production is stimulated;

e) Exports of goods are not completely exempt. That part of their value that corresponds to the cost of service inputs is taxed. The same is true in the case of capital goods.

On the other hand, there are also strong arguments against elimination of the ISS or, at least, in favor of postponing the efficacy of such precept:

a) VAT assessment of services is far more complex than that of goods. Many types of services require special tax norms that, although in force in other countries, are largely unknown in Brazil. Of course, norms may be imported and adapted; but because no Brazilian tax expert is acquainted with these rules and no possible foreign consultant has factual knowledge of pertinent Brazilian particularities, some learning time is necessary until a VAT on services can be properly implemented;

b) Substitution of value-added taxation of services for the ISS probably implies that revenue coming from these activities will shrink. Though there are no reliable estimates of the relative importance of services used as inputs in total ISS base, a rough appraisal indicates that they account for about 75 percent of its revenue in the city of São Paulo.[32] As no tax proceeds will be derived from intermediary consumption of services, rates on other services should be — and almost certainly will not be — around 4 times larger than current effective rates in order to compensate the revenue loss. Since losses amidst a fiscal adjustment process should be avoided, either substitution must be postponed, or other revenue sources must be sought for compensation;

c) Despite all difficulties, the number of local units that instituted the ISS is no longer small, and overall revenue is far from negligible. In 1996, over 4,000 of the more than 5,500 municipalities were collecting the tax. ISS revenue amounted to approximately 0.6 percent of GDP and represented 36 percent of

[32] This result was obtained by a research on taxation of services, conducted by Ana Luiza N. de Holanda Barbosa at IPEA.

total municipal own-tax revenue. ISS is an important source of funds, especially for larger cities like São Paulo and Rio de Janeiro, which accounted together for 43.6 percent of total ISS collected in the country.[33]

A proposal to replace the ISS by value-added taxation of services implies reduction not only in municipal resources, which may be compensated by an increase in transfers, but also in the taxing power of local governments. They will probably oppose the proposal unless they are awarded another source of own revenue. The proposal cannot count either on strong support from state governments. They show no enthusiasm for the additional revenue — small in relation to total VAT proceeds — provided by the inclusion of services in the VAT base and are well aware of the administrative difficulties resulting from the inclusion. Therefore, though the case for a general VAT is strong from an economic viewpoint, a political analysis may prove the proposal unfeasible.

Uniform VAT legislation all over the country implies an autonomy loss in relation to states' current taxing powers. A basic problem in fiscal federalism is to find a reasonable balance between the need to ensure some degree of financial (which may also mean political) autonomy to subnational units and the need to avoid perverse economic effects of fiscal instruments. "Reasonable," of course, means that this is a question that requires a political rather than an economic decision.

The Brazilian experience has been marked by the difficulty in harmonizing these objectives. It displays cycles of lesser and greater centralization of fiscal power that are related to the historical evolution of the political regime. Nevertheless, if cycles are disregarded, the trend shows a reduction in subnational fiscal autonomy, due to a growing concern with the coordination of public policies, with the impact of taxation on productive activities, and, lately, with international fiscal harmonization.

The 1988 Constitution, built upon strong reaction to centralism, though granting states the power to establish their own rates, maintained the previous rule of defining the main features of the ICMS in a national law. In practice, the power to set rates has seldom been exerted. Though rates differ among units, their dispersion is small, for they were fixed

[33] See ABRASF (1998) and Afonso et al. (1998).

at a level too close to the fiscal capacity of the population, and reductions are bound by downward rigid expenditures.

It follows that a national VAT legislation, as required by the dual VAT proposal, is barely a change from the current situation insofar as taxing power of the states is concerned. It seems that state authorities are prepared to accept that the central government has exclusive — or almost exclusive — power to legislate on VAT, for they are convinced that present tax disorder hinders economic growth and is thus prejudicial to their own finances.

The question remains whether nationally uniform rates should be adopted, for the sake of simplicity and avoidance of distortion, or some space should be reserved for autonomous determination of each state revenue level. Although state governments do not seem to offer strong opposition to the former solution, they would certainly prefer the latter. So does the theory of fiscal federalism.

No matter which border tax adjustment principle is chosen for treatment of interstate trade, households and non-registered traders purchases are taxed, in most cases, on an origin basis,. There is no practical way to determine their place of residence at the time of the sale. Thus, rate differential among states would provide stimuli to these classes of consumers to buy from the lowest tax jurisdiction. This includes distance-selling, such as the booming electronic commerce, and cross-border shopping, which is important only if sizable markets are situated close to state borders, or if the items being purchased are expensive, in which case low taxes may compensate for travel expenses. Aside from these stimuli, whose reflection on the supply side is a preference of the relevant retailers for locating their business in low-tax jurisdictions, the rate differential would have no effect on competition.

The demand-side incentives are at least partially counterbalanced by transportation, transaction, and information costs, which tend to be directly related to distance. If they neutralize the incentive, no problem exists. Otherwise, they express the cost of the economic distortion introduced by VAT: real resources are spent to economize on the tax. The social cost of disharmony in the federation, induced by resentment about revenue losses, should also be considered.

To prevent these effects, distance-selling firms could be required—some administrative cost being incurred to control compliance—to use the place of destination rate in assessing their sales to households. But hardly any control is practical in the case of cross-border shopping; only uniform rates among states would prevent tax effects. A reasonable compromise between autonomy and distortion costs would perhaps be reached if the law established a national standard rate and allowed states to fix their own rates within a range around it. This was the solution advanced by an IPEA/BNDES proposal[34] and adopted in the amendment proposal approved by a House of Representatives committee in the beginning of 2000.

The third question, whether the destination principle should be used for taxation of interstate trade, is, perhaps, the most difficult issue in present Brazilian tax reform. The replacement of the present hybrid solution — part origin, part destination — by the destination principle benefit most states but imposes losses on some, particularly heavy in the cases of São Paulo and Amazonas. Furthermore, it would practically deprive states of their power to grant ICMS incentives to attract firms to their territories, preempting the fiscal war, a move that is not consensual. Another important consideration is the expected increase in tax evasion if zero-rating of interstate exports is adopted.

ICMS is not a general tax, due to evasion, special assessment applied to small registered traders, and the existence of a large segment of the economic activity that is not subject to VAT. In such a case, tax effects on conditions and location of production are significantly magnified, unless VAT on interstate trade is collected at the origin and rates are equalized. The incentives affecting purchasers' decisions are of the same nature of those considered for a general VAT, but there are two important differences.

First, they affect a much larger set of purchasers, including, besides households, governmental institutions, most of the service sector (which is not subject to the tax), small registered traders (who disregard tax credits and pay an arbitrated duty, whose amount is fixed per period or proportional to the value of their sales), and tax defrauders (who understate their sales and, to produce consistent tax account, omit part of their purchases).

[34] Afonso, Rezende, and Varsano (1998).

Second, in the two last cases —small traders and defrauders —, the interstate rate set by the Senate rather than the rate of the state of origin applies. For these groups of registered traders, if the interstate rate is further reduced, the incentive to purchase out of state grows. Contrary to common sense, the destination principle implemented by zero-rating interstate exports is, regarding these tax effects, the worst case.

As there is a larger market to supply applying the origin rate, incentives to locate firms, even industrial plants, in a low-tax state are far greater than in the case of a general VAT. Furthermore, if clients are mainly small traders and tax defrauders, it does not matter at all whether the state of location is a high- or a low-rate state. They will always prefer to buy out of state, provided the differential between their own state and the interstate tax rates is larger than the weight of transportation (and other minor) costs in the total value of purchases.

To give a dramatic real example: The largest Brazilian wholesaler is situated in the west of Minas Gerais and its market is mainly in the Northeastern states — from 1,000 to nearly 2,000 miles away. Despite this, as there are plenty of small retailers in these states, he has an advantage over local competitors because the interstate rate is 7 percent while the most common internal rate is around 17 percent. This margin probably enables him even to buy merchandises from an industry located in, for example, Ceará and resell it to a shopkeeper in that state. If the destination principle were implemented and interstate exports zero-rated, the difference between internal and interstate rates would increase to 17%.

A hypothetical wholesaler could do even better. Unless revenue officers are spread all over the state, it is easy to evade controls and simply transfer the merchandise from the industry straight to the small trader. Only the industry invoice would go to the location of the wholesaler, and his invoice would travel back. By the way, in this event, so-called "invoice sightseeing", fraud would make the country better off due to reduction in transportation costs.

Due to the difference between the internal and the interstate rates, "invoice sightseeing" is also used without any economy but of tax payments. An interstate sale is simulated, but the true destination of the merchandise is a firm in the same state, which does not register the purchase in its books of account. Piecemeal evasion, rather than the usual VAT piecemeal collection, continues until the goods reach the final consumer.

Western Amazon states and the Manaus Free Trade Zone are preferential destinations of the invoice both because of the distance from large production centers, which makes controls more difficult and expensive, and of the interstate rate, which is zero in these cases, maximizing return to fraud. In the case of fuel, to which a zero interstate rate also applies, large distributors estimate that they compete with defrauders whose evasion amounts to R$1 billion a year.[35] If interstate exports are all zero-rated, the "invoice sightseeing" business will experience a boom.

It follows that the reason usually presented for preferring the destination to the restricted origin principle—to enable distortion-free (or almost) adoption of non-uniform rates among units of a fiscal union or a federation—does not hold. Restricted origin principle provides, in practice, less distortion than zero-rate destination-based VAT.

Another conclusion is that if full destination principle is implemented for treatment of interstate trade by zero-rating exports, compliant taxpayers will be worse off, because frauds will be larger in number and value, affecting their competitive conditions and, given equal government revenue, taxes due. To avoid evasion, tax collection at the origin is always best. Finally, though the revenue of less developed states may increase, their economy will probably be worse off, for producers will prefer developed states where production conditions are better, local markets larger, and access to remote markets ensured by rate differentials.

Notwithstanding the previous arguments, there is a strong case for the adoption of the destination principle for taxation of interstate trade flows. It is clearly superior in several aspects to the hybrid arrangement now in force.

As the destination principle is used for taxation of international trade, ICMS is, from a national perspective, a consumption tax. The role of its interstate border adjustments is,

[35] This estimate, though older, was published in a full page advertisement at Jornal do Brasil, a Rio de Janeiro newspaper, in April 4, 1999. To have a standard for comparison, the magnitude of the estimated fraud, which refers to the whole country, is almost twice the monthly ICMS revenue of the state of Rio de Janeiro. Two cases of "invoice sightseeing" that became famous some time ago involved massive forged exports of sugar and automobiles from São Paulo to Western Amazon.

essentially, determination of the distribution of the tax yield among states. However, the choice of border adjustments has other consequences; and, unless the destination principle is chosen, unintended redistribution of revenue among states and other undesirable effects take place.

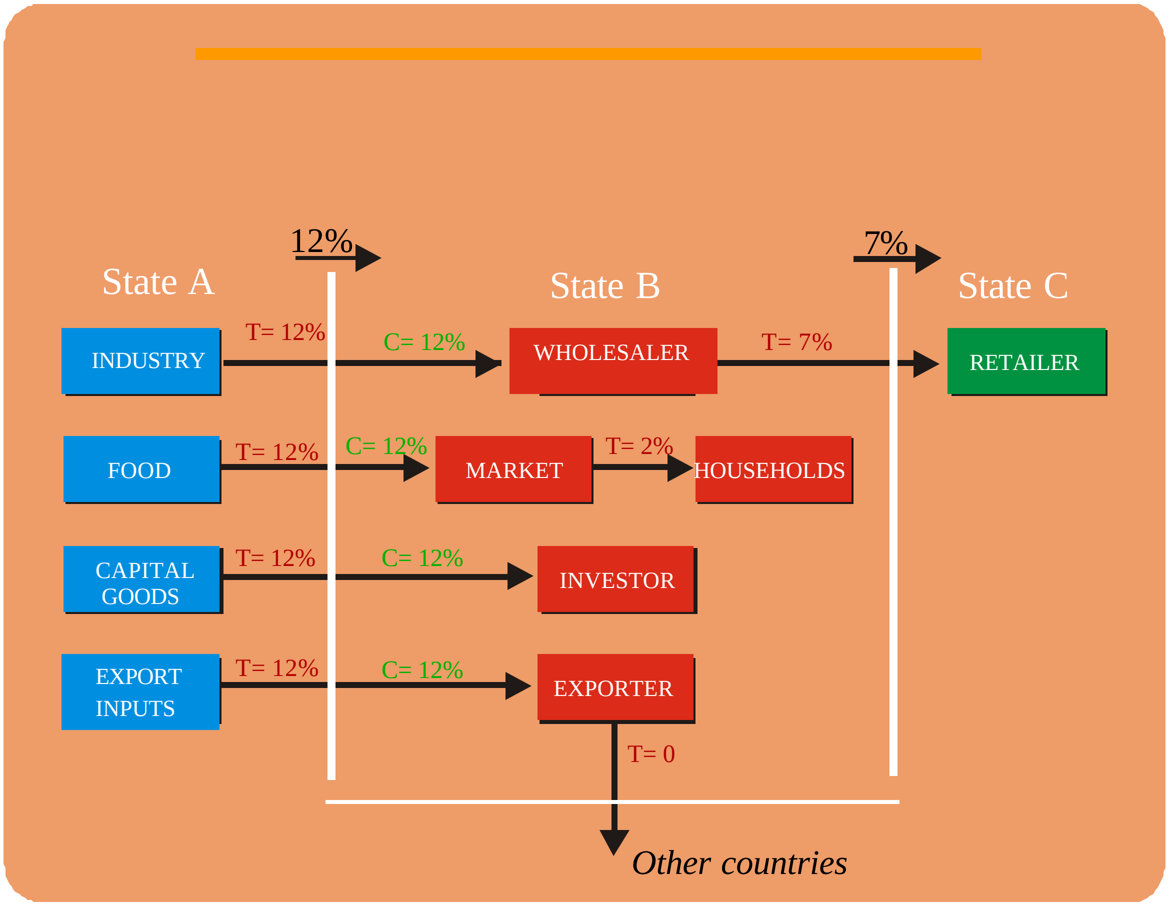
Substitution of the destination principle for the part-origin-part-destination arrangement now in use would benefit, through redistribution of the tax yield, the poorest Brazilian states, which are net importers in interstate trade. It would also correct an injustice of present regime: Though contributing to an important national objective, a state whose international trade balance is positive and, for this reason, tends to show negative results in its interstate balance is penalized. On one side, its exports to other country are exempt from tax; on the other, only part of the value of its imports from other states generates revenue.

The current interstate taxation scheme promotes unintended redistribution of revenue among states whenever the interstate flow is the last operation or is followed by transactions that are taxed at a lower rate than that flow. Redistribution occurs in several cases, as shown in Figure 1. For example:

- An industry in State B purchases a lathe from State A, which taxes the capital good at the interstate rate (12% in this case). No tax proceeds accrues to State B that must provide a 12% tax credit to its taxpayer.
- A soy oil exporter located in State B imports soybean from State A, paying a 12% tax. Its exports to other countries are tax-exempt and State B has to allow him a credit for the tax paid to A on its input.
- State B decides to tax rice at only 2% to benefit low-income families. A supermarket purchases rice from State A paying a 12% tax that is credited against its liabilities. As it sells the rice to consumers, a 2% tax is charged. State B owes a tax credit to the supermarket.
- A wholesaler located in State B buys tomato sauce from State A and resells it to a retailer in C. The interstate rate for flows coming from A to B is 12% and from B to C is 7%. The 12% tax paid by the wholesaler to A gives rise to an equal credit against B, while its export to C bears only a 7% tax.

Redistribution would be avoided in all these instances if the destination principle were applied to interstate trade.

Figure 1: Redistribution of Revenue among States Promoted by ICMS Hybrid Interstate Border Tax Adjustments



This principle also fares better than current interstate procedure in case equitable taxation is pursued by using reduced (or zero) rates for goods whose weight in the budgets of low-income families is high. As tax proceeds of a state depend partially on its production, units with production concentrated in one or more of these goods might oppose such a policy due to the revenue loss they would experience. Under the destination principle, tax collected by each state depends exclusively on its consumption, which distribution is much more well-balanced than that of production. No state would suffer an unacceptable loss of revenue if this equity policy were implemented.

Yet another advantage of the destination principle is the limitation it imposes on the use of the subnational tax as an instrument of the so-called “fiscal war”. State governments grant industries partial or total devolution of the ICMS paid, generally in the form of long-term credit at zero or near-zero interest rate, in order to attract production to their jurisdiction. Though this practice has been unlawful since 1975, except in cases in which the intended reduction is unanimously approved by the 26 states and the Federal District, legal restrictions have been ignored and have never been enforced. “Fiscal war” has increased in intensity in the nineties, bringing about conflicts in the federation. Foremost among many cases is the dispute for the wave of new automotive vehicle industrial plants that had looked for a location in the country since 1995.

Regional disparities and the absence of a national policy for regional development are the background behind the “fiscal war”.[36] Decentralized industrial policies are inspired by a legitimate aspiration of state governments to expand production, employment level, and income in their respective territories.

From the standpoint of any particular state, granting fiscal incentives to attract investment seems worthwhile. Unless the beneficiary would choose to locate his business in the state even in the absence of the incentive, the amount of tax revenue forgone would not exist anyway. Plus, aside from their direct impact on production and employment, newly attracted firms induce additional economic activity, creating still more jobs and income, and, of course, some tax revenue.

If this were the whole story, state tax incentive would be a valuable development tool. But, when other states replicate the successful experience of one of them, a destructive tax competition is set in motion. As attraction of new investors grows more difficult, state incentive policies become more aggressive. This includes sending government officials to other states in order to entice firms into relocation. Conflicts in the federation are exacerbated.

The dynamics of “fiscal war” is quite perverse. As the practice spreads out—with almost all states providing similar incentives —its efficacy fades. Revenue goes down in all

[36] Income disparities among Brazilian states are quite large. Per capita GDP of the Southeast region is more than threefold that of the Northeast; and per capita GDP of the richest state, São Paulo, is sevenfold that of the poorest, Tocantins.

states, but, since taxes have been equally reduced everywhere, the fiscal benefit ultimately loses its power to induce relocation of production. When the process reaches this stage, newcomers choose their location considering only market and production conditions; and important newcomers even promote a kind of auction in an attempt to get a better deal from the state they had previously chosen.

Since the incentive brings in unfair competition between newcomers on one side and firms to which no tax break was bestowed on the other, the latter justly press governments for equal conditions. In financially weaker states, which are the less developed, the level of revenue hardly is enough to provide the tax incentive and, at the same time, finance services and economic framework in quality and quantity necessary to attract new production. After some time, more developed states win all battles of the "fiscal war".[37] Disparities — already very large in the case of Brazil — naturally tend to increase.

The fiscal cost for the country of the "tax war" is very high. A recent dissertation that analyzes three cases of newly installed vehicle factories concludes that, in two of the cases, the present value of the stream of subsidies exceeds the value of the private investment; and the fiscal cost of creating a job is over US$ 350.000.[38] Furthermore, this does not seem to be a cost incurred to attract investment to the country. The plants would probably be located in Brazil in the absence of the tax break.[39] This is the cost of attracting the investment to one particular location that, if the incentive had been truly effective, would not be the one recommended by efficiency considerations.

Origin-based taxation provides a base for concession of incentives — interstate exports — which would not exist if the destination principle were put in practice. Moreover, importers are allowed a credit for a tax that is nominally positive but was, in fact, refunded to the exporter at the origin. This means that, in practice, the state of destination is the one paying for the incentive that brings into disadvantage its own firms that compete with the exporter. And the risk exists that these firms move to the state that

[37] Analyses of "fiscal war" in Brazil are found in Varsano (1997), Prado and Cavalcanti (2000) and Silva (2001).
[38] Silva (2001).
[39] A possible but improbable alternative location, given that the market to attend is chiefly the Mercosur, would be Argentina. If this alternative had, in fact, been considered and discarded because of the incentives, the fiscal cost cannot be said to be in vain. On the other hand, Brazilian states policy would be unduly inflicting a loss on the partner.

offers the incentive. This is another feature of the “fiscal war”: Once it is in place, non-participant states lose.

Adoption of the destination principle for treatment of interstate flows would drastically inhibit “fiscal war”. It would cut off part of the base for incentive concession. A state would be able to attract industrial plants by means of tax refund only insofar as their production is directed to their own market.

To sum up, there is clearly a case for the adoption in Brazil of a destination-based dual VAT, provided state’s zero-rating of interstate exports is avoided. The scheme in use in the European Union — pre-registration of exports and dissemination of the information by means of the VIES — is considered in Brazil insufficient to deal with evasion. The best solution is to tax interstate flows at their origin and to assign such revenue to the state of their destination.

Two procedures were proposed in the past, one in 1974 and the other in 1979, which could, in theory, provide such solution.[40] Both are akin to the Commission of the European Communities 1996 proposal (“clearinghouse” method).

The 1974 proposal, presented to the Senate, suggested the creation of a national fund. Tax proceeds would be deposited in and drawn upon the fund by states according to formulas based on interstate trade statistics. The formulas boil down to assignment of the amount of tax collected at the origin on interstate transactions to the states importing goods.

The 1979 suggestion, offered for consideration of the Constituent Assembly in 1987, was that taxes paid on interstate trade should be processed on a transaction basis. As both procedures were operationally awkward, given the state of the art of data processing at the time they were proposed, none was put in practice.

Regarding the recent proposals for adoption of a destination-based dual VAT in Brazil, a Ministry of Finance’s suggestion, presented in December of 1998, is similar to that of 1974, namely, to create an institution, where federal and state governments would be represented, to centralize and distribute dual VAT revenue collected by states. Interstate

[40] The 1974 procedure was proposed by Senator Helvídio Nunes (*Diário do Congresso Nacional*, October 31, 1974, seção II, pp. 5,013-5,028). The 1979 scheme was put forth in Varsano (1979), pp. 340-341.

trade statistics would be used for distribution of revenue among states on a destination basis.

PEC 175/95 provided a new solution to the problem of interstate border tax adjustment, originally named “the little boat procedure” and renamed as compensating VAT (CVAT) in the international economic literature.[41] It is a simple low-cost scheme that allows the adoption of a destination-based dual VAT without zero-rating out-of-state sales. Instead, sales are taxed at the origin, therefore minimizing evasion and distortions of the type discussed in the previous subsection. The 1998 IPEA/BNDES proposal presented an improved version of the scheme, adopted in the amendment proposal approved by a House of Representatives committee in the beginning of 2000.

The problem to be solved is that, to implement a destination-based dual VAT without zero-rating interstate exports, the origin state tax may not cross the border (say, a river, as many a time it happens to be). If it does, a tax credit must exist, to avoid double taxation in the next transaction; and the origin state cannot provide the credit to the importer, which is a taxpayer in another jurisdiction.

But, concerning the federal part of dual VAT, state borders are irrelevant. Therefore, a solution to the problem, inasmuch as both exporter and importer are federal taxpayers, is to transport the state tax across the river on board “the little boat”, i.e., the federal tax. In other words, the state tax on cross-border trade is collected at the origin, embodied in the federal tax, and central government provides the corresponding credit to the importer. The result is that subnational VAT reaches the other bank of the river free from previous tax collections and ready to follow its course as a tax of the state of destination.

This simple procedure is able to take care, automatically and practically at no cost, of transactions between registered traders subject to the normal tax regime, which is the bulk of interstate trade. In case the importer is an identifiable household (distance-selling), a non-registered trader or a small registered trader not assessed according to value added, a different scheme must be used. The state tax is also paid to the central government - but

[41] The original version of the procedure is found in Varsano (1995). The improved version, presented in Varsano (1999), benefited from a discussion of the method with Prof. Charles E. McLure Jr., from which also resulted his McLure (2000).

separately, so that total tax collection of this kind may be known -, which shares the proceeds to states in proportion to their respective own VAT revenues, which distribution is that of a destination-based tax.

No workable general treatment for cross-border shopping is possible, for the seller cannot identify the buyers domicile. In this case, the origin tax applies. But this is an unimportant component of interstate trade, except when state rates are far different or high unit price goods are transacted.[42]

A fourth feasible solution to the problem, never discussed in Brazil, is the so-called "pre-paid VAT", presented in Poddar (1999). According to this procedure, the importer would pay the tax concerning the interstate transaction to the state of destination. The proof of payment would be presented to the exporter previous to shipment. The importer, if a registered trader, upon receiving the goods, would be entitled to a tax credit, equal to the value of the pre-paid VAT, that he would compensate with his VAT liabilities.

The dual VAT solution brings to light — and, maybe, exacerbates — the question of vertical fiscal competition, i.e., the dispute between two levels of government that exploit the same tax base. Federal and state governments must reach an agreement — or National Congress must decide — about how intensely each of them will use the common tax base.

To avoid this difficult question some advocate that the IPI should be replaced by a set of excises, becoming more specific rather than more general. One problem regarding this proposal is that oil products, communication services and electric energy, three important candidates for excise taxation, are presently, according to the Constitution, bases exclusive of the ICMS and of taxes on foreign trade.

Others argue that VAT is not adequate for subnational units and support its federalization (or extinction) and the adoption by the states of a RST. These should remember that Brazilian states have been collecting VAT for 37 years while no tradition exists with respect to RST. In addition, the retail sector in Brazil, despite a recent move

---

[42] Vehicles, probably the most important of these items, could be taxed, if convenient, according to their place of registration, owners being required to pay the difference between its jurisdiction tax and the actually paid one.

toward concentration, is still characterized by a large number of small firms. RST may be useful as a municipal tax that overlaps VAT at the retail level; but, it is highly improbable that it could provide proceeds in an amount comparable to the ICMS.

4.3. Income, payroll and property taxes: equity, competitiveness and savings

Taxation of individual income is more important as a source of revenue for developed countries than the corporation income tax. Despite the fact that evasion control is more difficult, this tax offers the advantages of little interference with the production process and of allowing graduation of the assessment according to the ability to pay, in order to introduce some progressivity in the tax system or, at least, compensate the regressivity inherent to other levies.

Taxation of business income, as well as payroll taxation, despite their widespread use, may promote important economic distortions. Moreover, as the agreements ruling international trade do not contemplate tax rebates for exports concerning these taxes, they may reduce the competitive capacity of domestic firms in case their intensity is above that of similar taxes in force in competing countries.

In Brazil — considered, besides the income tax, the CSLL — business income is taxed heavier than individual income. This situation should be reversed, to improve both equity and the impact of taxation on the competitiveness of domestic firms. Taxation of property or wealth could also contribute to make the tax system more equitable.

It must be recognized that the fast and intensive international capital mobility that exists nowadays precludes steeply progressive taxation of income as well as heavy taxation of wealth. An attempt to impose such taxation would be frustrated by capital flights, resulting in reductions in investment and employment. A corollary is that government redistributive action should concentrate on the expenditure side of the budget, by means of social programs focused on the poorest. This does not mean, however, that there is no room for improving the equity of the Brazilian tax system.

Concerning wealth taxation, the 1988 Constitution empowered the Union to impose the IGF; but the tax has not been instituted so far. The ITCMD, assigned to the states, which should be assessed on the total value of the estate, generally takes into account only the value of real estate, which is taxed at a flat rate, usually 4%. The ITR, a federal tax, should penalize idle agricultural land; but its proceeds are close to zero.

Creation of the IGF with reasonable rates; better administration and adoption of progressive taxation of the value of the estate in the case of the ITCMD; and a serious effort to enforce the ITR, maybe transferring the authority to levy the tax to state or local governments, would certainly contribute to make the tax system more equitable.

Most of the discussion on tax reform taking place since 1995 has concentrated on Constitutional Amendments. As reform of the income tax depends only on changes in ordinary laws, it has not been in the agenda. Notwithstanding, several changes could be carried out in the income tax in order to improve tax system equity and, maybe, increase the Brazilian savings rate, which low level is an important restriction to growth. A non-exhaustive list of themes that should deserve consideration is the following:

- Favored treatment of agricultural income should be reviewed.

  Despite the fact that agricultural activities present peculiarities that should be taken into account by the tax legislation, treatment of agricultural income is one of the main shortcomings behind the slack progressivity of the Brazilian income tax;

- Preferred taxation of distributed profits should be abolished.

  In Brazil, two propositions were accepted as accurate without much discussion. First, that individual and business income tax should be integrated to avoid double taxation of capital income. Second, that the income tax discriminates against equity capital, which income is taxed while interest payments are deductible. The first of these propositions is doubtful and the second is false.

  Double taxation would exist only if the incidence of the business income tax were on capital. The public finance literature is inconclusive in this respect and a host of empirical papers on the shifting of this tax did not help much to solve the puzzle. Notwithstanding, Brazilian income tax legislation exempts dividends from the individual income tax. If reality is such that partial or total shifting of the tax occurs, the law is privileging capital income.

Furthermore, taxation of dividends, no matter whether the tax on business income is shifted or not, would introduce a bias against profit distribution. As retained profit is an important source of savings while dividends may be either saved or consumed, such practice would increase society's savings rate and, thus, economic growth.[43] Certainty about the effect on savings and doubtful incidence lead to the conclusion that full taxation of dividends is a better policy.

The argument that the income tax discriminates against equity capital is incorrect in the case of the Brazilian business income tax. In fact, borrowers deduct interest payments from their receipts to compute tax dues. But, this does not mean that interest payments go untaxed since the lender, usually a bank, is also a taxpayer whose interest receipts are subject to the income tax.

To avoid the alleged discrimination, the law accepts that interest be paid to equity capital owners and deducted from the business income tax base. Moreover, interest on equity capital is subject exclusively to a 15% withholding tax while labor income is liable to progressive withholding taxation and to the annual tax adjustment, when pooled income is taxed at progressive rates.

In short, interest payment to equity capital is an unwarranted legal fiction that favors capital vis-à-vis labor income, provided profit is distributed in the form of interest payment. Thus, it discriminates against retained profits and, as in the previous case, tends to reduce savings.

- An investment deduction provision could be created.

A boost in the savings rate is clearly a desirable goal in a country like Brazil, which needs to grow fast and has a relatively low level of savings. Retained

[43] Investment of retained profits would accrue to capital in the form of an increase in the value of stocks. Capital gains are taxed only upon realization; thus, the tax is deferred until the stocks are sold. It should be noted that preferential treatment for dividends was part of a policy that intended to stimulate the capital market, with an eye on the goal of "democratizing capital ownership". Democratization did not happen.

profit is everywhere an important — if not the most important — source of savings. Therefore, the elimination of the preference for profit distribution could be complemented by some incentive to invest retained earnings, which may take the form of a tax deduction related to capital accumulation by the firm.

- Individual income tax rate structure should be more progressive.

Above an exemption threshold, Brazilian individual income tax rates vary from 15% to 27.5%. The amplitude of the tax brackets is small and the higher marginal rate is relatively low in comparison with those of other countries. There seems to exist a case for improving the rate structure to compensate the regressivity of other important sources of revenue.

Of course, progressivity and intensity of income taxation are not purely technical matters. The questions must be decided in a political debate. A rate structure proposal, which preserved total tax proceeds but increased the progressivity of the rates and suggested a maximum marginal rate of 35% was presented to National Congress — and refused — less than two years ago. Maybe the newly elected Congress is more sensible to the question than the previous one.

- Individual income tax deductions for educational and medical expenses should be discussed.

The individual income tax law allows full deduction of medical expenses, including health insurance, and a limited deduction of registration fees and other educational outlays. These are old, well enrooted clauses and, thus, difficult to change. They should deserve, however, a political debate.

As the poor citizens do not pay income tax, these clauses privilege the middle and the upper classes. Moreover, the subsidy provided depends on the marginal rate of the taxpayer and is, therefore, regressive. The question to discuss is whether society should continue subsidizing the expenditures of better-off people, while those in the lower income brackets, who cannot pay for private school and medical care, have to resort to the public education and health systems that are in bad conditions due to decades of funds shortage.

- Constitution of a firm to disguise an employment relation should be prevented.

Constitution of a firm to substitute for a previous or a would-be employment relation is a widespread practice among high wage earners in Brazil. Business executives, artists, and other well paid professionals are no longer employees but owners of small businesses that render services to their previous employer. This practice has the twofold objective of avoiding some rigidity imposed by the law on the labor market and of economizing on both income and payroll tax payments. Labor market reform and changes in taxation rules are necessary to revert the incentive that exists for such behavior.

The payroll tax is the chief source of financing of social security systems, in Brazil and elsewhere. Therefore, though it affects the competitiveness of Brazilian firms, this problem is not as serious as in the case of turnover taxation, since the difference in the intensities of taxation is what counts.

However, reform of social security systems is an important item of the international agenda. Payroll taxes impose a large fiscal wedge between the cost of labor to the firm and the take-home pay that stimulates informal labor relations. These, besides their contribution to the precarization of employment, reduce the base of the payroll tax. The general trend is a reduction of the burden on wage income, which means that, unless similar changes take place in Brazil, the tax differential will increase.

One possible solution to the social security problem is to curtail protection provided to workers in order to reduce financial needs and, thus, make feasible a lighter payroll tax burden. Reactions to this kind of proposal vary according to the different political and institutional realities of each country, labor union's strength being an important factor. Payroll taxation is far more important in Europe than in Asia. In Latin America, Chile is the country that produced the most radical reform in recent years and, as a consequence, it shows a low participation of wage taxation in the total tax burden.

The alternative solution is to assign payroll taxation exclusively to the financing of social insurance expenditures, which is not the case in Brazil, and look for complementary sources of revenue that could reduce dependence of the system on taxation of wages. Since the Brazilian social security system underwent a recent reform that adjusted benefits and further adjustments has barely any chance of approval,[44] the alternative considered in this paragraph seems to be the only plausible one.

4.4. A proposal for the social contributions

As mentioned in footnote 1, social contributions are taxes earmarked to social security activities, which comprise social insurance, health and social assistance. The wage tax is assigned exclusively to the social insurance; but the payroll tax finances also the insurance for on job accidents, the FGTS, educational expenditures and a set of institutions known for short as the "System S". The other important social contributions are PIS/PASEP, COFINS, CPMF and CSLL.[45]

CSLL is a profit tax, akin to the business income tax, but with different base and features. Both should be object of an effort aimed at simplification that might result in the unification of the taxes, i.e., common features and a single base to which two rates would be applied.

A contribution on value-added (CVA) could substitute for the PIS/PASEP and the COFINS. It might replace, as source of financing, also the CPMF and the contributions to the "salário-educação" and the "System S". According to a crude estimate made elsewhere,[46] a 12% rate would be enough to produce the necessary proceeds.

Elimination of the payroll tax is impossible. But, the lower the intensity of its use, the better for the competitiveness of Brazilian products, both in the domestic and in foreign markets. Another source of revenue could be used to yield part of its proceeds. A good candidate would be the CVA. But considering that Brazilian states will continue to collect the ICMS, which most common rate is around 17%, and that the federal government also

[44] The text is referring to the Social Security General Regime. Civil servants are subject to a especial regime, which benefits will go though a revision.
[45] See Table I.
[46] Varsano (2003).

uses the VAT base (or that a dual VAT would be created), 12% is an already high rate for the CVA.

An attractive alternative to reduce the burden on the payroll is to assign the CPMF exclusively to the financing of the social insurance. The yield of the tax collected from individuals would replace part of the present payroll tax proceeds. Enterprises would be allowed to compensate the CPMF paid with payroll tax liabilities. For those who properly pay the payroll tax, CPMF would perform the function of a withholding tax or, if liabilities are low, of a minimum tax. CPMF main shortcoming, its cumulative effect, would be practically eliminated; but its favorable features would be preserved.

CPMF favorable features include its high yield, obtained at very low administration and compliance costs. It is also a powerful instrument for controlling evasion, since the total amount of bank debits is a good indicator for the taxpayer's turnover or economic life. It would penalize those doing business in informal markets that are not reached by other taxes. Formalization of labor relations would be stimulated both because informality grows more expensive (if the rate is higher than now) and formal labor relations become cheaper. Further more incidence on individuals is probably very progressive, because people in the lower income brackets do not detain bank deposits.

A crude estimate indicates that each 0.1 percentage point of the rate of the CPMF would produce the same revenue as one percentage point of the rate of the payroll tax.[47] Another article argues that there is a Laffer curve relating CPMF yield to its rate and that the maximum yield corresponds to a rate of 0,7%.[48] Admitting that this conclusion is correct, revenue coming from the CPMF at the maximizing rate would replace about a third of the present yield of the payroll tax directed to the social insurance.

5. The Reform Process in Progress and the Difficulties Ahead

The present discussion on tax reform has been in course since 1995, when the President proposed to National Congress an amendment to the chapter on the tax system of the Constitution (PEC 175/95). Almost eight years have passed and the process continues,

[47] Varsano (2003).
[48] Albuquerque (2001).

after interruptions and setbacks, with few practical results so far. Expectations are that it will gain some impetus in 2003.

Legislative procedures concerning PEC 175/95 started by the designation of a special committee of the House of Representatives to evaluate the proposal. Few months later, mounting evidences that the proponent himself had hardly any interest in carrying out the proposed reform led the process to a halt. Instead, an effort was made to approve, in September of 1996, the already mentioned Lei Kandir. Though this law promoted important changes in the ICMS, it let aside other major questions which treatment depends on a constitutional amendment, prominent among them the tax treatment of interstate trade flows.

In 1997, the members of the special committee decided to resume the tax reform process. Authorities of the Executive branch were invited for hearings. The general conclusion was that the scope of PEC 175/95 was too narrow and that reform should contemplate not only taxes but also the social contributions. Legislative procedures were reactivated and the committee relater prepared a substitutive project, based on PEC 175/95, that encompassed the social contributions as well taxes. The same technical group that had prepared PEC 175/95 assembled a similar project, the already mentioned IPEA/BNDES proposal, publicized in November of 1998. The Ministry of Finance prepared a different reform proposal that was announced some days latter.

When the next legislative period started, in the beginning of 1999, a new special committee was designated to treat the question. After months of discussion, another substitutive project was prepared — based on the previous one and on the IPEA/BNDES proposal —, voted in the committee, and approved with 35 votes in favor and only one against.

According to the lonely voter against, this result does not reflect unanimous approval of the content of the substitutive proposal but rather an agreement among committee members that divergences could be settled later, at the time the proposal would be considered by the plenary of the House of Representatives. Anyway, it represented a large step toward reform, as the project had resulted from a big negotiation effort involving all political parties and state governments, as well as institutions representing the municipal governments and most segments of the private sector.

Despite all the political effort, the proposal did not prosper, due to strong opposition coming from an agent central to the process, the Ministry of Finance. The allegations were that the elimination of cumulative taxation could be achieved without resorting to a constitutional amendment — what, accepted some technical limitations, is, in fact, true —; and that the proposal, if approved, would, at least in the short run, put in risk the tax yield amidst a fiscal adjustment process.

In December of 1999, a tripartite commission — Ministry of Finance officials, secretaries of finance of the states and congressmen — was formed in an attempt to resolve the dispute. After more than three months of conversations, a deadlock was declared. The proposal was sent to the plenary of House of Representatives, but, without the support from the federal government, it has never been voted. So, an unparalleled opportunity to carry out a full tax reform was lost.

Political mobilization toward a tax reform has not been totally in vain. Using the very argument of the Ministry of Finance, a project of law was presented to Congress in 2001 aiming at mitigating the cumulative effect of social contributions. Negotiations were reinitiated and Provisional Measure 66, converted into Law 10,637/02, [49] put the proposal in force regarding the PIS/PASEP, which revenue is relatively small, implying low risk to the fiscal adjustment. The law determines that, following the PIS/PASEP experiment, the Executive Power will submit to the National Congress, until December 31 of 2003, a project of law with the purpose of alleviating the cumulative effect of the COFINS.

The substitutive tax reform project approved by the Special Committee is yet dormant into some drawer of the House of Representatives presidency. A recent document subscribed by the President of the Republic and all State Governors states that it will be used in the "process of definition of the tax reform proposal". [50] Thus, the hint is that federal and state governments will try to put forth a new and consensual proposal. The difficulty is

[49] Provisional Measure 66, of August 28 of 2002, converted into Law10,637, of December 30 of 2002.
[50] The document, known as "Carta de Brasília", signed by the President and the Governors in February 22 of 2003, is a pledge to support tax and social security reforms. The quotation in the text corresponds to item 10 on tax reform of the document.

that consensus among all states and the federal governments is possible only with respect to a limited set of questions, mostly with focus on fiscal rather than economic affairs. Any consensual tax reform will certainly be insufficient.

It should be noted that most of the discussion on tax reform since 1995, including the recent one involving the Governors and the President, has addressed to the constitutional level. A full tax reform in Brazil must consider three different levels of changes.

The first is the constitutional level. The Brazilian Constitution defines the master lines of the tax system and, in some instances, even the characteristics of some taxes. For example, a reform in depth of the ICMS requires constitutional amendments.

The second level is that of other legal norms. Constitutional amendments require new complementary laws or changes in the existing ones. Besides, there are cases in which the intended reform demands only changes in ordinary laws, as is the case, for example, of the income tax.

The third is the tax administration level. No matter how good is the conception of a tax system, its quality is limited by the ability of the tax administration. Improve its qualification is a desirable everyday task. However, a major reform, which requires changes in norms and procedures, is a good opportunity for a qualitative leap.

The fact that reform discussions have considered almost exclusively the first of the levels mentioned explains the lack of emphasis on equity issues, typically a subject for ordinary laws. On the other hand, it should be stressed that all progress achieved so far in the reform process was at the second level, namely, the ICMS law, of 1996, and that modifying the PIS, of 2002. The failure to put together a major reform at the constitutional level is due to several constraints that check the process. The challenge is to reach desirable objectives while satisfying the constraints. This requires technical proficiency and, most of all, a big political negotiation effort.

An important obstacle for carrying on the reform has been apprehension about its repercussion on fiscal adjustment. Any relevant tax reform entails some risk to the level of tax revenue; not because of technical or administrative troubles, which can be surmounted, but due to judicial disputes about the changes, which may interrupt tax payments for some time. On the other hand, unless some risk is accepted, the reform that would reduce inequity and the pernicious effects on production will not happen and, as a consequence, it will be impossible to sustain tax revenue at its present high level for long. Therefore, the dilemma between tax reform and fiscal adjustment is only apparent. Adjustment will not last long unless the reform is accomplished.

Another difficult question, a real one that requires intense negotiation, is subnational fiscal autonomy. Though intergovernmental transfers play an important role in the financing of Brazilian subnational governments, especially of poorest units, own revenues have accounted for a large share of the total budget in more developed states since federalism was established by the 1891 Constitution. Subnational units have always enjoyed a high degree of autonomy to legislate on tax matters. Tax tradition, as well as a worldwide trend toward decentralization of public spending, recommends preservation of subnational fiscal autonomy.

Though subnational autonomy is a desirable attribute, it must not rank higher than public interest. That is to say, subnational units taxing power must not bring about distortions in the allocation of resources or in the geographic distribution of commercial and financial flows. Particularly, "beg thy neighbor policies", a source of conflict in the federation, must be avoided, meaning that some degree of harmonization of subnational taxes is necessary. Hence, a difficult question that must be considered by the tax reform process is to find an adequate trade off between subnational autonomy and the need for coordination — both horizontal and vertical — of tax practices.

Whenever reform discussion restarts, distribution of revenue among the three levels of government and among units of each level pops up as a prominent issue. This is a difficult, inherently conflictual, question that must be submitted to meticulous analysis and that cannot be resolved without a long and hard negotiation. Despite its importance, given current Brazilian conditions, it is less urgent than the need to correct distortions imposed by taxation to the production system. It is, thus, convenient to keep the subject out of the agenda until completion of that part of the reform which aim is the removal of obstacles to economic growth.[51]

Notwithstanding, any tax reform implies changes in the distribution of the tax yield among government units, as well as of the tax burden among taxpayers. Assuming that the reform intends to keep total tax burden constant — a stated goal of the current process — there will be, in the short run, winners and losers. In the long run, the benefits arising from the reform may lead to a situation in which all are winners. However, no guarantee exists that such event will occur. On the contrary, odds are that, even in the long run, despite the global gain, some will lose.

This fact imposes two additional conditions for the realization of the reform. First, whenever large changes in the distribution of the tax burden or of the yield are foreseen, a transition period from one tax regime to the other is necessary in order to smooth out changes in relative prices and budget sizes. Second, the conception of the new tax system must take into account that each unit of the federation will oppose changes that imply revenue losses. If these are sizable, the project must anticipate means — increase in own revenue or in intergovernmental transfers — to make up for the losses.

It follows that a key provision for the success of the Brazilian tax reform is to furnish an intense political negotiation effort with previously conceived transition rules and mechanisms for compensation of large non-intentional variations in the disposable revenue of each government unit. Some of the chief tax improvements — adoption of the destination principle for treatment of interstate trade flows, for example — have the side effect of severely reducing the disposable revenue of some units. If not compensated and/or smoothed out somehow, the side effect will bring about strong resistance to the implementation of the measure.

Summing up, the tax reform process in course has not go too far after more than seven years of discussions. An extensive tax reform is still a remote goal; but some topical results, like those regarding the ICMS and the PIS/PASEP, where accomplished. This reinforces the judgment, implicit throughout this paper, that tax reform in Brazil must be

[51] Of course, this is not an impediment to the immediate beginning of technical work that will support future negotiations and decisions.

treated as a long process in which an ideal tax system model is implemented piecemeal, as allowed by the economic and political conditions, rather than as a one-shot event.

If this judgment is correct, tax reform consistency requires that government assign to an executive group, with technical and political attributions, the responsibility for conceiving an ideal tax system model and for conducting the tax reform process. After each round of legislative procedures, the group should adjust the model, by taking into account changes introduced by the Congress, in order to keep the tax system consistent.

Section 4 above does not provide a complete tax system model, but contains a reasonable, though not exhaustive, inventory of tax features in need of reform and several proposals in this direction.

List of Abbreviations

CIDE – Contribution for intervention in the economic domain (on the importation and commercialization of oil and derivates, natural gas and derivates, and combustible ethylic alcohol)

COFINS – Contribution for the financing of social security

CPMF – Temporary contribution on bank debits

CSLL – Contribution on net profit

CVA – Contribution on value-added

CVAT – Compensating value-added tax

EEC – European Economic Community

EU – European Union

FEF – Fiscal Stabilization Fund

FGTS – Fund for the Guarantee of Time in Service

FINSOCIAL – Social Investment Fund

FPE – States participation fund

FPM – Municipalities participation fund

FSE – Emergency social fund

FTAA – Free Trade Area of the Americas

GDP – Gross domestic product

ICM – Tax on the circulation of merchandises

ICMS – Tax on the circulation of merchandises and on communication and interstate and intermunicipal transportation services

IE – Export tax

IGF – Tax on large fortunes

II – Import tax

IOF – Tax on financial operations

IPI – Tax on industrialized products

IPTU – Tax on urban real estate

IPVA – Tax on the property of motor vehicles

IR – Income tax

ISS – Tax on services of any nature

ITBI – Tax on commercial transfers of real estate

ITCMD – Tax on donations and sucessions

ITR – Tax on rural land

IUCL – Single tax on fuel and lubricants

IUEE – Single tax on electric energy

IUM – Single tax on minerals

MERCOSUR – Common Market of the South

PASEP – Program of Assistance to Public Servants

PEC – Constitutional amendment proposal

PIN – Program for National Integration

PIS – Social Integration Program

PROTERRA – Program of Land Redistribution and Stimulus to Farming in the North and Northeast

RST – Retail sales tax

VAT – Value-added tax

List of References

ABRASF (1998). “O Financiamento dos Municípios Brasileiros”. November.

Afonso, J. R.; F. Rezende; and R. Varsano (1998). “Reforma Tributária no Plano Constitucional: uma Proposta para Debate.” Texto para Discussão, No. 606, Brasília: IPEA, November.

Afonso, J. R., et al. (1998). “Tributação no Brasil: Características Marcantes e Diretrizes para a Reforma.” *Revista do BNDES*, 9, Rio de Janeiro: Banco Nacional de Desenvolvimento Econômico e Social, June, pp. 25–50.

Albuquerque, P. H. (2001), “Os Impactos Econômicos da CPMF: Teoria e Evidências”, Trabalhos para Discussão No 21, Brasília: Banco Central do Brasil, June.

Commission of the European Communities (1996). “A Common System of VAT: A Programme for the Single Market”. Brussells.

Ebrill, L. et alii (eds.) (2001). *The Modern VAT*. Washington D.C.: International Monetary Fund.

Fundação Getúlio Vargas, Comissão de Reforma do Ministério da Fazenda (1967). *A Reforma do Ministério da Fazenda e Sua Metodologia - Relatório Final.* Rio de Janeiro: Fundação Getúlio Vargas.

International Bureau of Fiscal Documentation (1963). *The Report of the Fiscal and Financial Committee and the Report of the Sub-Groups A, B and C.* Amsterdam: International Bureau of Fiscal Documentation.

Lezan, E., and Varsano, R. (1981). “O Sistema Tributário Brasileiro.” mimeo.

McLure, C.E. (2000). “Implementing Subnational Value Added Taxes on Internal Trade: The Compensating VAT (CVAT).” *International Tax and Public Finance,* 7 (6), pp. 723-740, December.

Mora, M., and Varsano, R. (2001). “Fiscal decentralization and Subnational Fiscal Autonomy in Brazil: Some Facts from the nineties”. Texto para Discussão nº 854, Rio de Janeiro: IPEA, December.

Poddar, Satya (1999). “ Considerations in the Design of a VAT at the State Level in India”. Paper prepared for the VAT Seminar for Senior Officials from the Centre and the States, July.

Prado, S. and Cavalcanti, C.E.G. (2000). *A Guerra Fiscal no Brasil.* São Paulo: Fundap: Fapesp; Brasília: IPEA.

Santana, I.C. et al. (2002), “Carga Tributária no Brasil – 2001”, Estudo Tributário No 6, Brasília: Ministério da Fazenda, Secretaria da Receita Federal, Coordenação Geral de Política Tributária, junho de 2002.

Silva, M.A. da (2001). “Guerra Fiscal e Finanças Federativas no Brasil: o Caso do Setor Automotivo.” Campinas: Universidade Estadual de Campinas, Instituto de Economia, master dissertation.

Varsano, R. (2003), “O Financiamento do Regime Geral da Previdência Social no Contexto do processo de reforma tributária em Curso.” Mimeo.

__________ (2002), “Sistema Tributário Para o Desenvolvimento”, in Castro, A. C. (org.) *Desenvolvimento em Debate: Painéis do Desenvolvimento Brasileiro – I,* Rio de Janeiro: Mauad: BNDES, pp.231-250

__________ (2000). “Subnational Taxation and the Treatment of Interstate Trade in Brazil: Problems and a Proposed Solution”. In S. J. Burki et al. (eds.) *Decentralization and Accountability of the Public Sector. Proceedings of the Annual Bank Conference on Development in Latin America and the Caribbean.* Washington, D. C.: World Bank, pp. 339-356.

__________ (1997). “A Guerra Fiscal do ICMS: Quem Ganha e Quem Perde.” *Planejamento e Políticas Públicas,* No. 15, Brasília: IPEA, July, pp. 3–18.

__________ (1995). “A Tributação do Comércio Interestadual: ICMS Atual versus ICMS Partilhado.” Texto para Discussão, No. 382. Rio de Janeiro: IPEA, Sept.

__________ (1979). “Os Ajustamentos de Fronteira do ICM, o Comércio Interestadual e Internacional e a Autonomia Fiscal dos Estados.” *Pesquisa e Planejamento Econômico,* 9(2), August.

Varsano, R. et al. (2001), "Substituindo o PIS e a COFINS — e por que não a CPMF? — por uma Contribuição Não-Cumulativa", Texto para Discussão nº 832, Rio de Janeiro: IPEA, outubro de 2001.

__________ (1998). "Uma Análise da Carga Tributária do Brasil", Texto para Discussão nº 583, Rio de janeiro: IPEA, agosto.