

TAX REFORM TO PROMOTE COMPETITIVENESS AND FACILITATE INTEGRATION

The Case of Brazil

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ABOUT THE FEDERATION AND THE TAX SYSTEM



Brazilian Federation

created in 1891 with 3 levels of government

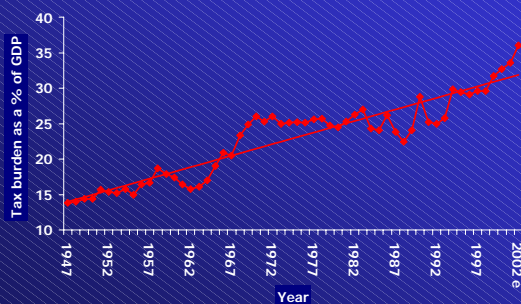


- Central Government
- 26 States and a Federal District
- More than 5500 Municipalities, which, according to the 1988 Constitution, are members of the federation

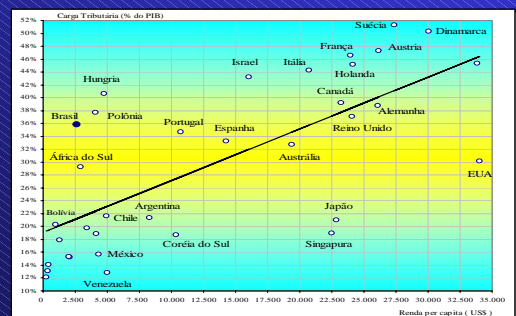
Structure of the Tax System and Tax Assignments

- ✓ Government revenue is provided by taxes (impostos), contributions (contribuições) and fees (taxas).
- ✓ Fees, for services or for exertion of police power, are collected by all levels of government.
- ✓ Each tax is assigned by the Constitution to a tier of government that legislate, administer and collect it (subject to rules set in the Constitution and complementary laws).
- ✓ Almost all contributions are federal.
- ✓ Proceeds of several federal and state taxes (but not of contributions) are shared with lower levels of government.

Tax Burden as a % of GDP 1947/2002



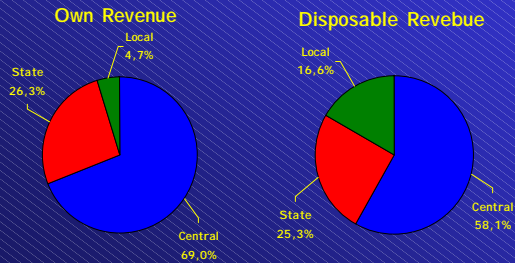
International Comparison



Fonte: AMIR RHAIR (dados primários: FMI)

Own and Disposable Revenue 2002

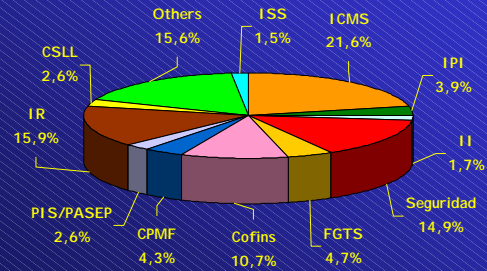
Total tax burden = 36,0% of GDP



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Revenue from Major Taxes

Total Tax Burden (2002) = 36,0% of GDP



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**WHAT REFORM?
HOW REFORM?**

The Main Tax Plagues

- CUMULATIVE TAXATION
- ICMS: PROCEDURES FOR TAXATION OF INTERSTATE TRADE FLOWS; FISCAL WARS; EVASION; COMPLEXITY; TAXATION OF SERVICES
- EXCESSIVE PAYROLL TAXATION
- TOO MUCH TAXATION OF BUSINESS INCOME AND TOO LITTLE TAXATION OF PERSONAL INCOME

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Effects of Cumulative Taxation

- International tax harmonization cannot be correctly accomplished
- Exports bear taxes
- Capital goods bear taxes
- Tariffs apart, tax burden on domestic products is larger than on similar imported goods
- Decisions on how to produce are distorted
- Relative prices are unintentionally changed, implying efficiency loss
- Competition conditions are distorted

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Cascading contributions as a percentage of total revenue



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Cumulative Taxation Accounts for almost 1/4 of Brazilian Tax Revenue

- COFINS, PIS (until Dec. 2002), CPMF, ISS
- ISS INTERACTION WITH IPI AND ICMS
- CIDE INTERACTION WITH IPI AND ICMS
- IPI AND ICMS: "PHYSICAL CREDIT CRITERIA"
- IPI AND ICMS: RELUCTANCE TO PROVIDE ADEQUATE TREATMENT TO ACCUMULATED TAX CREDITS
- TAXATION OF CAPITAL GOODS BY THE IPI AND, UP TO 1996, BY THE ICMS
- OPTIONALLY:
 - IRPJ E CSLL: TAXATION OF TURNOVER AS A PRESUMPTION OF PROFIT
 - SIMPLES: ON TURNOVER OF SMALL FIRMS TO REPLACE A SET OF FEDERAL TAXES

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Proposals for Reform of Social Contributions

- Substitute a value added contribution for PIS and COFINS, using it, as well, to replace the proceeds of the CPMF and of the payroll contributions that are not assigned to the social insurance
- CPMF would finance exclusively the social insurance, under the following conditions:
 - The tax on individuals would replace part of the revenue presently collected by means of the payroll contribution
 - CPMF paid by firms would be compensated with its payroll contribution liabilities (CPMF would have the function of a withholding or minimum contribution)

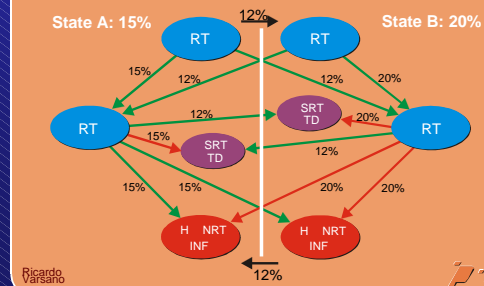
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Other ICMS Problems

- **Complexity**
 - There is a basic national ICMS law ("Lei Kandir"); notwithstanding, there are 28 different sets of legal and administrative VAT norms.
 - Any good may, in principle, be subject to up to 30 different VAT rates
- **Taxation of interstate trade = a host of problems**

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INTERSTATE TRADE ICMS HYBRID SYSTEM

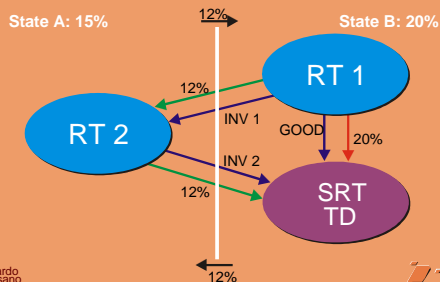


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INVOICE SIGHTSEEING



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Taxation of Interstate Trade

Stimulates

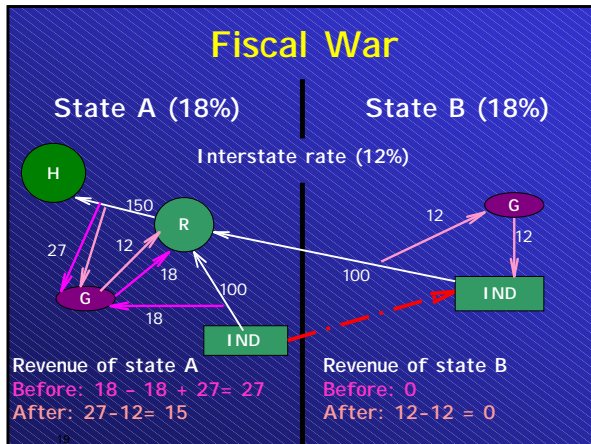
1. Non-registered traders (*all the service sector!*) and households purchases from state with lower rate
2. Under certain circumstances, registered traders purchases from outside the state, no matter the difference between state internal rates
3. "Invoice sightseeing": inefficiency and evasion

Solutions

No full solution exists short from rate equalization; but:

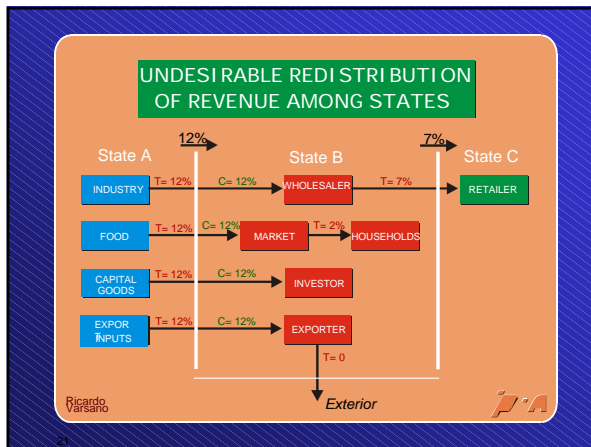
- Problem # 1: inclusion of services in the tax base would drastically reduce the problem
- Problems # 2 and 3: collecting the tax at the origin would reduce the problems. A perfect (except for fraud) but awkward solution would be to collect ICMS at the origin using the rate of the state of destination

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Solution for the Fiscal War

- **Solution: adopt destination principle for treatment of interstate trade.**
 - Destination principle does not prevent production subsidies but eliminates the base for their concession at the expense of other states.
 - As each state would pay its own bill, they would carefully appraise the incentives granted and, probably, cut down subsidies.



Taxation of Interstate Trade

Promotes

- Unintended revenue redistribution between states.
 - **Solution: adopt the destination principle.**

And Creates Other Problems

- States with surpluses in international trade (and that, for this reason, tend have deficits in interstate trade) are penalized.
- A policy which, for equity reasons, reduces rates or grant exemptions for goods with high weights in the budget of low income families may be unfeasible.
 - **Solution: adopt the destination principle.**

Taxation of interstate trade: Synthesis

- Some problems of interstate trade taxation require collection of the tax in the origin
 - Example: “Invoice Sightseeing”
- Other problems may be solved only if the destination principle is adopted for taxation of interstate trade
 - Example: a) undesirable redistribution of revenue among states; b) “fiscal war”

General Lines for an Ideal (but Feasible) Reform of Brazilian VATs

- Replacement of both the IPI (federal) and the ICMS (state) by a consumption type dual VAT, using “financial credit criteria” and including services in its base (with consequent extinction of the ISS and CIDE).
- Uniform legal norms across the country, except that states would have the power to legislate on local specificities.
- Tax rates, both federal and state, set by a national law; but each state would have the power to increase or decrease its rates within a given interval centered on the set rates.
- Adoption of the destination principle for both international and interstate trade, with tax collection at the origin state and assignment of the revenue to the destination state by means of an accounting or administrative procedure.