



Brazilian subnational VAT: Problems, proposals for reform and prospects



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***Forum of Federations: Making the 18th Amendment and
NFC Award Work***

Islamabad , 30-31 October 2010

Issues

- ☐ ICMS: Background information
- ☐ Operations and functioning
- ☐ Main shortcomings of the ICMS
- ☐ Proposals for reforms
- ☐ Prospects and lessons

ICMS: Background information

- ❑ Brazil was one of the first country to introduce a full-fledged VAT (1967): Tax on Operations Related to the Circulation of Goods (ICM), which had uniform rates nationally.
- ❑ The ICM substituted the tax on sales and consignment (IVC), which was a cumulative tribute on goods' sales.
- ❑ Initially, a single tax rate of 15% was approved, but it was modified later to make it compatible with the higher rates of the IVC in the North and Northeastern regions (between 4 and 11%, the country average was 6.63%).
- ❑ At that time there was an intense debate about the regional impact of the ICM: a transfer of wealth from the poorest regions to the richest ones.
- ❑ During this initial phase, the granting by states of fiscal incentives to promote industrialization was very common.

ICMS: Background information

- ❑ The Constitution of 1988 broadened the base of the ICM by incorporating into it the production of oil and oil by-products, as well as selected services: electrical energy, telecommunications, and inter-state transport services. Other services are taxed by the municipalities (ISS).
- ❑ The ICM was renamed as Tax on Operations Related to the Circulation of Goods and on Interstate and Inter-municipal Transportation and Communication Services (ICMS)
- ❑ The intra-state rates are set by each state within a range determined by the Brazilian Senate.
 - Basic necessities: Exempt and zero-rated or 7%
 - Industrial sectors: 12 – 18%
 - Utilities and oil/fuels: 25%
 - Luxury and excisable goods: 30 – 35%

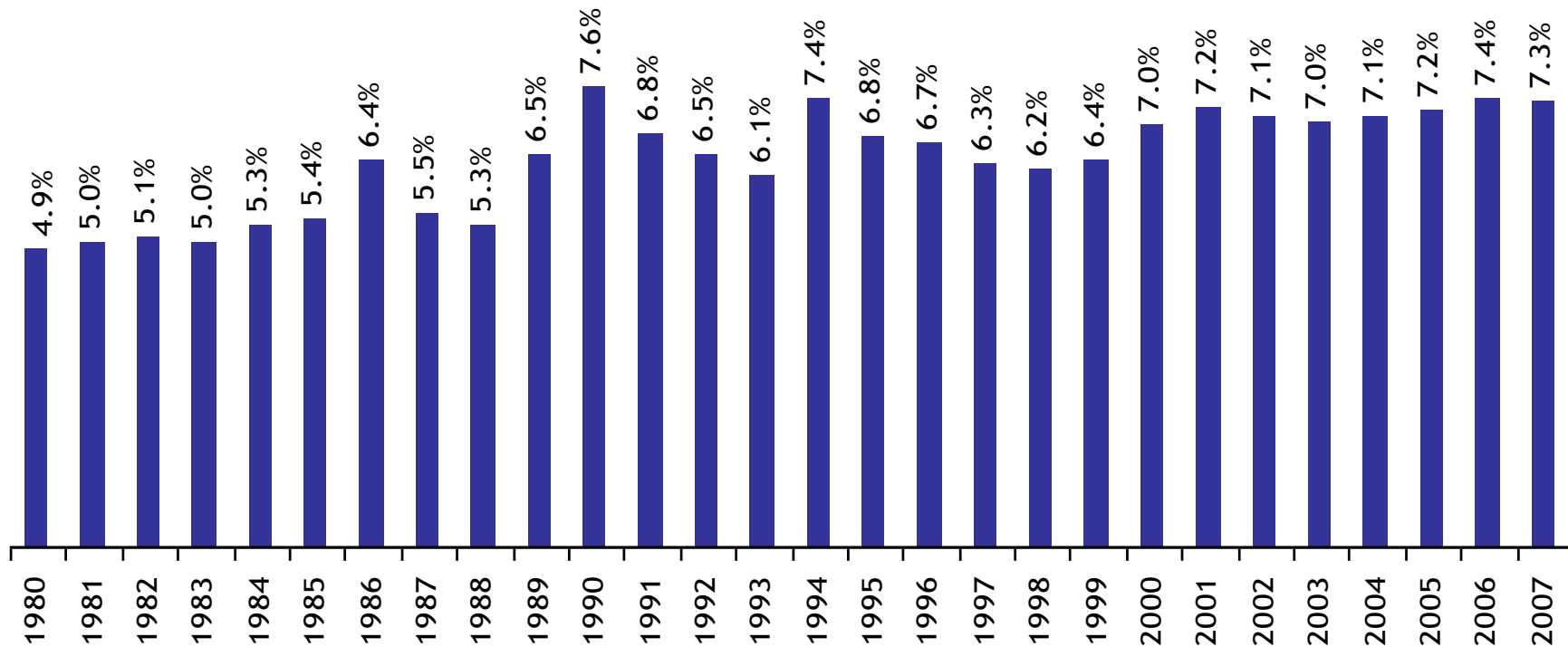
ICMS: Background information

- ❑ The ICMS follows the origin-principle (revenue accrues to the state where the good or service is produced)
- ❑ The ICMS is a credit invoice VAT (sale-by-sale and purchase-by-purchase basis tracking)
- ❑ Over the years, the ICMS has become a more specific and complex tax

ICMS: Background information

ICMS COLLECTION: 1980 – 2007

(As a % of GDP)



Source: Rezende (2009)

Operations and functioning

How does the ICMS work?

- ❑ Brazil's ICMS differs from most VATs in that:
 - It is collected by the states, not the central government
 - It is not a broad-based tax since it is restricted to goods and selected services
 - It has many rates (intra- and inter-state)
 - The internal rates are defined by the state and the interstate rates are determined by the Senate (there are more than 40 rates and 27 legislations)
 - The tax liability is calculated on a tax-inclusive basis, not on a tax exclusive-basis
 - It is mainly an origin-based tax, not a destination-based tax.

Operations and functioning

How do other consumption taxes work in Brazil?

- ❑ Imposto sobre Produtos Industrializados (IPI) / Tax on Industrialized Goods
 - A federal, single-stage tax that falls on manufactured goods only.
- ❑ Contribuição para o Financiamento da Seguridade Social (COFINS) / Contribution for the Financing of Social Security
 - A federal, cumulative tax that has incidence on goods and services.
- ❑ Programa de Integração Social (PIS) / Social Integration Program.
 - A federal, cumulative tax that has incidence on goods and services.

Operations and functioning

How do other consumption taxes work in Brazil?

- ❑ Contribuição de Intervenção no Domínio Econômico (CIDE-Combustíveis) / Contribution of Intervention in the Economic Domain
 - A federal, single-stage tax that falls on gasoline and diesel.
- ❑ Imposto sobre Serviços (ISS) / Tax on Services
 - A municipal, cumulative tax that falls on services.

Main shortcomings of the ICMS

- ❑ The legislation regulating the ICMS varies from state to state
- ❑ This gives rise to excessive complexity, high compliance costs for taxpayers, and opens scope for evasion and predatory tax competition
- ❑ Preservation to some degree of the cumulative taxation due to the exclusion of the services of the tax base (which prevents the crediting of the tax paid on service inputs in the production process)
- ❑ The tax is much more productive in states that are large producers and net exporters of industrialized good

Main shortcomings of the ICMS

- ❑ Another problem has been exporters' tax credit accumulation. In theory, the firm would be entitled to a refund from the state where the tax originated, but in practice exporters just kept accumulating credits that lost their value over time as a result of inflation
- ❑ High level of evasion, part of which is due to the difference between the rates applied to intra-state and inter-state transactions
- ❑ There is no administrative integration (vertical coordination) between the IPI and the ICMS
- ❑ Brazilian states have to deal with cross-border trade due to the origin principle that applies to interstate trade (horizontal coordination)

Main shortcomings of the ICMS

- ❑ With the broadening of the tax bases of the ICMS a space was open for the expansion of tax competition (fiscal wars) through proliferation of tax benefits.
- ❑ Such benefits affect the location decisions of firms and generate resistance to adopt the destination principle.
- ❑ Fiscal wars create distortions because the allocation of resources is based on tax costs, not on the relative prices of the factors of production, and it also creates unfair advantages for the firms benefiting from tax reductions.
- ❑ Fiscal wars have also meant a loss of current revenue, with the possibility of not generating a stream of revenue that would compensate for the current tax benefits in the future if the firms decide to move away from their current location.
- ❑ The fiscal war among the states disturbs the harmony in the federation, encourages tax planning, and facilitates tax evasion.

Main shortcomings of the ICMS

Lack of efficient coordination mechanisms among the states

- ❑ The CONFAZ (National Tax Policy Council) a committee of all the Treasury secretaries of the Brazilian states initially was charged with approving any tax benefit granted by individual states
- ❑ At the time of the military government, CONFAZ was the key to inhibiting the fiscal wars
- ❑ When the Brazilian states were granted greater autonomy on legislative matters of the ICMS in 1988, CONFAZ started to relax its stance on the ICMS
- ❑ Direct ICMS exemptions still needed unanimous approval of CONFAZ, but indirect benefits were profusely utilized (Ex: the granting of state credits with below-market interest rates on ICMS owed)
- ❑ The result of these practices were the fiscal wars between Brazilian states
- ❑ With the passing of time, CONFAZ was blatantly ignored and no longer functioned as a harmonizing body for the ICMS rules

Proposals for reforms

Proposal	Taxes to be eliminated	Taxes to be created
Proposal of the Executive government at the end of 1997 October 1997	<ul style="list-style-type: none">- All sales' taxes and in cascades (Cofins, PIS-Pasep) With the exception of taxes on financial transactions- Federal tax on manufactured products (IPI)	<ul style="list-style-type: none">- VAT administered at national level- Federal tax on the consumption of goods and services- Tax on retail sales (IVV)
Proposal of the Executive government at the end of 1999 October 1999	<ul style="list-style-type: none">- State VAT (ICMS)- Tax on services applied by the local governments (ISS)	<ul style="list-style-type: none">- Federal VAT- State tax on consumption of goods and services- Municipal tax on retail sales (IVV)

Source: Werneck (2004).

Proposals for reforms

Proposal	Taxes to be eliminated	Taxes to be created
<p>Proposal of Special Committee</p> <p>March 2000</p>	<ul style="list-style-type: none"> - All sales' taxes and in cascades (Cofins, PIS-Pasep, CPMF) - Federal tax on manufactured products (IPI) 	<ul style="list-style-type: none"> - Dual VAT (Coexistence of Federal and State VATs) - Municipal tax on retail sales (IVV)
<p>Proposal of Secretaries not selected by vote</p> <p>March 2000</p>	<ul style="list-style-type: none"> - State VAT (ICMS) - Tax on services applied by local governments (ISS) 	<ul style="list-style-type: none"> - Dual VAT (Coexistence of Federal and State VATs) - Non cumulative tax on consumption
<p>Proposal of the Executive government</p> <p>August 2000</p>	<ul style="list-style-type: none"> - Federal tax on manufactured products (IPI) - State VAT (ICMS) - Tax on services applied by local governments (ISS) 	<ul style="list-style-type: none"> - Federal tax on goods and services (IBS) - State VAT uniformed at national level - Municipal tax on retail sales (IVV)

Proposals for reforms

Proposal	Taxes to be eliminated	Taxes to be created
Constitutional Amendment December 2003	<ul style="list-style-type: none">- 27 different state codes were classified under a single VAT federal law.- Deferral of the charge until year 2007 of the provisional contribution on the financial movement (CPMF) and the union budget separation mechanism (DRU)	<ul style="list-style-type: none">- Unified ICMS (the administration would be in charge of the States, but under a unified national framework)-CONFIS – non cumulative tax (to reduce the importance of the cascade tax)- Creation of another tax on sales that could liberate the taxes on the payroll from a part of the financing burden of the social security systems.- Distribution of a quarter of the economic contribution on fuels to finance investments in transport (Contribution of intervention in the economic domain-CIDE)

Proposals for reforms

Proposal	Taxes to be eliminated	Taxes to be created
Proposal of the Executive Federal Government (Constitutional Amendment) 2008	<ul style="list-style-type: none">- COFINS- PIS- CIDE-Fuels- Contribution on the payroll Salary-Education- CSLL (Social contribution on the liquid profit), which would be incorporated in the corporate income tax.	<ul style="list-style-type: none">- Federal VAT- New ICMS which unifies the 27 state laws.- Adoption of the “destination principle” in the ICMS (compensations through the creation of the Fund for income balancing)
Proposal of the Federal Senate 2010	<ul style="list-style-type: none">- IPI- COFINS- PIS- CIDE- FUST- FUNTTEL and other federal contributions.- ICMS	<ul style="list-style-type: none">- All internal taxes on goods and services are merged into a sole and broad national VAT.

Source: Prepared on the basis of Federal Senate (2010)

Why have proposals for reforms failed?

- ❑ The implementation of each one of the reforms previously revised would generate:
 - ❑ Changes in the tax autonomy of the different levels of governments.
 - ❑ Winners and losers in terms of fiscal revenues.
- ❑ Two basic questions:
 - ❑ Consensus for reform?
 - ❑ How to compensate?

Prospects and lessons

- ❑ One major technical problem with sub-national VATs, is cross-border trade. The ICMS is no exception: it generates
 - fiscal wars,
 - regional inequality and
 - an accumulation of exporters' tax credits.
- ❑ The different rates for the ICMS have created
 - economic distortions and
 - evasion practices such as “tax tourism” (cross-border shopping) and “invoice sightseeing” (false interstate sales).
- ❑ The lack of uniformity in tax rules and rates among states (more than 40 rates and 27 legislations) hinders international fiscal harmonization.
- ❑ The absence of vertical coordination has generated excessive administrative costs.
- ❑ Due to the exclusion of certain services from the tax base there is also some degree of cumulative taxation. A cascading effect results from the interaction between the IPI (federal), the ICMS (state) and the ISS (municipal).
- ❑ The reform of the ICMS involves the political economy of Brazil's intergovernmental system as a whole.
- ❑ Lesson: think the “exit strategy.”



Thank you for your patience!

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