SPECIAL SECTION

Sharing the pie

Sharing taxes with Brazil's states and cities

Lula's government is being pressed to provide a more generous deal.

BY *ROGÉRIO BOUERI*

Brazil has weathered its share of economic problems in recent years, but the key to its stability is an equitable fiscal relationship among the three orders of government. This relationship encompasses vital aspects of the country's economic development, as it is tightly linked to its tax system and to the capacity of the public sector to invest in basic infrastructure projects.

Brazil is one of the most unequal countries in the world in terms of the relative wealth of the regions. There are substantial differences between the fiscal capacity of the rich states like São Paulo and Rio de Janeiro, most of them in the south and southeast regions, and the poor states of the north and northeast such as Rio Grande do Norte. This inequality also exists between the larger cities, such as the state capitals, which have greater economic activity than the smaller ones.

Brazil's tax system looks complicated to an outsider. There is one income tax, collected by the federal government and known to Brazilians as the IR from its Portuguese initials. However, there are two value added taxes (VAT): a federal VAT on manufactured products, known as the IPI, and a state VAT collected on all merchandise, known as the ICMS.

The poorer states and municipalities, especially those where there is not much manufacturing, have a lower tax base. To help these poorer states and cities, the federal government, in the tax reform of 1965, created revenue-sharing mechanisms, mainly based on two funds: the municipalities' participation fund (FPM) and the states' participation fund (FPE).

Sharing the tax, Brazilian style

A portion of the proceeds from the federal income tax and the federal VAT provides the finances for these funds. Shortly after the military took power in 1964, this proportion was reduced to 10 per cent from its previous level of 20 per cent. This reduction reflected the centralization of powers that occurred in Brazil during its non-democratic period. But beginning in 1976, when pressure for re-democratization became stronger, the repartition rate began to rise, until 1993 when it reached its peak of 44 per cent. This record rate was made up of 21.5 per cent for the states' participation fund and 22.5 per cent for the municipalities' participation fund. Since then, the rate has remained unchanged.

The distribution formula is based on total population and on the inverse of the per capita income in the case of

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Sao Paulo, Brazil's richest city, produces more than half its revenue from a value added tax known as ICMS.

states and capital cities. For other municipalities, only the population size matters. It is interesting to note that, since the collection of the federal VAT and federal income tax is strongly correlated with local economic activity, richer states and cities contribute more than their share to the financing of the system.

The amounts transferred by both the municipalities and the states' participation fund systems are significant, totalling $24.25 billon U.S. in 2005, or 2.5 per cent of Brazil's Gross Domestic Product. The importance of the states' participation fund in the total revenue of the states varies. In São Paulo state, for example, funds from states' participation fund account for only 0.3 per cent of the state's revenue. But they can account for 56 per cent of revenue in some of the poorer northern states. There is an even greater variation for municipalities, where it is not rare for cities to receive as much as 70 per cent of their total revenue from the municipalities' participation fund account.

Less funding from the federal government

During the last 10 years, the states and municipalities' participation funds have remained at a stable proportion of Brazil's GDP — about 2.5 per cent — but the proportion of federal tax revenue they receive has fallen in this period. This has occurred because the federal government has directed its tax collection efforts to those taxes which are not shared with states and municipalities.

As a result of this move by the Central Bank, the collection of Social Contributions increased more than that of income tax or federal sales tax (IPI). The combined revenue from income tax and IPI, which in 1995 used to account for 31% of the overall tax collection, plummeted to mere 25% in 2005. "Social contributions" are a special type of tax that, besides being excluded from sharing with states and municipalities, can be charged to the taxpayers in the

Photo: Michael Maxey

An office of an aid agency for farmers in Apodi, Rio Grande do Norte. The governments of Brazil's poorer states, such as this one, depend on the central government for most of their revenues.

same year as their congressional approval. This allows the federal government to keep all the proceeds from these contributions and gain more flexibility in its fiscal administration.

For example, one of the most important among these social contributions is the "Provisional Contribution over Finance Transactions" (CPMF), which imposes a charge of 0.38% on all bank transactions. This contribution is going to expire in September 2007, but it is an important revenue source for the federal government (generating about $15 billion per year) and it is likely to be extended. If the annuality principle held, and the requirement that a tax rate could not be changed in mid-year, the government would have had to approve its extension before the end of 2006 in order to keep charging beyond next September, but as we are talking about a contribution, this principle does not hold and the government can approve the extension this year and keep charging it during the last quarter of 2007.

Thus, it has been a preferred instrument of the federal government in its quest for more net revenue. Its downside comes from the fact that most of the contributions are cumulative and are collected from corporate payrolls, which favour informality and inefficiency in the economy.

In an effort to try to compensate for these losses, states and municipalities have increased their own revenues, but the dependence of the poor states and small cities is still quite great and any improvement of the situation in the short term depends on the prospects of economic growth in the next few years.

Mayors and governors of the states have made several proposals to strengthen the fiscal and financial positions of the sub-national governments. In the latest one, some state governors asked for inclusion of the social contributions in the redistribution of funds. They argued that, even if this inclusion would mean a decrease in their repartition portion, there would be a general improvement in their situation, since future revenue increases would be totally shared.

Demands from the mayors and governors

The federal government has not been receptive to proposals from the mayors and governors. In fact, the federal government has dismissed all proposals seeking to amend the sharing formula, in part because giving up some of its tax revenues in favour of sub-national governments would make it more difficult to generate a fiscal surplus.

This demand might only be a pressure tactic associated with the other requests that state governments have made to the central government. But the states' most important request is one that proposes to re-open state debt negotiations, which would be contrary to Brazil's fiscal responsibility law. This is a major objective for the state governments. At the end of the last century, the federal government bought the states' debts and established new conditions and a new payment schedule. This renegotiation also led to provisions tying maximum debt-service payments to a proportion of each state's net revenue.

Now, states want to re-visit the purchase of those debts by the federal government, as well as to subtract the states' own infrastructure investments from the calculation base of their net revenue. This would in turn allow the states to provide more basic infrastructure services, which are badly needed in some regions, and would also have the effect of reducing their debt payments to the federal government.

A simple plea

The plea of the mayors is simpler and more likely to be accepted. They have requested for many years a one-per-cent increase in their share of the state VAT and federal income tax to municipalities' participation fund (to 23.5 per cent from 22.5 per cent). This measure would cost the federal government about $1 billion U.S. per year. The mayors already have obtained support in both the upper and lower legislative chambers, but their lobbying efforts were not sufficient in getting a bill passed late last year. It is expected that they will resume their pressure this year with the new Congress.

All these proposals are temporary fixes in the view of the federal government. Only the approval of the proposed constitutional tax reform known as PEC 285, which has been discussed by Congress for more than two and a half years, could provide a real improvement in the states' fiscal health. Some argue that this reform, by harmonizing the states' consumption-tax (ICMS) rate, would end the fiscal competition between the states and increase the total amount of state tax collection. However, even if approved, this reform would not put an end to fiscal competition among the Brazilian states, because it is fed by the mixed origin-destination principle applied to the states' VAT.

This might be true for the richer, net producer states, such as São Paulo, Minas Gerais and Rio Grande do Sul, which would be the major beneficiaries of such a reform, given the origin-based nature of the states' consumption tax, which now hits the net producer states harder. But for the poorer states in the northeast region, this proposal could lead to even greater dependence on federally transferred resources, as the tax rate harmonization would tend to decrease their own fiscal capacity.

In conclusion, it is likely that in this second term, President Luiz Inácio Lula da Silva's government will have to allow a small increment in transfers to municipalities, but the relationship with the states is not expected to be substantially improved. The state governors will keep talking in favour of the inclusion of other taxes in the repartition funding base, but it is likely that this demand will soon be exchanged for some additional base points in the states' participation fund.