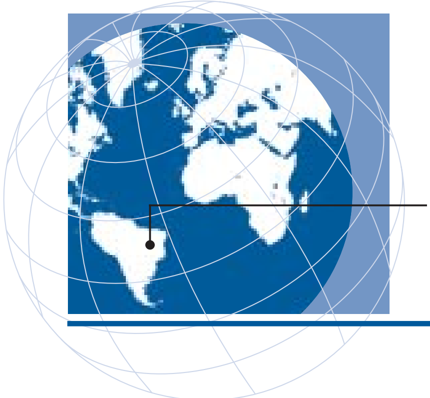

Brazil's new government: Ready to reform taxes?

BY *CARLOS ARAÚJO LEONETTI*

If Brazilian President Luís Inácio Lula da Silva finds a way to feed all of Brazil's poor, he will have to confront yet another huge challenge: how to pay for the new food program.

Brazil's tax structure under the 1988 constitution cannot support the current level of government services and commitments, let alone a program to eradicate hunger. In fact, if the Brazilian government fails to increase its tax revenues it will surely face unmanageable deficits and the loss of vital IMF support.

The present Brazilian tax structure was under considerable pressure at the beginning of 2003. Politically, the tax system undermines fiscal federalism and encourages "fiscal warfare" among orders of government. Economically, the system penalizes production and foreign trade. These are some of the fiscal constraints Lula must grapple with if he is to succeed in feeding Brazil's poor.

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Constitutional constraints

The Brazilian constitution sets clear limits on the taxation powers of the federal government (known as "the union"), the states and the cities. It even stipulates the tax powers of the Federal District of Brasilia. The union is competent to impose taxes on foreign trade, incomes, rural properties, industrialized goods, credit operations, currency exchange, insurance and financial instruments. States may tax motor vehicles, inheritances, gifts and sales in general. And cities may tax real estate, sales and services in general. The union, states and cities can also charge fees for public services or law enforcement.

Only the union may collect other taxes, called "compulsory loans" and "special contributions". The "compulsory loans" are assessed in response to extraordinary expenses caused by wars or other calamities, or in support of urgent public projects. After a time period fixed by law, the federal government must refund all the money collected on this basis to taxpayers. The "special contributions", on the other hand, are federal taxes collected to help finance social security and other public expenses. Finally, only the union may impose taxes not specifically mentioned in the constitution.

The states and cities feel that their hands are tied because they may only collect those taxes that have been allocated to them by the constitution. This constraint usually results in states and cities lacking the financial capacity to meet all of their policy commitments. Moreover, the Fiscal Responsibility Act of 2001 imposes heavy penalties on all authorities that run a budget deficit or spend money on programs not set out in the annual budget. This statute has added yet another constraint to governments' freedom of fiscal action.

Two major aspects of Brazil's tax structure require particular attention: the value-added tax and the "special contributions". The value-added tax – known as the ICMS for its acronym in Portuguese for "tax on the circulation of goods and services" – is collected by the states and not by the central government as is the practice in most European countries and in Canada. This difference enables each state to set its own rules for the ICMS – a state of affairs that contributes to "tax warfare" among the states. Another problem arises from the fact that the ICMS applies to inter-state sales: companies operating nationwide incur significant expenses in attempting to comply with often contradictory state regulations.

Federalize the value-added tax?

Arguably, the ideal solution would be to transform the ICMS into a federal tax. This would involve transferring the power to legislate on the ICMS away from the states to the union, leaving enforcement and collection to the former. This way, Brazil could have a nationwide ICMS system and thereby both avoid a fiscal war among orders of government and reduce the cost structures of multi-state companies. This innovation would require a constitutional amendment, not an easy feat given the fact that it would require the consent of at least three-fifths of the members of each house of the National Congress – that is, the Chamber of Deputies and the Federal Senate. Such a change would also threaten states' fiscal independence because the ICMS as it stands is the most important revenue source for the majority of states.

Another possible reform of the ICMS regulations would entail reforming the principle that regulates the taxation of inter-state sales. According to the "origin principle" – the one currently in

Carlos Araújo Leonetti *is a professor of law at the Federal University of Santa Catarina (UFSC) in Florianopolis, Brazil, and a national finance attorney for the Brazilian Ministry of Finance.*

Two faces of Brazil's cities:

Photos: Reuters Digital Fellowship

A beach in Recife shows one face of Brazil's cities: affluence and a tourist paradise.

A mother and child on the street of a "favela" – a Brazilian urban shantytown near an affluent neighbourhood.

force – ICMS revenues from inter-state sales belong to the seller's state. This approach benefits the richer jurisdictions, where most industries are located, and punishes the poorer ones. Replacement of the origin principle with the destination principle would raise the non-industrial states' ICMS revenues and thus increase the fairness of the tax system as a whole.

The other major issue regarding Brazilian tax reform concerns the "special contributions" collected by the union. This tax is imposed on almost all business transactions, from food sales to telephone communications, on a cumulative basis. In other words, this tax is applied to each transaction involving the same good without taking into account the taxes levied on preceding transactions. This system inflates the prices of goods and services, imposing a heavy burden on consumers.

> **The consequences are perhaps even more severe when the 'special contributions' are applied to exports: Brazil's goods lose competitiveness on international markets.**

The consequences are perhaps even more severe when the special contributions are applied to exports: Brazil's goods lose competitiveness on international markets. The union has always resisted the idea of simply eliminating these special contributions because they generate significant revenues. It is possible that Lula's administration will change the current profile of these taxes to a non-cumulative basis in order to reduce the burden on exporters and consumers. Such a reform would not require a constitutional amendment, only an act of the National Congress.

Non-progressive income tax

Many Brazilians are also demanding reforms to other aspects of the tax system. Among these, the personal income tax is currently receiving particular attention. In Brazil, only the federal government has the authority to impose taxes on personal incomes. Brazilian income taxes are only modestly progressive as there are only two income brackets, the first applying to annual incomes above 12,684 reals (about US$3,960) at a rate of 15 per cent and the second applying to incomes above 25,753 reals (about US$8,040) at a rate of 27.5 per cent. In comparison with many countries, the list of eligible itemized deductions is quite short. Consequently, many citizens are asking for further deductions to be allowed.

Another important issue closely connected to tax reform is the constitutional division of powers. At the same time as the constitution divides taxation powers among federal, state and local authorities, it reserves the greatest flexibility for the union: only the federal congress may impose taxes that have not yet been allocated to one of the three orders of government.

The state and local authorities, on the other hand, often find themselves unable to raise sufficient funds to meet their constitutionally mandated commitments. Given that Brazilian sub-national governments provide the majority of the services on which most citizens depend, it's fair to say that the country's fiscal *status quo* is strongly weighted in favour of the privileged classes of the society.

Division of powers

Ideally, tax reform and the division of powers should be discussed at the same time because they are so closely intertwined. The country's state and municipal authorities currently have a habit of flying to Brasilia, the federal capital, to ask for financial help. An effective and responsible tax reform could well reduce or even eliminate such cap-in-hand requests. Moreover, President Lula da Silva's decision to establish a federal "Ministry of Cities" with responsibility for municipal affairs is arguably another example of a concerted effort to bolster the institutions of fiscal federalism.

Tax reform was a major plank in Lula's campaign platform, though his proposals in this regard were rather vague. The essence of his policy on public finance rested on the transfer of the major burden of the tax system from taxes on production to taxes on income and estates. On the other hand, Lula cannot curtail federal revenues without running the risk of breaking perhaps his most important campaign promise – the eradication of hunger among Brazil's poor.

Lula's challenge is clear: he must find a way to strike a new fiscal balance in the Brazilian federation that will allow him to meet his many policy commitments.