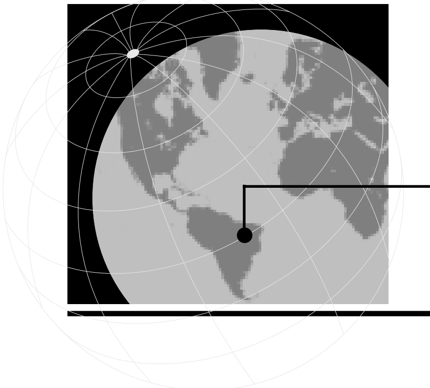

Brazil: tax reform and the "fiscal war" in the federation

BY *RICARDO VARSANO*

The stabilization and opening of the Brazilian economy in the nineties, together with changes in international relations that we've come to call globalization, radically modified the economic setting where Brazilian firms operate.

The current challenge is to reform the tax system, which is inadequate to the new circumstances faced by the country.

The Brazilian tax system suffers from four major plagues:

- cumulative taxation (which causes economic inefficiency and loss of competitiveness);
- too much evasion (the results of which are often fiscal inequity and unfair competition);
- excessive complexity (bringing in its wake awkward administration and high compliance cost);
- and "fiscal war" (which causes a misallocation of resources and unrest in the federation).

Virtually all recent works on tax competition in federations conclude that the last-named practice is pernicious. And there is ample evidence that the Brazilian fiscal war is wreaking havoc on state financing, and disturbing harmony and cooperation in the federation.

An unequal federation

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.

When you take that into account, it's reasonable that state governments should pursue decentralized industrial policies. They have the legitimate goal of expanding their own production, employment levels, and income.

And, of course, from the standpoint of any particular state, granting *fiscal incentives* to attract and keep investment seems worthwhile.

If we assume that companies benefiting from such incentives would not otherwise choose to locate their businesses in the state offering the tax breaks—then the incentives don't really cause losses in tax revenue.

Plus, aside from their direct impact on production and employment, newly attracted firms bring additional economic activity, creating still more jobs and income, and, of course, tax revenue.

If this were the whole story, state tax incentives would be a valuable development tool.

But, when the successful experience in one state is imitated by others, destructive *fiscal war* starts.

The dynamics of fiscal war

One of the features of fiscal war is that, in effect, it tends to engulf all the players. Firms benefiting from fiscal incentives are conferred an advantage in relation to competitors located in other states. These competitors often threaten to move into the state granting the incentive unless a similar benefit is offered in the state where they are located.

Soon, to avoid the risk, all states engage in the war.

When fiscal war is pervasive, large firms are able to promote a kind of auction to select locations for their plants, in an attempt to get additional incentives. They may even choose a location and simulate the auction just to get a better deal from the chosen state.

And, as it becomes more difficult to attract new investors, state incentive policies become more aggressive. This includes sending government officials to other states in order to entice firms into relocation.

Conflict in the federation is exacerbated.

As the practice spreads out, its efficacy fades. Revenue goes down in all states. And, since taxes have been equally reduced everywhere, states ultimately lose the power to induce relocation of production. When the process reaches this stage, firms tend to choose their locations considering only market and production conditions.

Pressed by larger spending and reduced tax revenue, the financially weaker states, which are the less developed, become unable to provide services and public works necessary to attract new investments from the private sector.

At the final stages of the fiscal war, the more developed states win all the battles. Disparities—already very large in the case of Brazil—naturally tend to increase.

Preventing fiscal war

The practice of states reducing the value-added tax to attract new investments has been unlawful since 1975 (except in cases where the intended reduction is approved by all states). Yet the law has been disregarded and the fiscal war has intensified in recent years.

A change in interstate trade taxation rules may provide the result that the law was not able to bring about.

Almost all firms attracted to a state by tax incentives have the bulk of their markets elsewhere. Were these firms located in one European Union country and their markets in another, governments would not be able to grant value-added tax incentives—because the tax rate on exports from one member country to another is zero.

But in Brazil, interstate sales are taxed at a positive rate under the state value-added tax, known as the ICMS. Interstate taxation provides the base for the incentive, which consists of a disguised refund of ICMS dues, generally in the form of a zero or low interest long-term loan.

One way of undercutting this practice would be to assign revenue arising from interstate trade to the state of *destination* of goods rather than the state where goods are made. This would limit the value of tax incentives to attract investments. They would only work to the extent that the goods produced in a given state were sold in that same state.

Adoption of this *destination principle* would also improve revenue prospects of less developed states, where consumption tends to be larger than production. And it would solve some other problems that stem from current interstate tax procedures.

On the other hand, implementing the destination principle by zero-rating the tax on interstate sales, as in the European Union, would exacerbate some of the other major shortcomings of the value-added tax system in Brazil, such as excessive evasion and costly unfair competition.

A better solution would be one in which the destination principle is implemented with the use of similar rates for taxation of both *out* of state and *intra*state sales.

Tax reform as a constitutional matter

Changing the Brazilian tax system is an extremely difficult task.

Since the republic was proclaimed and federalism adopted, in 1889, all Brazilian constitutions have indicated which taxes may be levied by each level of government. And, since 1965, constitutional provisions have also defined the general characteristics, or even the details, of many taxes.

So, in order to change the structure of the tax system and even the features of certain taxes (the ICMS among them), a *constitutional amendment* is required.

Approval of an amendment proposal demands hard political negotiation within the course of a long and complex legislative procedure.

A proposal to amend the constitution, presented to one of the Houses of Congress, must first be submitted to its Constitution and Justice Committee in order to have its constitutionality certified.

(Yes, in Brazil, a constitutional amendment may be *unconstitutional!*)

Next, a special committee, specifically appointed to perform this task, analyzes its merits. The committee may accept, reject or modify the proposal. If approved, the original or modified version advances to the plenary, where it may be further altered.

Approval by the House requires favorable votes of at least 3/5 of its members in each of two ballots. The approved terms of the proposal, which may be utterly different from the original, are then presented to the other House where a similar procedure takes place. If modified, the proposal is sent back to the former House for a final round of political negotiation.

An attempt at reform

A constitutional tax reform process was put in motion in 1995, soon after discontinued, then reinstated in 1999.

The main targets of the tax reform proposal were federal cascading taxes, (excellent sources of both revenue and distortions of all kind) and the ICMS, so intricate a tax that few realize it is—or was originally—a value-added tax (VAT).

The reform proposal recommends:

- substituting the ICMS, the existent municipal tax on services (a “turnover tax”) and the federal tax on industrialized goods (a partial VAT) with a “dual VAT”;
- replacing the federal cascading taxes with a non-cumulative tax;
- and implementing a version of the “destination principle” for interstate trade mentioned above.

Reform on hold

The proposal, discussed throughout 1999, received 35 favorable votes out of a total of 36 in the special committee constituted to study it. Nonetheless it has been strongly opposed by the Ministry of Finance and by some state governments, especially by those intensely engaged in fiscal war.

Such opposition, which means the proposal would hardly have any chance of approval in the plenary of the House of Representatives (and even less chance yet in the Senate!), stopped it in its course and reopened the discussion.

A tripartite commission—with representatives of Congress, federal and state governments—was formed in an attempt to reach an agreement about the content of the tax reform.

But, by March 2000, a deadlock was finally declared, the proposal was sent to the plenary, and the legislative procedure suspended. The 1999 tax reform proposal is now lying, maybe forever, inside some drawer at National Congress.

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This does not mean that Brazilian tax reform has reached the end of its journey. Those familiar with the stops and starts of past reform processes would bet this is just another delay. They believe that the process will be resumed, maybe as soon as the first half of 2001.

The sooner the better, because if tax reform is stalled it means not only that fiscal war will continue upsetting federative relations, but also that investment will remain below its potential level and economic growth will be sluggish.