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BRAZILIAN TAX AFFAIRS ♦

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Abstract:

In this paper, the Brazilian tax system is reviewed in detail, covering the key points of its main taxes and contributions. Additionally, a brief historical overview spanning the tax system as well as the budgetary and economic framework is provided, accompanied by extensive data on the tax structure. Two other relevant issues are subsequently addressed: the regressive nature inherent in the system and the tax competition that exists between sub-national governments. Finally, the paper assesses the two recent failed attempts to reform the tax system and suggests some hypotheses as to why these attempts failed.

1. Introduction

Brazil is Latin America's largest nation in terms of population, GDP and land area. The country still boasts the world's tenth largest GDP (US\$796 billion)¹, its fifth largest population (184.2 million) and its fifth largest land area.

The Brazilian economy experienced profound structural changes throughout the last century and the nation became urbanized at a very rapid rate. Following a long period of stagnation during the 19th century, the Brazilian economy registered the fastest pace of growth of any country in the world in the period from the 1870s to the 1970s. In the last

♦ This paper is an extended version of the Brazilian chapter to the book "Tax Systems and Tax Reforms in Latin America", carried out by the Department of Public Economics at the University of Pavia, under the direction of A. Barreix, L. Bernardi, A. Marenzi, P. Profeta, and under the supervision of V. Tanzi.

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¹ Data from the OECD for 2005, converted at the current exchange rate.

twenty-five years however, this rate of economic growth, which had been especially robust following the Second World War, has suffered a strong downturn. Between 1951 and 1980, a period encompassing the so-called Brazilian Miracle, the average annual rate of growth was of 7.3 percent, whilst in the period that followed (1981-2005) this pace dropped back to just 2.5 percent p.a. As a result, the country's per capita income is ranked eighty-sixth (US\$7,450)² and 22.8 percent of the population still lives below the poverty line.³ An even more worrying aspect of this situation is the high degree of concentration of income and social inequality: the Gini index only began to fall back after the introduction of Brazil's present currency, the Real (R\$), falling from 0.607 in 1993 to 0.568 in 2005. Despite this, the country still has the unenviable distinction of being one of the world's most unequal economies.

The present political structure goes back to the proclamation of the Republic: The first Constitution (of 1891) created a Federation, in response to the profound regional differences and administrative needs that existed in view of the country's continental proportions. Contrary to its North American counterpart, the Brazilian Federation was not born of some coalition "from down upward"; but rather, it was imposed as a break up of a unitary State. More than in other countries, the federative question was always fundamental in shaping the organization of the tax system.

The present federative structure is composed of three tiers: the central tier, referred to as the Union, is better known as the federal government; the intermediate tier is made up of 26 states plus the Federal District; and the local tier is made up of 5,564 municipalities. The institutional framework existing today was imposed by the Federal Constitution of 1988, which resulted in a sharp decentralization that was not only political but also administrative and fiscal. This was largely the result of a political moment in time – the re-democratization of the country – which sought to limit the concentration of power at the central tier of government that had always been a mark of dictatorial regimes. In particular, this new framework tried to bring about a tax reform that transferred tax responsibilities to regional or sub-national governments and furthermore, increased their participation in federal taxes, with detailed rules related to this issue set down within the body of the

² According to the 2002 World Bank classification related to *per capita* gross domestic product, measured using purchasing power parity.

³ According to the Getulio Vargas Foundation (FGV), 2006, which considers those with per capita income of less than R\$121 per month as poor. This was the same source of the Gini Index.

constitutional text itself. Thus, central government played a diminished role in planning or coordinating the decentralization of taxes, actions and services – differently to other emerging market economies.

Brazil's advanced stage of decentralization is evidenced by the participation of sub-national governments in the country's public sector accounts, of which they are directly responsible for a third of national tax revenue, two-fifths of total expenditure and 35 percent of public sector debt. On the political front, each state and each municipality elect both the head of the Executive Power and the members of the Legislative Power by means of a direct vote, awarding them a four-year term. The Judiciary is also an independent power at national and state levels. The most unusual aspect of this new structure has been seen at the local level of government, which has been attributed the constitutional *status* of 'member of the federation', with the same prerogatives as those of state governments – see (Afonso and Araújo, 2006). Central government has almost no power to control sub-national governments, at least in terms of taxation, formulation of budgets, their implementation and accounting for, hiring personnel, investments and debts. All of these areas are regulated, executed and evaluated at state and municipal levels.

The tax system is made up of taxes, fees and contributions. The latter have specific characteristics in Brazil as they are not exclusively levied on payrolls. The 1988 Constitution diversified their sources, which resulted in social contributions also being levied on the revenues and profits of employers as well as on lotteries, government revenues, licensing among others. These different contributions today already account for half the total Brazilian tax burden⁴ revenue, this thanks to strong expansion since the last reform which has been due basically to the fact that central government can charge them exclusively, that is it doesn't have to share them with sub-national governments (as in the case of taxes on similar bases).

The tax burden went through an expansionist phase in the post-war period, which accelerated towards the end of the last decade – see Table 1. The bases of the present tax system were defined in the mid-1970s. From that time until 1993, the total tax burden averaged around the equivalent of 25% of GDP, which was already a high level compared with many other emerging economies, and especially those in Asia. The stabilization of the

⁴. Taking into account all their different forms and titles, contributions as a whole raised the equivalent of 19.5 percent of GDP in 2005, over one percentage point of GDP more than was raised through traditional taxes.

economy in 1994 resulted in two expansionist cycles. Firstly, the Real (R\$) took the tax burden to 29% of GDP levels, which one could say were already existing levels but which had been somewhat hidden until then by the so-called Tanzi effect. Either way had the burden stayed at that level then Brazil would be on a par with other emerging market economies today. The second cycle came in the wake of the serious external crisis of 1998, when the country began an impressive and steady process of expansion of the total tax burden that continued, even after the change of government in 2003 and the resulting crisis of confidence had dissipated.

As a consequence, by far the most striking characteristic of the Brazilian tax system today is the size of its total burden: 39 percent of GDP. This percentage exceeds, and considerably, the average of emerging market economies and is a serious hindrance to the competitiveness of Brazilian goods. Worse than the burden's size, is its structure that is concentrated on indirect taxes: more than half of the total tax revenue comes from different forms of taxing the domestic market of goods and services, with many of these taxes being of a cumulative nature (such as in the case of contributions on financial transactions and on gross revenues of the majority of companies). This places a burden directly on capital goods (and helps increase the cost of fixed investment, whose participation in national accounts is very low), and indirectly on exports (even in the case of value added type taxes, it is not easy to recover accumulated tax credit balances). The most perverse side of this system can be seen in the distribution of the tax burden amongst households, where the poorest families pay proportionally more tax relative to their household income than the richest families – and this in a country that is already marked by a high level of poverty and social inequality.

Table 1– Evolution of the Composition of the Total Tax Burden: 1980-2005 (In % of GDP)

Tax/Year	1980	1985	1990	1995	2000	2001	2002	2003	2004	2005
TOTAL	24,52	24,06	28,78	29,41	33,36	35,12	36,63	35,85	37,03	38,94
International Trade	0,70	0,40	0,39	0,76	0,77	0,76	0,59	0,52	0,52	0,46
Goods and Services	9,98	10,06	14,06	13,73	15,63	16,37	16,16	15,81	16,85	17,25
<i>being, General Tax (ICMS)</i>	4,87	5,44	7,24	7,30	7,47	7,69	7,65	7,53	7,73	7,92
<i>Industrial Products</i>	2,19	1,84	2,40	2,07	1,59	1,57	1,37	1,15	1,19	1,24
<i>Revenues (social security)</i>	1,02	1,43	2,68	3,34	4,37	4,74	4,70	4,76	5,47	5,57
<i>Financial Transactions</i>	0,00	0,00	0,00	0,50	1,59	1,73	1,80	1,76	1,79	1,80
Property	0,27	0,17	0,27	0,80	1,01	1,02	1,04	1,02	1,04	1,07
Income & Gains	3,01	5,13	5,67	5,69	5,15	5,62	6,53	6,30	6,21	7,10
<i>being, General Income Tax</i>	3,01	5,13	5,13	4,78	4,36	4,88	5,61	5,30	5,12	5,81
<i>Profits (social security)</i>	0,00	0,00	0,54	0,91	0,79	0,75	0,92	1,01	1,09	1,29
Payroll	5,96	5,84	6,56	6,41	6,95	7,43	7,59	7,56	7,81	8,10
<i>being, Social Security</i>	4,66	4,73	5,11	4,89	5,25	5,67	5,92	5,95	6,21	6,43
Other Taxes	4,60	2,46	1,82	2,03	3,86	3,91	4,72	4,64	4,60	4,96

Source: (Afonso e Meirelles, 2006) (Araujo (2001). Global Tax Burden defined according to the National Account System.

Other Taxes = fees, economic contributions (such as royalties), other taxation bases, small amount revenues from abovementioned tax bases

Despite these distortions, all the initiatives undertaken to try to reform the tax system have failed, and indeed there has been no lack of such projects in recent years. Some have argued for a radical change (such as the popular creation of a single tax), whilst others have suggested specific changes to be implemented on a gradual basis, with some of these changes proposed by federal government bills (in principle, with greater parliamentary backing), but the majority put forward by individual Congressmen (more sensitive to the demands of sub-national governments and taxpayers). As the definition of tax responsibilities is set down in writing in the National Constitution, which also details the norms set down for many taxes (especially the state tax on the circulation of goods, whose interstate taxation system is fully regulated by the text), any attempt at reform, however limited its scope, would inevitably require an amendment to the Constitution (which depends on the approval of two-thirds of the members of the two Houses of Congress, in

two rounds of voting). The few bills that have been discussed have always avoided issues sensitive to the federative debate. The few measures that have managed to be approved have involved merely topical changes that have almost always been aimed at increasing the tax burden (a typical example being the tax on financial transactions or CPMF, created provisionally in 1993, but successively renewed or reedited until 2007).

The debate on tax reform has however attracted increasing attention within the national political agenda. There is absolute consensus over the need for such reform, but when the debate shifts to the details of proposals, so dissention increases. This lack of agreement in relation to the ideas and measures put forward comes from the broad gulf that separates different interests, not only between taxman and taxpayer (which is natural in any system around the world), but also between the governments of different regions and at different levels (see the federative question) and between sectoral interest groups (many benefited by constitutional links).

This paper aims to describe the present tax system in Brazil and to reflect on its recent evolution and attempts at its reform. It has been organized into five sections, including this introduction. The next section sets out a general view of public finances. The third section details the characteristics of the main taxes, using as its base the International Monetary Fund's typology. The fourth discusses topics that are relevant to the present day – such as the issue of regressive taxation and the federative question and the final section looks at the recent debate over tax reform initiatives, both those that have failed and those that are necessary.

2. A General View and the Recent Development of Taxation.

2.1. Historical and Institutional traits of Public Finances.

Brazil has had a long history in which the State has played a leading role in the economy, and at the same time, seen a strong decentralization of public administration – see (Afonso and Rezende, 2006).

Whilst still a colony, Brazil's economy was based on the export of primary goods and this trade was a monopoly held by the Portuguese Crown. This meant that the regional administrative divisions (“Capitanias” or “Captainships”) had limited relations among themselves for geographical but also economic reasons, and instead dealt directly with the

Court in Europe. It is worth noting that excessive taxation by the Portuguese, especially on gold (“derrama” - local tax assessed according to the income of each taxpayer) was behind most of the more relevant uprisings at the time. Following the Declaration of Independence in 1822, the Brazilian Imperial regime was suffocated by bloody wars and separatist uprisings and only maintained national unity through force. The Republic, declared in 1889 marked a victory for the spirit of liberalism, which adopted the abolition of slavery as its banner. The first Constitution instituted the federation and conceded broad autonomy to the provinces as a peaceful solution aimed at uniting the highly diverging interests of the regions of such a large and unequal nation. The last century saw an oscillatory movement in the division of power within the federation and within the government regimes themselves: one moment seeing a strong movement to decentralize in fiscal terms (always linked to periods of greater political democracy), and the next to aggressively centralize (during the dictatorships –military, which lasted from the mid-1960s to the end of the 1980s).

The option for a federal regime (imposed “from up downwards” to ensure national integrity) explains the tendency towards lengthier and more detailed constitutions adopted in Brazil when compared to those of many other countries. This is especially the case of the tax system since the definition of, and distribution between different levels of government of the responsibilities for taxation, has helped shape the division of power between these same levels of government.⁵ The Republic began the tradition that details and demarcates taxation in the country: exclusive responsibilities for taxation, which have been defined from the outset within the body of the constitutional text itself and often detailed the form and cases in which it may be applied and even exemptions; each tax having always been explicitly assigned to each of the three tiers of government, so that little has been left for the said residual responsibility.

⁵ This can be exemplified by the fact that during the first constituent assembly of the Republic, one of the most important controversies under discussion involved the resistance (victorious) by the elite agrarian classes to the taxation of property, and especially rural property. The dominant elite preferred to maintain and expand taxation on exports, including through the intermediation of provincial governments, as had been done since colonial times (even though the authorities had already warned that this was prejudicial to the competitiveness of Brazilian goods, even before the declaration of independence), instead of taxing property, including rural property. This was a movement that was radically different to the North American constitution, whose only two tax norms were aimed at ensuring immunity for exports, including between states, and local taxation of land. Till this day, Brazilian states still indirectly tax exports (by not returning tax credits accumulated in the state tax on the circulation of goods) and the federal government receives almost nothing from rural land tax (0.01% of GDP in 2005).

Sub-national or regional governments have always benefited from a broad level of autonomy, both in terms of legislating on their taxes (defining, by means of state or municipal laws the forms of raising tax, tax rates and terms of payment), levying them directly, and also deciding on how to allocate resources, and generate and provide accounts. In view of the profound regional inequalities that have always existed, a vertical division of revenues has always been adopted, from upper to lower levels of government, and with a horizontal distribution in favor of less developed regions and localities. During the centralizing cycles, even though central governments tried to take on the more solid tax bases and interfere in the sub-national government management of taxes, the main form of control involved the reduction in automatic transfers and the directing of voluntary transfers and sub-national public sector debt – with a similar secular history, which has combined strong accelerations, including directly abroad, with defaults and rise of the central governmental tier.

The historical relevance that state governments have always had within the federative division of tax powers, explains the predominance of indirect taxation at the different levels of government. These governments applied a tax on sales in general, which was then substituted by the reform program imposed by the Military in 1965 with an innovative tax on the circulation of goods of the value added type (the ICM). Not only was this the first time in the world that such a tax was created on a national scale, but it was also the only time that such a tax was delegated to an intermediate tier of government. Even after the change, the states continued to tax exports, fully or in part, until they were stripped of this power by national law in 1998 (in exchange for compensatory transfers from the federal government); but to this day, they resist and place barriers in the way of rebates of accumulated tax credit balances. The main legislative focus of this tax was on inter-state taxation: created originally as a purely at-source tax, it gradually transformed into a mixed tax, although it tends to be more beneficial to the state receiving the goods, above all in the less developed regions. As a result, the last constitutional reform included within its main body of text, a considerable quantity of detailing of rules. From a political standpoint, ending the state government power to levy tax on goods is seen as an impossible task, largely because this has become the largest single source of own income for this tier of government, and the more developed the state, the more income it receives.

Whilst due prominence has been given to taxation within the Brazilian institutional framework, reasonable attention has also been paid to expenditure, to debt and even to fiscal management as a whole. The country has a long and worthy historical tradition of public accounting, with the first great code of accounting principles written up during the 1920s. The general norms for registering and monitoring present-day public finances are based on a straightforward law approved in 1964. This law from its conception already required that public expenditure follow the regime of responsibilities applied to the three tiers of government, as well as to indirect administrative entities (except productive companies). Expenditure is registered not only in accordance with its nature (capital, current) but also according to government functions and programs (health, education....). Annual balance sheets and less regular reports produce an interesting and complete set of integrated information that is not limited to merely detailing budgetary execution, but also includes details of financial flows, asset valuations and even changes in these valuations: that is, the same standards and processes are applied as those used in private sector accounting. Brazilian government accountants have therefore, over a period of four decades adopted a budgetary and accounting system that was only implemented in many other countries, including richer nations, during the last decade.

The governmental planning process underwent important reforms in 1988. Today, the government's principle investments have to be defined and included in a Multi-Year Plan (Plano Plurianual - PPA) and the priorities and targets for each year have to be stated in the annual Law of Budgetary Directives (Lei Anual de Diretrizes Orçamentárias - LDO), which comes before the elaboration of the budget. The process is also subject to legislative screening – every government has to approve a law with the multi-year plan valid for four years as from the second year of each political mandate.

In 2000, Brazil approved the Law of Fiscal Responsibility (Lei de Responsabilidade Fiscal – LRF), considered by many international entities as one of the farthest reaching and advanced of its kind in existence, especially because it applies to the three tiers of government and combines sets of principles and rules. Fiscal transparency was given special attention by this law, which included the creation of more regular reporting (on two and four-monthly basis) on the evolution of the budgetary execution and the achievement of targets, dealing not only with results (primary and nominal), but also providing information regarding debt and net assets. These targets are set annually as an attachment

to the Law of Budgetary Directives (LDO), and cover the following three-year period. Limits on personnel expenditure meanwhile were set by the Law of Fiscal Responsibility (LRF) itself, whilst debt level limits were set by the Federal Senate; in both cases, using indicators specific to each one of the three tiers of government individually.

2.2. Recent Changes in the Tax System⁶

The last reform of the tax system in Brazil was carried out by the National Constituent Assembly, which elaborated the National Constitution in 1988. This reform was neither innovative nor did it alter the tax structure significantly, largely because efforts were rather concentrated on fiscal decentralization. Five federal taxes on strategic inputs were eliminated (fuels, electric energy, minerals and transport and communication services). These had previously been levied using a single rate with resulting cumulative effects, and their bases were now integrated into the old state tax on the circulation of goods (ICMS), which was theoretically non-cumulative. Its management was entirely delegated to these state governments, who furthermore had the power to freely fix tax rates on the internal circulation of goods (rates on interstate flows remained in the hands of the Senate).

Central government continued to levy tax on value added, but limited this to other industrialized products (Industrialized Products Tax – IPI) and the municipal governments maintained their tax (cumulative) on services in general (ISS). Most of the attention in the 1988 reform was focused on continuing to raise the sharing out of federal tax revenues in favor of sub-national governments: ⁷ the percentage of the two main federal taxes, on income (Income Tax – IR) and on industrial products (IPI) transferred to the state participation funds (FPEs) and to the municipal participation funds (FPMs) increased from 18 to 44 percent between 1980 and 1990; in the case of the IPI, a further 10 percent was set aside for exporter states.

The implementation of this system remodeling resulted, firstly in a strong decentralization of tax revenues and, secondly, in a steady and vigorous increase in the tax burden, especially through non-shared federal contributions – as shown in Table 2.

⁶ Reproduces extracts and arguments written and put forward by (Afonso & Varsano, 2004) and (Serra & Afonso, 2006).

⁷ The capacity to mobilize revenues is concentrated in the governments of more developed regions, mainly in the country's Mid-South, but a series of mechanisms to share tax revenues and to regionalize federal expenditure provides an equalization of the spending capacity of governments in less developed regions.

Table 2– The Historical Evolution of the Total Tax Burden and the Federative Division of Tax Revenues.

Concept	Central	State	Local	Total	Central	State	Local	Total
	Tax Burden - in % of GDP				Composition - in % of Total			
OWN TAXATION								
1960	11,14	5,45	0,82	17,41	64,0	31,3	4,7	100,0
1980	18,31	5,31	0,90	24,52	74,7	21,6	3,7	100,0
1988	16,08	5,74	0,61	22,43	71,7	25,6	2,7	100,0
2005	26,72	10,01	2,26	38,99	68,5	25,7	5,8	100,0
AVAILABLE REVENUE								
1960	10,37	5,94	1,11	17,41	59,5	34,1	6,4	100,0
1980	16,71	5,70	2,10	24,52	68,2	23,3	8,6	100,0
1988	13,48	5,97	2,98	22,43	60,1	26,6	13,3	100,0
2005	22,53	9,70	6,76	38,99	57,8	24,9	17,3	100,0

Source: Afonso e Meirelles (2006) - based on data from STN, SRF, IBGE, Social Security Ministry, CEF, Confaz e Local Gov Balances.

National Accounts System methodology includes taxes, fees and contributions, including financial transactions tax and other taxes levied on the payroll, as well as the revenue obtained from the stock of overdue taxes.

Direct Taxation: tax revenue collected by every government level with its own means. Available Revenue: direct taxation plus/ minus intergovernmental transfers

The redistribution of resources had clear directional results: in vertical terms, all the relative gains favored the municipal tier, when adopting the concept of available revenue (own exclusive tax revenues plus or minus the constitutional sharing out of tax revenues), meaning that both the federal tier and the state tier lost out in terms of their proportion of the total tax revenue; in horizontal terms, the additional resources of sub-national governments were transferred in greater proportion to less developed regions⁸ - rather than reverting the high economic concentration in wealthier regions through the sharing out of available tax revenues as well as expenditure.

The 1988 Constitution created a kind of parallel tax system, which was almost entirely the exclusive responsibility of the federal government and under which contributions escaped the classic restrictions on the power to tax and were levied on broad and diversified bases. Central government effectively reacted to the decentralization of taxes by creating and

⁸ As an example, revenues from inter-governmental transfers in 2005 totaled a national average of R\$366 per inhabitant, but the regional transfers were considerably differentiated: Whilst in the wealthiest region (Southeast) the average transfer was of R\$195, in the poorest, the Northeast and North, the transfers reached R\$542 and R\$740, always stated in terms of R\$ per capita.

successively expanding the incidence of contributions (non-shared), which resulted in a rise in the tax burden and the cumulativeness of indirect taxes. It especially placed a heavy burden through the levying of contributions on strategic inputs and services, which had escaped from the scope of its value added tax applied only to industrialized goods (the IPI), and, more recently, also on imports.⁹

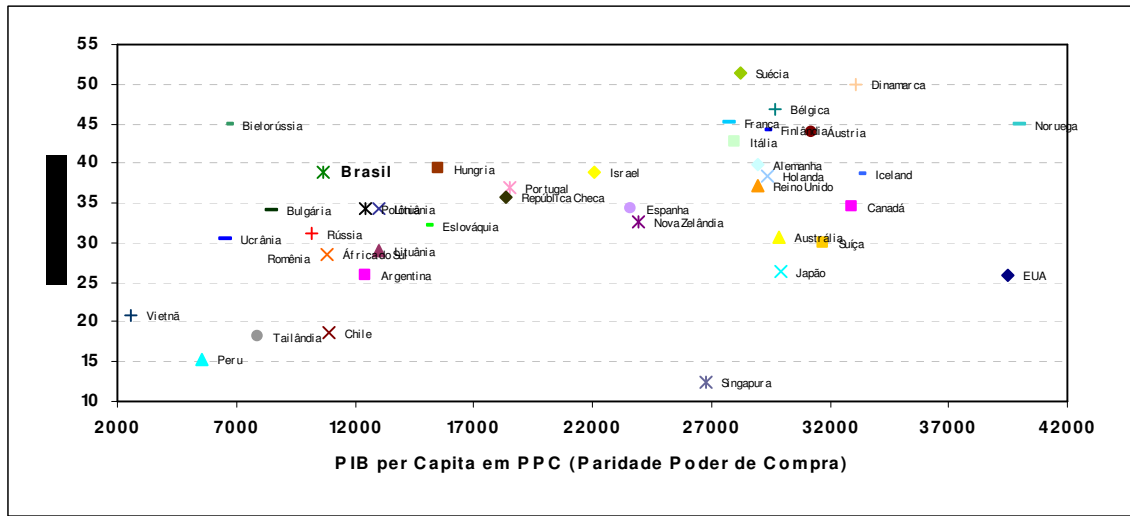
Recent changes to the composition of the national tax burden suggest, in the view of some analysts such as (Serra and Afonso, 2006) that the process of gradual change combined with reasonable flexibility in federative relations has been abandoned. Public policies, from macroeconomic to social, point forcefully to a fiscal re-centralization, not least to satisfy the growing pressure from enormous federal government spending on the transfer of income (ranging from pension and assistance benefits to interest on public sector debt in treasury form).

2.3. International Comparisons

International comparisons of tax burdens show that Brazil is significantly above the prevailing standard among emerging market economies. Taking as a base, data from 2004 contained in the last government finance yearbook published by the IMF, one notes that the total Brazilian tax burden is on a par with the average burden of developed nations (38.8 percent of GDP), and a full 12 percentage points above the developing nation average (27.4 percent of GDP). In the correlation between income *per capita* and level of taxation (see Graph 1), Brazil is level with the economies of the old Communist block, such as Byelorussia, the Ukraine and Bulgaria, the only countries that manage to ignore the rule and combine low income with a high tax burden.

⁹ The performance of the federal tax burden structure speaks for itself. On one hand, there has been a drastic reduction in the burden of the only value added type federal tax, the IPI: in 1970, this raised the equivalent of 4.4% of GDP; in 1980, and 1990, this coefficient was cut in half; ten years later (in 2000), it failed to exceed 1.6% of GDP; in 2005, revenue from IPI fell to just 1.2 percent, one of the lowest levels in its history. On the other hand, social contributions levied on revenues in general and on earnings (such as the PIS/PASEP, created at the beginning of the 1970s, and the COFINS, created at the beginning of the 1980s, and such as the FINSOCIAL) have been vigorously expanded since the 1988 reform. In 1980, revenue from PIS was the equivalent of only 1 percent of GDP; in 1990, the two contributions together were already bringing in the equivalent of 2.7 percent of GDP; in 2000, their joint revenue was 4.4 percent and in 2005 it hit a record 5.6 percent of GDP (of which 4.4 percentage points were due to COFINS). If we also include revenue equivalent to 1.5 percent of GDP obtained with CPMF and 1.3 percent of GDP from CSLL levied on profit, the total tax burden of these four contributions alone hit 8.4 percent of GDP in 2005. The total raised through such contributions was equivalent to more than six times that raised through federal IPI and already exceeded state government revenues from ICMS or even federal income tax.

Graph 1– Tax Burden and Income Per Capita Compared - Various Nations: 2004

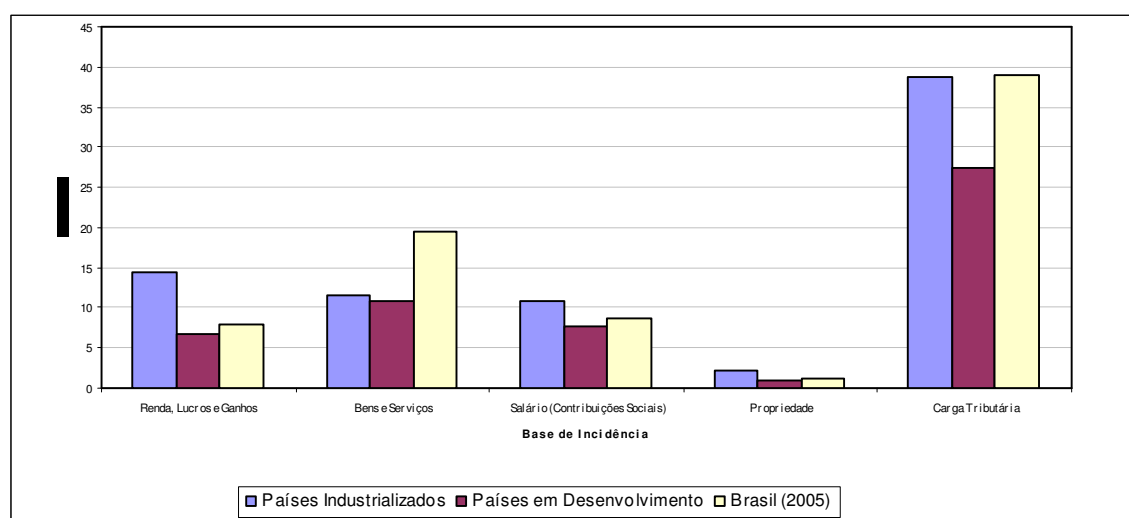


It is perhaps important to look deeper into our analysis and divide up the burden according to bases of incidence: although the Brazilian tax burden is equal to that of many rich nations in percentage of GDP terms, the situation is quite different when we look at types of incidence – see

Graph 2. In the case of taxes on income and profit, the average of the rich nations (14.4% of GDP) is 84 percent greater than that of Brazil (7.9 percent of GDP). An expressive difference can also be seen in taxes on assets: the average of rich nations (2.1 percent of GDP) is 70 percent greater than that of Brazil (1.2 percent of GDP). The highest burden falls considerably in the case of contributions incident on payrolls: the rich nations (10.8 percent of GDP) levy 24 percent more than Brazil (8.6 percent of GDP). This picture changes radically when we look at taxes incident on the domestic market for goods and services - 19.5 percent of GDP in Brazil exceeds the average of the world's most industrialized nations (11.5 percent of GDP) by 70 percent. In other words, it is the stark difference of the indirect tax burden that creates the unusual situation of Brazil being on the same level in terms of total taxation as the world's richest nations, and which ends up harming the country's competitiveness and fiscal fairness. A pioneering move to adopt a tax of the value added type on a national scale through reform in the mid-1960s, did not lessen the distortions because Brazil's indirect tax did not keep up with the evolution of the tax in other countries – the non-cumulative tax is limited to large taxpayers (by right or in

fact) and even then continues to be tied to the old taxman regime, conceding capital gains tax credits with considerable delay and obstructing or even denying rebates of accumulated credit balances, especially by exporters; the greatest symptom of a cumulative system is the taxing of financial transactions, which alone brings in 1.5 percent of GDP.

Graph 2– Tax Burden per Incidence and Compared with a Group of Nations: 2004



3. Institutional Characteristics of the Principle Taxes Levied

Before analyzing the characteristics of the principle taxes levied in Brazil, one should stress the relative importance of each block or even each tax. This can be done by looking at the details of a recent composition of tax revenues: which totaled 38.9 percent of GDP in 2005, according to (Afonso e Meirelles, 2006). In principle, the methodology usually adopted in international statistics, interpreted in the strictest sense, divides up revenue between: taxes, in the broadest sense (30.2 percent of GDP or 78 percent of the total), and social contributions, in the strictest sense, incident only on payrolls (8.6 percent of GDP or 22 percent of the total). A broader analysis by type of incidence can also be adopted, using the classification recently adopted by the IMF for its government finance yearbook – see Table 3.

Indirect taxation generates a little over half of natural tax revenue if we include in addition to taxes on the domestic market (16.4 percent of GDP), those which are incident on

financial transactions (1.8 percent of GDP, of which 1.5 percentage points result from the taxation of financial transactions in general). By far, the category of taxation that is most relevant in Brazil is that which is levied on production, consumption and sales in general form: 16.4 percent of GDP raised (by itself alone, the size of the total tax burden of many Latin American and even emerging market economies), or 42 percent of national tax revenue, which includes from the state tax on the circulation of goods to federal contributions on turnover and revenue. The very small size of the burden of taxes considered as selective or specific (1.4 percent of GDP or less than four percent of national tax revenues) can be explained by the unusual form in which the above-mentioned category of generic indirect taxes is levied. They do not follow general rules and do not always apply single tax rates and in fact, in the case of the exclusive bases of specific taxes (such as fuels, cars, tobacco and beverages) it is common practice to adopt different tax bands, rising from zero to higher rates levied by each tax (without mentioning the generalized use of tax substitution and other forms of presumption).

Table 3 – Composition of Tax Revenues in 2005.

Global Revenue and by Categories	R\$ billions	R\$ per inhabitant	% of Total Revenue	Tax Burden % GDP
Global	754,4	4.160	100,0%	38,94%
Goods and Services	355,1	1.958	47,1%	18,33%
<i>General Goods and Services</i>	317,7	1.752	42,1%	16,40%
<i>Excises Taxes</i>	27,7	153	3,7%	1,43%
<i>Public Services</i>	9,8	54	1,3%	0,50%
Payroll	178,7	985	23,7%	9,22%
<i>Employees, Public Servants, Self-employed</i>	37,8	208	5,0%	1,95%
<i>Employers</i>	128,5	709	17,0%	6,63%
<i>Others</i>	12,4	68	1,6%	0,64%
Income and Gains	152,7	842	20,2%	7,88%
<i>Families</i>	46,5	256	6,2%	2,40%
<i>Companies & Shareholders</i>	75,8	418	10,0%	3,91%
<i>Others</i>	30,5	168	4,0%	1,57%
Financial Transactions	35,1	194	4,7%	1,81%
Property and Wealth	23,7	131	3,1%	1,22%
International Trade	9,0	50	1,2%	0,47%

Source: (Afonso e Meirelles, 2006), in accordance to the IMF Government Finance Yearbook classification.

The taxation of salaries constitutes the second large block, despite the loss of relative importance of salaries within income, a world phenomenon that in Brazil has taken on dramatic forms that have reduced the income of salaried workers to a level that constitutes a mere quarter of national income (excluding taxes).¹⁰ By computing the many different forms by which salaries, the payroll or manual labor wages are taxed, one comes to a burden equivalent to 9.2 percent of GDP (in 2005), of which 6.6 percent of GDP is retained at source by employers, reflecting the fact that Brazil is one of the countries that adopts among the highest aggregate employer tax rates in the world (close to the highest European examples).

Contrary to the situation that exists in richer economies, taxation of income and profits and gains in Brazil accounts for a fifth of the total tax burden (8 percent of GDP). The difference (on the downside) is even more evident in the case of income tax levied on individuals: a mere 2.4 percent of GDP or 6 percent of the national tax burden. On the other hand, taxation on the profits of companies and shareholders brings in 3.9 percent of GDP, or 10 percent of the total.

One can consider as low, on the one hand, taxation levied on assets (a burden of 1.2 percent of GDP) when comparing with the average in the richest countries, and on the other that levied on foreign trade (0.5 percent of GDP) relative to less developed economies, which reflects regional treaties and agreements, such as the Mercosur trade block, but covers up the fact that, implicitly, taxes and contributions on sales in general end up taxing exports via inputs.

Finally, it is worth noting the decentralization (that has in the past been greater) in the direct generation of the tax burden of 38.9 percent of GDP in 2005: 68.4 percent was raised by central government (of which only 20 percent in the form of taxes); 26 percent by the state governments (of which 20 percent related to tax on goods); and 5.6 percent by municipal governments (who collect more tax on services - 0.7 percent of GDP – than they do through traditional taxes on urban property – 0.5 percent of GDP).

¹⁰ Comparing the annual functional distribution of the Brazilian GDP in 1991 and 2003, salaries decreased from 32 to only 25.7 percent and self-employed earnings from 7 to 4.5 percent; in the meantime, social contributions changed little (9.9 percent in 2003), in other words, what really increased most in the formation of national income was the net tax burden (from 12.9 to 16.9 percent) and the said surplus (from 38.5 to 43 percent). As a result, the size of salaries and taxes in Brazil is incredibly low when compared to other economies – 36.1 percent as against 64.4 percent in the Euro Zone for example.

3.1. Taxation of Income, Profits and Gains

3.1.1. Individuals

Brazil has had a long history of taxation – the first form of tax on the income of individuals (IRPF) was implemented in 1923. The taxation of individual incomes brought into state coffers 2.4 percent of GDP in 2005, of which only 0.4 percent was stated in, and paid under the annual income tax return. In other words, the bulk of this was paid at source.

Salaried workers are discounted tax direct at source in their pay packets and the employer pays the Income Tax Retained at Source (IRRF) on their behalf, applying the same tax rates as set down in the annual table.¹¹ Liberal professionals (self-employed) are obliged to issue receipts and pay tax due, direct and on a monthly basis; retention is also required even in the case of professional services rendered between companies (such as in the case of law, engineering, consulting, brokerage, advertising firms, labor cooperatives and credit advisors). Lottery winnings are also taxed as income at source.¹²

The Receita Federal (“Inland Revenue Service” responsible for raising federal government taxes) raised 1.5 percent of GDP in 2005 through retentions related to income from work. A further 0.5 percent of GDP was collected by state and municipal administrations, which, for example do not pay the central government what they have retained at source from salary payments (and other incomes) made to their public sector workers. In fact, this is the only form of concurrent tax responsibility existing in Brazil.

Retention of tax at source is also applied to other forms of income that are not considered salaries: income from capital, raffles, earnings abroad and services received by companies. In the specific case of financial investments (including gains in variable income investments)¹³ and withdrawals by shareholders of their companies’ results, these are taxed exclusively at source (the normal tax rate is 15 percent but it rises to as much as 22.5

¹¹ In addition to salary, income tax retention is required of the employer in the case of indirect remuneration (such as benefits paid to management in the form of company cars with driver, education of children etc.)

¹² The IR income tax rate is 30 percent on winnings paid out in cash form and 20 percent if paid in the form of goods or services. In addition, lotteries, which form part of a state monopoly, are also levied on social contributions and other revenues directly extracted for use by the government in spending on prisons, sports (including Olympics), culture and student financing.

¹³ The principle retention at source on income from capital falls upon investments in fixed income: the tax rate applied to gains made differs according to a progressive table, with the size of the rate reduced proportionally to the term of the investment (the longer the term the lower the rate) and the term of the notes in the fund portfolio. Other earnings taxed at source include those from royalties paid to individuals, swaps, stock funds and day-trades.

percent in the case of shorter-term investments) and are not levied according to the annual table (raised 1 percent of GDP in 2005).

The annual tax declaration or return is only for adjustment purposes – in other words, used to check on any additional tax due from those who have more than one source of income; or to establish whether any tax already paid needs to be refunded (rebate), due to the standard deduction of 20 percent or to deductible expenditures (dependents, allowances, schooling, health plans, private pension plans, or even donations to cultural or social entities such as charities, always subject to limits and ability to provide evidence of payment).¹⁴

Taxation on income of individuals (at source and in the annual tax declaration or return) applies only two tax rates,¹⁵ in accordance with brackets of income, which in 2006 were as follows:

- exemption: on up to R\$14,992.32 (approximately US\$7,000) earned in the tax year
- rate of 15%: from R\$14,992.33 up to R\$25,958.88 (between US\$7,000 and US\$12,000) earned in the tax year
- rate of 27.5% on anything over R\$25,958.88 (over US\$12,000) earned in the tax year.

With the implementation of the economic stabilization plan in 1994, the automatic indexation of this table to past inflation was extinguished; readjustment of the tax brackets was made sporadically and always below the cost of living. As a result, the number of tax payers who declared income tax rose from 7.64 million in 1996 to 22 million in 2006,¹⁶ of which 21 million made their declarations or returns by means of the Internet.

The coverage of income tax in Brazil is relatively low (the economically active population totaled 91 million), the direct result of a decreasing formalization of the labor market (only

¹⁴ Those exempted include people with serious illnesses, students or researchers with grants or scholarships and pensioners who are more than 65 years old (on pensions of up to R\$1,257.12 p.m.).

¹⁵ Application is gradual, meaning that if a person receives for example, an annual income of R\$40,000, he won't be taxed 27.5% on the whole amount: he pays nothing on the first R\$15,000 earned (limit of exemption); pays 15% on the next R\$15,000 to R\$26,000 earned (the first tax bracket) and pays 27.5% on anything earned over R\$26,000 (second tax bracket); ultimately he pays an effective tax rate of 12.5% on the whole. Retention at source adopts the same table except with the annual amounts divided by twelve.

¹⁶ Tax payers who delivered their tax returns by electronic means (Internet or diskette) – excluding the minority who delivered their returns in paper form (SRF 2004). The progressive table was left frozen from the mid-1990s to 2001, when it was readjusted (below inflation accumulated over the period); it was only then corrected again in 2005, when further corrections were also projected for the following two years.

44 percent of workers are formally registered with signed labor documents) and low salaries or wages paid (almost 90 percent of income declared by families in a household survey was within the exemption bracket – below R\$15,000 p.a.).

Tax income from annual declarations is even more limited: of the total 16 million tax declarations or returns filed in 2003, only 31 percent concluded with tax due – according to (SRF, 2006b). The total income declared was equivalent to 33.1 percent of GDP in 2002 (the tax year in question), but the taxable amount in the declarations fell to 24.1 percent of GDP (the significant difference was basically caused by tax-exempt income, such as low value pensions and earnings from savings accounts); the total sum of net income was reduced even further after allowable deductions were made, to just 17.8 percent of GDP. In the end, tax due was equivalent to 1.7 percent of GDP and constituted an effective total average tax rate of 7.1 percent on the taxable income in the declarations. The total rebate or tax refund was 2.5 times greater than the amount of tax due. Despite the low level of coverage, those declaring income tax also declared a total of assets and rights that were equivalent to 120 percent of GDP.

3.1.2. Companies.

Companies pay Corporate Income Tax (Imposto de Renda da Pessoa Jurídica or IRPJ) as well as a Social Contribution on Net Profit (Contribuição Social sobre o Lucro Líquido or CSLL - virtually a CIT surtax), which is linked to financing social security and was created by the 1988 Constitution. Although they are two distinct taxes, the bases for incidence and the rules for levying are the same (the contribution is settled before the tax and offers fewer options of incentives). The general legislation can be considered as straightforward if compared to the tangled rules of the state ICMS tax or even the multiplicity of tax rates adopted in other countries.

The tax rates within the normal accounting regime (real profit) are 15 percent in the case of the tax, and 9 percent in the case of the contribution. An additional 10 percent in tax is payable on annual profits that exceed R\$20,000/month (equivalent to US\$110,000 p.a.).

Companies with an annual turnover that is less than R\$ 48 million (around US\$ 22 million), may opt for the regime of presumed profit under which they only need to declare their turnover and apply a tax rate to that, which is differentiated by economic activity and reflects a profit margin that is set by legislation (varying from 1.6 to 32 percent on gross

revenue). A similar system is also applied to micro and small companies, who can opt for a simplified tax regime (known as the “Simples”), also applicable to other federal taxes (including substituting the employer’s contribution to social security due on the payroll), in such a way as to levy a percentage on earnings that is differentiated by sector (the collecting entity is responsible for separating the proportion of each tax originally due within the official accounts).

Profits and dividends distributed by companies and interest on own capital, are not taxed. Among other forms of tax incentives, a portion of tax due from companies on their real profit may be converted into donations (incentives) to finance investments in less developed regions, defined in the tax return/balance sheet as an economic contribution (PIN/PROTERRA).

In 2004, the last consolidation to be published, according to (SRF, 2006a), slightly fewer than 3 million annual company tax declarations were filed, which between them declared a total income equivalent to 189 percent of GDP.

The regime of real profit included a mere 6 percent of the whole universe of taxpayers (176,000 companies and 2,500 financial institutions), but generated 81 percent of total tax revenues (156 percent of GDP in 2003, the base year). As it offers the opportunity for deductions and incentives, at the end of the declaration period, corporate income tax (IRPJ) was found owing in 77,000 companies (in a total amount equivalent to 1.6 percent of GDP) and social contribution on net profits (CSLL) found owing in 62,000 companies (0.6 percent of GDP). In other words, out of the total number of companies, only 3.3 percent of the net revenue from their declared activities was found to be due in tax. The case of financial institutions was no different. They collected 0.5 percent of GDP, in both IRPJ and CSLL, but this was equivalent to a mere 1.4 percent of the total of their revenues from financial activities.

The presumed profit regime was used by 683,000 corporate taxpayers (22 percent of the total number of taxpayers), who between them had revenues equivalent to 17 percent of GDP. They collected a total of 0.6 percent due in IRPJ and CSLL in 2003, which represented 3.7 percent of the total gross revenue (a proportion slightly higher to that found in the case of the real profit regime).

However, the largest contingent of companies (two thirds of the total) was made up of 1.6 million micro companies and 334,000 small companies, which opted for the special regime

(the “Simples”, or simplified tax return) and declared revenue that was equivalent to 11.6 percent of GDP and tax due (not only income tax but all federal taxes) totaling 0.6 percent of GDP. This consumed 5.3 percent of the revenue pile, therefore an average proportion that goes against the popular belief that this regime should produce a significant reduction in the tax burden for this corporate segment.

Finally, one should mention that some transactions are taxed at source. Typical examples include remittances abroad (at a rate of 15 percent, which rises to 25 percent if these remittances are earnings from business activities) and, of less importance, benefits from private pension plans and prizes or awards won in intellectual and artistic competitions, among others. These taxes raised 0.5 percent of GDP in 2005.

3.2. Taxation of payrolls and the workforce.

This IMF adopted category is not taxed in Brazil but it is levied various contributions other than those linked to social security, although many are even levied on the same tax collection payment slip. Compared to the classic social contribution, the aggregate revenue from this group is relatively small: 0.6 percent of GDP in 2005.

The most important in this category is the Salary-Education contribution (0.3 percent of GDP in 2005), set down within the constitutional text itself in the chapter on education, and meant to provide an additional source of financing for public elementary education. It is levied by the same entity that is responsible for the administration of social security revenues (INSS) and applies a rate of 2.5 percent on the total payroll. A company is allowed a deduction for any funds it has invested directly in maintaining its own school (s) or in offering education scholarships.

Another two types of contribution that can also be levied on salaries have in common the fact that they are compulsory (once again, based on rulings set down in the Federal Constitution of 1988), and that the proceeds from both are passed on to private entities such as union, employer and worker representations (associations, trade unions etc.), which means that the management and application of these contributions does not form part of public budgets. In the first case, the same tax form that collects the contribution to social security also requires a contribution at a rate equivalent to 2.5 percent of the payroll (can differ in specific sectors) to finance social service and professional training benefiting workers of the respective sector and to support micro-companies through the

intermediation of 11 different employer institutions (known as the System S); in 2005, 0.28% of GDP was raised through this contribution. The second case, of lesser relative importance, deals with the so-called union contributions, which requires that workers contribute the equivalent of one day of work's pay annually and employers a percentage value of their company's capital to fund unions and other entities.

3.3. Property Taxation.

This IMF adopted category deals with taxes which are levied in the case of the ownership of an asset or right, or the transfer thereof. In this sense, a restricted interpretation here also classifies the taxation of the transmission of financial assets, such as checks and other forms of bank debit. In other words, this category also includes the CPMF (Contribution on financial transactions – presently at a rate of 0.38%) as levied in Brazil (and in few other emerging market economies). Thus, the tax burden on property and its transmission reached 2.7 percent of GDP in 2005, which was a very high percentage even if compared with richest nations; but, excluding the exceptional contribution (CPMF), this percentage dropped to 1.2 percent of GDP (largely the result of sub-national taxation on urban property and vehicles). There is no general form of taxation on property, nor on corporate assets (such as in some countries), although the Constitution of 1988 innovated by attributing to central government the responsibility for taxing large fortunes. However, no such tax has even been implemented nor has there ever been any proposal put forward to regulate it.

3.3.1. Real-Estate ownership

The taxation of real-estate in Brazil has always been separated into two distinct taxes – the tax on urban properties (IPTU), which has always been levied by municipalities and presently raises 0.5 percent of GDP; whilst the tax on rural property (ITR), at times in the past levied by other tiers of government, is now the domain of central government. However, the ITR has always generated derisory revenues, which were equivalent to just 0.014 percent of GDP in 2005. To show the insignificance of this tax, one need only to look at the neighborhood of Copacabana in the City of Rio de Janeiro, which alone pays more IPTU than the ITR raises in the whole of Brazil.

The insignificance of the rural tax (ITR) is a consequence of the fact that it is perceived more as an instrument of land and agrarian reform policy than as a source of revenue. The constitution itself gives exemption to small rural holdings exploited by single families. The rate levied varies according to the size of the land holding and the intensity of the use of the available land on that property. The majority of tax assessments do not result in any tax being paid and there is a lack of interest on the part of the Receita Federal (Brazilian IRS) to monitor a country of continental dimensions to then take only half of the tax revenue raised, this because the other half is transferred to the municipality where the land is located. It is for this reason that recent legislative changes have opened the way for the full responsibility for this tax to be delegated to local governments, who, if they so wish, may sign agreements with the Receita Federal to this effect.

The IPTU (tax on urban properties) meanwhile, has been given increasing attention by municipal governments, including through investments to improve registers and modernization of its levying process: Its total revenue jumped from a low 0.14 percent of GDP in the year of constitutional reform (1988) to 0.5 percent of GDP in 2005. Municipalities have full autonomy to legislate, levy and raise this tax, which includes fixing the tax rates (the Constitution set down that these could be progressive according to the value of the property, and differentiated according to location and use, which is why rates tend to vary from 0.2 to 1.5 percentage points). Local government finance departments fix the value of each property, basing this on maps of average values per neighborhood, using parameters approved by law and annual market research surveys, as well as taking into account physical, age and usage characteristics of each property.

3.3.2. Vehicle ownership

State governments are responsible for the Tax on the Ownership of Automotive Vehicles (IPVA), levied each year of owners of cars, boats, trucks, motorbikes and aircraft, on the purchasable value, a definition that is based on market prices with rates fixed by the legislation of each state and differentiated by type and usage. In general, the lowest rates are levied on utility vehicles and the maximum rates on luxury cars. For example, in São Paulo, home to the country's largest fleet of vehicles, the percentage tax rate ranges from 1% to 6%. The most common exemptions are applicable to taxi drivers, drivers with

disabilities, government and diplomatic vehicles and agricultural vehicles amongst others. Like the IPTU, the IPVA has also received considerable investments from state governments in terms of improving its collection process: the total burden of 0.5 percent of GDP in 2005 was ten times greater than that registered when the Constitution of 1988 was proclaimed.

3.3.3. Transmission of assets and rights

The classic taxation of the transmission or transfer of assets and rights, especially of real-estate, generates minimal revenues (presently at around 0.14 percent of GDP) and is divided up into two taxes and between two tiers of government: a municipal tax on the transfer in life of property (the ITBI - tax on the transfer (sale) of real-estate) and a state tax on inheritance and donations (the ITCMD), both entirely sub-nationally regulated in terms of legislation, fixing rates, assessments and monitoring. The municipal ITBI covers the purchase, sale or donation of any real-estate property (except in the case of inheritance) and the most common rate levied is 2 percent. An upfront payment of the tax is required before the transaction is officially registered with the Public Notary, although it is common practice with this tax to declare a value of the property that is well below its true market value. The state ITCMD meanwhile covers the transfer through death of the owner or through donation, of real-estate assets such as houses, apartments or liquid assets such as stocks and bonds. In the richer states, a rate of 4 percent is generally applied in this case. The taxation of debits and other bank transactions, as mentioned previously, is the most profitable and singular form of taxing the transfer of assets, in this case of financial assets. Initially, a federal tax was created (the IPMF), which was only levied in 1994, at a rate of 0.25 percent and produced revenue equivalent to 1 percent of GDP. In 1996, it was recreated, but this time in the form of a provisional contribution (the CPMF -contribution on financial transactions) to be used to finance the public health system, with a rate set at 0.2 percent. The term of validity of the CPMF was later successively extended (there have already been six constitutional amendments since the first tax) and is presently valid until 2007, with a single rate of 0.38 percent (since 1999) now applicable generating annual revenue that has been stable at around 1.5 percent of GDP since 2002. Its base of incidence includes financial transactions and its system of levying is very simple: it is levied on any

operation that is settled or any issue that is carried out, which represent the contractual or physical circulation of money, which result, or not in the transfer of ownership of such monies, credits or rights. Thus, the CPMF is applied to withdrawals, deposits and bank loans, as well as payment orders and transactions in the futures or stock markets. Exemption is given to transfers by a title holder to himself (e.g. an individual or company transferring money from one account in their name to another account in their name), government and charitable transactions, simplified accounts of low-income individuals and public share offerings.

3.3.4. Contribution on improvements

The contribution on improvements is a tax that for decades, according to the Constitution, the three tiers of government have been able to levy on any gain in value of property resulting from the carrying out of public works. It has however, been rarely applied (in part because of complicated pre-requisites imposed by legislation), by just a few municipal governments in wealthier regions of the country, and presently raises a derisory 0.007 percent of GDP.

3.4. Taxes on Goods and Services

The taxation of goods and services in the domestic market constitutes by far the most important tax block within the national tax burden if one follows the IMF's traditional classification – was equivalent to 18 percent of GDP in 2005, of which 15.8 percent was in the form of general type taxes. Of these, the equivalent of 9.2 percent of GDP came from value added taxes (thus defined constitutionally, although they leave a lot to be desired in practice), and 5.8 percent came from contributions on sales in general (part levied in the form of a non-cumulative regime since 2003).

The three tiers of government all exercise tax powers within this block, contrary to the principles initially drawn up in the reform of 1988. These had attempted to divide up the bases in such a way that goods in general and communications would only be levied the state tax (the ICMS), services would be levied the municipal tax (the ISS) and industrialized goods (almost in the form of a selective tax) would be levied the federal tax (the IPI). Social and economic contributions, however, had their bases, and later, their rates successively

expanded and increased by central government and this allowed for an excessive increase in the federal and the total tax burden on all bases. In fact, today, contributions on revenues (such as the COFINS and the PIS) have a broader base and a more sector diversified collection than the traditional state ICMS tax.

3.4.1. Value-Added Taxation

Brazil made a pioneering move, in 1965, when it replaced a state cumulative sales tax with a tax on the circulation of goods – the ICM (excluding fuels, electricity and minerals; items that were taken under the federal umbrella as a single levy tax), in which the charge was based on the value added, using however a system of physical credit (maintained to this day) and a mixed system for apportioning the revenue from inter-state transactions. Under the same reform process, the central government was assigned a tax on industrialized products – the IPI (once again failing to cover the bases mentioned earlier), which was also levied on the value added but, in practice and over time, effectively became a selective federal tax, since the charges were concentrated on a limited tax base (automobiles, other vehicles, tobacco and imports). An old municipal tax on professions was also replaced by a tax on services in general (the ISS), but it was charged cumulatively (and for this reason, is addressed in the next section).

The 1988 constitutional reform did not change the apportionment of the three taxation tiers, despite the already ample international experience of charging VAT on a national scale and familiarity with the problems, limitations and criticism of charging this tax in Brazil at the state level. The only step taken in 1988 was to do away with the selective federal taxes (including those on communications services and on inter-state transportation), including them instead within the state taxation base (as ICMS - Value-Added Tax on the Circulation of Goods and Services). This was done in such a way as to explicitly preclude the levying of federal IPI on such strategic inputs (the federal government subsequently took progressive recourse to the introduction and/or expansion of a variety of different contributions, to make inroads on these bases), while services were left solely to the municipal tier (a base that, in 1988, was not subject to federal contributions, but later came to be ever more exploited, notably through the CSLL - Social Contribution on Net Income).

The ICMS is easily the greatest revenue earner among the nation's taxes, yielding the equivalent of eight percent of Brazil's annual GDP, and has dominated attention during all the various attempts to institute tax reform. In 1988, the state governments enjoyed ample freedom to legislate, organize, collect and monitor the levying of ICMS. In theory they ought to observe the principles established in the Constitution (which addresses the issue in considerable detail) and the general regulations set down in complementary laws. However, this does not always occur - particularly with regard to the granting of exemptions and other incentives, which are supposed to be regulated and approved by a national council of finance secretaries: the local governments used a variety of creative expedients to get around the requirements, including fake loans and other credits, setting off an unprecedented fiscal war that has endured for more than a decade. The ICMS became, in practice, 27 different taxes, each with its own rules and rates, which vary considerably from state to state.

With regard to the rates, the first Brazilian anomaly is that the ICMS calculation base includes the tax itself. For inter-state transactions, it is set by the Federal Senate, which in 1989 created a dual system: the normal rate is 12 percent, but this drops to 7 percent on goods moving from the richer states to the poorer states (with the exception of fuels and electricity, where the distribution is constitutionally guaranteed). State law sets the nominal rates for internal transactions, and many affirm that there are more than four dozen variations:¹⁷ the normal rate is 17 or 18 percent (in practice, the charge is 20.5 or 21.9 percent of the base value); two reduced rates are commonly used (set at 7 percent on goods that form part of the "cesta básica" basket of staple goods and for low energy consumers, and at 12 percent on goods whose production is to be encouraged, such as automobiles and alcohol or diesel fuel), as well as two higher rates (set at 25 percent on fuels, electricity and communications and, occasionally, 35 percent for certain items considered superfluous, or weapons – equivalent to 33 and 53 percent, respectively, of the base value).

¹⁷ The levying of ICMS on electricity is an illustration of the complexity: first, it is necessary to classify the consumer within one of seven classes (residential, low income, industrial, commercial, rural, public parks, public lighting, public services or own consumption); then, each state can impose different rates within a single class, in accordance with the level of consumption. For example, in the state of Mato Grosso, there are five different rates (exempt, 10%, 17%, 25% and 30%) for residential consumers alone. As a result, there is a considerable variety of rates, which are also frequently altered.

The Constitution assures that ICMS is to be non-cumulative and, since 2003, that it is not levied on exports; however, serious problems persist, for there is no safeguarding of the use of eventual accumulated credit balances; it ends up having an indirect impact on sales abroad; credits relating to the acquisition of capital goods can only be used over a period of four years; and those relating to consumer and durable goods are even today frequently undeclared. As mentioned above, the harmonization of the application of ICMS should be the responsibility of a collegiate body of finance secretaries (CONFAZ) – from time to time, the Federal Senate may set minimum and maximum rates, for the purpose of settling conflicts (this has been done just once, and had nothing to do with federative issues: it restricted the air transport rate to 4 percent). With the 1988 reform, the Finance Ministry lost the authority and means to influence that collegiate body and the coordination of the ICMS started to erode. The requirement of the unanimous approval of any tax incentive led to a veritable fiscal war, as benefits were granted without waiting for the approval of that body, and were never judged, much less condemned, by the Supreme Court.

Once fiscal competition ceased to be a means of attracting productive investment to the smaller and poorer states and became a nationwide practice, together with the fact that dynamic activities such as services escaped this tax (and even municipal ISS, since the federal government took advantage of the lower taxation of the sector to increase its burden of contributions), the treasury administrations focused their efforts on raising the rates on strategic inputs and the output of oligopolies: these days, 42 percent of the national ICMS revenue comes from just three bases – oil and fuels, communications and electricity (19, 12 and 11 percent, respectively). The proportion is even higher, the less developed the state, where the rest of the ICMS revenue comes more and more from tax substitution and the advanced charging of inter-state revenues. The more developed states, for their part, are turning more and more to imports (which have been favored by the commercial opening up of recent years) and are investing heavily in the modernization of their equipment (indeed, they have already begun to introduce electronic invoicing, which promises to be as revolutionary a change as internet income tax declarations, introduced a decade ago). At any rate, what was created as the most generalized domestic market tax has been whittled

down over the past ten years, taking on more and more the appearance of a selective or specific tax.¹⁸

The traditional federal value-added tax is the IPI, but the revenue generated is limited: just 1.2 percent of GDP and barely 3 percent of the overall tax burden, because the federal authorities largely ignored this tax after the 1988 reform raised the allocation of other tiers of government and regional funds to 57 percent (suffice it to say that the revenue was 3.5 times greater in 1968). In practice, it became a selective tax, and in this way met a principle established in the Constitution itself, which determines that its rates should take into account the essential degree of the product: hence, they were defined on a case by case basis, using a table divided into 21 sections and 97 sub-sections, and ranged from zero percent (for staple ‘cesta básica’ products) up to 42 percent on perfumes and 45 percent on snow or golf vehicles. On top of the sheer complexity of the tariff structure, the IPI is frequently used as a means for granting sectorial incentives (as in the recent case of the construction industry), since it doesn’t involve much sacrifice, most of which is borne by the state and local government tiers. Never has the revenue from the IPI been so low, since its inception, and it is largely concentrated on just three superfluous items – automobiles, beverages and tobacco (one third of the total) and imports (accounting for a further 22 percent).

3.4.2. General sales taxation

The taxing of revenues in general (not just on commercial, but on other revenues as well, such as financial income and even income from government work) is carried out by means of two social contributions charged by the central government: one is known as COFINS (Contribution for the Financing of Social Security) – which the 1988 reform tied to social security, in place of the FINSOCIAL (Fund for Social Investment), created in 1991; the other embraces two contributions, for the Social Integration Program (PIS) and for the Public Service Employee Savings Program (Pasep), created in 1970 and, following the most recent constitutional reform, tied to the funding of unemployment benefit.

¹⁸ A good illustration of the depleting of the ICMS over time is to compare the 1968 tax burden with that of 2005: in that first year, the state ICM, without the major bases and with a general rate of 15 percent, accounted for 7.3 percent of a total of 8 percent of GDP, but fell to around 20 percent of the national tax burden, despite becoming the ICMS with the incorporation of fuels, power and communications, the significant rise in the general rate and the creation of special higher rates.

COFINS contributions raised the equivalent of 4.5 percent of GDP in 2005, making it the country's fourth largest source of tax revenue, behind the ICMS, income tax and payroll contributions to social welfare. It is the tax that has grown the most, by far, since the 1988 reform – indeed, in that year, it yielded a mere 0.8 percent of GDP and the general rate was 0.5 percent of gross turnover. It was raised to 3 percent of total revenue, but special regimes were established, under which financial institutions pay 4 percent of their net income from financial intermediation; large companies (which pay corporate income tax on their realized profit) pay 7.6 percent of the difference between what they sell and what they buy (known as the non-cumulative regime) and importers pay the same 7.6 percent at the moment of customs clearance (created following a constitutional amendment, in mid-2004, to give equal treatment to domestic and imported products). Exports are not taxed and are granted specific exemptions and specific and varied treatment, according to specific cases (allowing large companies in certain sectors, for example, to avoid the non-cumulative regime).¹⁹ Special regimes were also created in order to impose tax substitution (as in the cases of cigarettes and vehicles) or even single levy tax regimes (for fuels and pharmaceuticals, among others) levied on certain specific activities – with rates ranging from 3.2 percent to 10.8 percent.

If there was evident harm caused by the cumulative effect of the earlier COFINS system, aggravated by the excessively high rate of 3 percent, (see Varsano *et alli*, 2001) the recent changes have been mindful of the need to improve the quality of the taxation. However, they have brought fresh problems, such as a huge increase in the burden, resulting from the wilfully excessive level of the rate for the non-cumulative regime (the same change, effected a year before on the charging of PIS/PASEP, had clearly demonstrated the consequences of increasing the burden) and its retention even after the broadening of the calculation base by including imports, as well as the growing complexity (caused when the government decided to make specific modifications, without any clear technical criteria, in order to

¹⁹ The non-cumulative COFINS regime was introduced in March 2004 (after being tried out for the PIS/PASEP during 2003) and led to a profound sectorial redistribution of the burden of taxation (as well as an increase in the overall burden), due to the productive diversification of the Brazilian economy, which mainly penalized the more labor-intensive sectors, with few production stages, that are vertically integrated, because their tax credits were not sufficient to offset the heavy rate increase, which went from 3 percent to 7.6 percent. In an effort to compensate for these effects, the federal government approved a succession of legislative changes, creating dozens of exceptions to the general rule, as in the cases of telecommunications, tourism, the press, medical services, transport and information technology (which were allowed to opt for the previous system, the cumulative regime). Even so, some sectors suffered a real increase in their tax burden.

make the system more flexible, instead of acknowledging the error in calibrating the rate and simply reducing it).

It should also be noted that, contrary to the official line taken by the federal authorities, contributions were not converted into authentic non-cumulative taxes, because the companies within the regime buy from and sell to companies outside it – not to mention the special regimes; in effect, the COFINS and PIS have become a kind of distinctive bundle of indirect taxes. On the other hand, compared to the state ICMS, the COFINS at least has the advantage of being more productive, applies national regulations and raises revenue in a more diversified fashion (for example, fuels, power and communications account for 22 percent of the total, 20 percentage points less than in the case of the ICMS; moreover, services provided to companies and financial institutions, two bases not covered by ICMS, generate 12 percent of the total COFINS). Looking at it in another way, the COFINS will tend, in the future, to follow the country's indirect taxation reform agenda, taking over the former role of the ICMS, which has become less productive, more complex and heavily concentrated.

As already mentioned, the second contribution levied on sales in general is the PIS/PASEP, which yields the equivalent of 1.1 percent of GDP and, for companies and financial institutions, adopts exactly the same levying arrangements as the COFINS, for the same contributors, but at much lower rates: 0.65 percent for companies under the cumulative regime and 1.65 percent under the non-cumulative regime. This contribution has one advantage over the COFINS: the contributor population is broader still, covering all legal entities, so that not-for-profit organizations also contribute, paying 1 (one) percent of their payroll, while public administrations pay 1 (one) percent of their current budget revenue. Another difference is with regard to the allocation: while the COFINS is of a general nature (financing social security as a whole), the PIS/PASEP is of a specific nature (for the workers' support fund, which covers unemployment benefit, an annual bonus and professional training, with a 40 percent reserve directed towards investment programs); in addition to a provisional constitutional ruling that set aside 20 percent for allocation by the central government (also applied to the other contributions).

3.4.3. Specific taxation

The most important specific tax is that levied on services (the ISS) and has been exacted by the municipalities ever since the reform back in the 1960s. They have the autonomy to legislate, charge and inspect, but they can only levy against those services provided internally, that do not come within the sphere of the ICMS (inter-state communications and transport) and are specifically identified in a complementary national law (the last update occurred in 2003). To avoid the fiscal war that had been burgeoning, as the leading municipalities learned how to best exploit this tax, a constitutional amendment introduced a minimum rate (set at 2 percent) and prohibited the granting of tax incentives at a lower rate. Since each municipality can set its own rates, there is a broad and varied spectrum – the most common being 5 percent (taking the country's largest city, São Paulo, as an example, the ISS rates there range from 2 percent, on private educational services, up to 10 percent, on nighttime entertainment, with 5 percent charged to hotels, restaurants, banking and security services, among others).

A federal tax (the IOF) is levied on credit, foreign exchange and insurance transactions and also those involving bonds or securities, the purpose of which is strictly regulatory (that is to say, its use is determined more by the guidelines of monetary, foreign exchange or credit policy than as simply a revenue source). It is true that, in 1990, it was utilized to effect the confiscation of 20 percent of national savings – under what was known as the Collor Plan. The regulations are diverse and complex, with many exemptions and reduced rates: the maximum general rates are presently 1.5 percent per day, in the case of bond or security operations (but with a zero rate for 23 types of credit operation), and 25 percent on exchange operations (but falling to zero in the case of contracts stemming from the exporting of goods and services or the importing of services, among others); in the case of gold purchases, the rate is 1 (one) percent, based rather unusually on the text of the constitution (since revenue from this specific source pertains in its entirety to the government of the state and municipalities where the gold is produced, to compensate for the fact that no ICMS is charged on gold).

Other specific duties (which are not taxes, as such) have also been introduced by the federal government since the late 1990s, to be levied on strategic inputs, such as fuels and communications, on the pretext of financing infrastructure investments in the respective areas. In practice, there was a reversal of all the original endeavours by the members of the Constitutional Assembly to do away with the old single levy taxes on such inputs (which

were initially included in the base of the general contributions, COFINS and PIS, and were also later to have other taxes, contributions and even disguised charges levied on them, often as a result of constitutional amendments) and reserve such bases for state ICMS or municipal ISS (which had been left behind during the building up of the overall tax burden, despite their rates having been raised substantially every time it was felt that the federal government was about to encroach upon these tax bases).

The most significant example is the CIDE (Contribution on Intervention within the Economic Domain), charged by the federal government since 2001 on imports and the commercialization of oil and oil products, natural gas and fuel alcohol,²⁰ at specific rates,²¹ yielding the equivalent of 0.4 percent of GDP. A similar case is that of telecoms services, which contribute at the rate of 1 (one) percent of operating revenue to the Fund for Universal Telecom Service Coverage (FUST) and at the rate of 0.5 percent to the Fund for Telecoms Inspection (FISTEL) (to finance the operations of the sector's regulatory agency). The most peculiar feature of these revenues is that the lesser part actually goes towards those investments for which they were created – the greater part is put aside as a disguised indirect means of increasing the federal government's primary budget surplus.²²

One source that is always surrounded by controversy, as to whether it should or should not be classified as a tax, is that of royalties and other forms of stake holding in the revenues and results from the production of oil, gas and electricity and the extraction of minerals. In this work, it was decided to treat them as a kind of tax (of a specific nature), because in Brazil these revenues are included in the public budgets and recorded as an economic contribution, as well as being subject to broad and complex legislation, which specifies details ranging from its calculation to its application. The aggregate revenue is sizeable: equivalent to 0.8 percent of GDP in 2005 (but it could even exceed 1 (one) percent, given

²⁰ CIDE is also levied, at the rate of 10 percent, on payments abroad in relation to licences for the use and transfer of technology, with the revenue tied to the financing of the Program for Encouraging University-Company Interaction in Support of Innovation.

²¹ The maximum rate on gasoline is R\$ 860/m³ and on diesel fuel is R\$ 390/ m³, but the government has the right to charge a lower rate, as it does at present, with gasoline taxed at R\$ 280/m³ and diesel at R\$ 70/m³. The rates are not "ad valoram".

²² The FUST is the clearest example: though the objective is to cover part of the investment in projects aimed at providing universal telecom service coverage, and 30 percent is supposed to be invested in fixed telephony in the country's poorest regions (North and Northeast), with a further 18 percent going into projects at public education establishments, as the revenues tend to be insufficient to remunerate the private investment, since it was created in 2000, not one cent had been disbursed up to September 2006; as a result, the fund has an accumulated balance of R\$ 4.2 billion (equivalent to US\$ 2 billion).

the relative growth of the GDP and oil prices, which accounts for the greater part of the revenue).²³ The charges levied on oil are: royalties, at a general rate of 10 percent of the gross production (this may fall to 5 percent, in the case of geological hazards or anticipated production, among other factors), and an additional amount (of up to 40 percent), considered to be a special stake, can be charged on highly profitable wells or large production volumes (the base excludes royalties, investment in exploration, operating costs, depreciation and taxes).

There is a wide range of other small forms of specific taxation of goods and services, or their use, or the permission to perform certain activities, which are always linked to actions or services of collective or individual interest.²⁴ Of these, it is worth citing the most unusual. Through a constitutional amendment of 2003, the municipalities can regain their ability to finance the cost of public lighting, by charging a special contribution on the invoicing of the electricity distributed (the previous charge, in the form of a fee, was rejected by the Supreme Court). Meanwhile, the federal government has for some time used a form peculiar to itself for taxing the licensing of vehicles, on the pretext of assisting the victims of road accidents, by demanding insurance (known as DPVAT), along with the state IPVA (it doesn't seem much, but it yields more than three times the revenue of the ITR). The three tiers of government charge fees for the provision of public services, using the most varied pretexts, earning an aggregate amount equivalent to 0.4 percent of GDP (once again, it is no small amount, exceeding the revenue from the IOF, which is levied on all financial transactions).²⁵

²³ The exploiting of natural resources is a financial opportunity for federative entities: on the utilization of water resources, a rate of 6 percent is levied on the value of the energy produced (small producers and own consumption producers are exempt); in the case of mineral resources, 3 percent is levied on the net revenue from the sale of the mineral production.

²⁴ Among other charges made in the form of economic contributions, one can cite the Contribution for the Development of the National Cinematographic Industry - CONDECINE, the Additional Charge on Domestic Airline Tickets, the Assessed Share of the Additional Freight Charge for the Renewal of the Merchant Fleet, the Contribution of the Companies Installed in the Amazon Region and Other Regions, and the Contribution on Horse Racing Bets.

²⁵ The Brazilian Constitution provides for the levying of two categories of tax: one in relation to the exercising of policing powers and the other relating to the utilization of specific and divisible public services. The former deals with the implementation and enforcement of the legislation – as in the cases of fees for environmental surveillance, metrology, commercial registration and health inspection (yielding less, just 0.12 percent of GDP). The latter is charged on the utilization of any public service which is not defined as a public good (ie: when one person's consumption precludes another person's consumption of the same good), as in the case of federal charges on the providing of services such as the commercialization of medicines, books, pesticides, transport services and lodgings, up to the revenue giving rise to the charge on the use of the Central Bank's IT system.

3.5. Taxes on Foreign Trade

The federal import tax (II) currently yields the equivalent of 0.5 percent of GDP, which does not constitute a significant revenue inflow, despite the commercial opening up of the economy promoted since 1990; this is largely a reflection of the structure and regional trade accords. Thus, rates are defined within the sphere of the Mercosur trade bloc, comprising the TEC (Common External Tariff), with a minimum rate of zero and a maximum rate of 35 percent – that is to say, the full members tax the same products at a unified rate and these products circulate freely within the trading bloc. Until 2008, each country may retain a list of exceptions, of up to 100 products, taxed at different rates to the TEC, and half yearly reviews may be conducted (allowing the changing of up to 20 percent of the items on the list). By definition, the tariff structure should have a low spread and a small number of different rates.

The federal tax on exports, meanwhile, has a basic rate of 30 percent, and the government has the authority to reduce it or increase it by up to 150 percent, for foreign exchange or foreign trade policy purposes or to regulate supply. However, it is rarely charged and the revenue is negligible.²⁶

3.6 Payroll Social Contributions

The manuals and international experience define social contributions as those levied upon the payroll, generally being due from both the employer and the employees, and used to finance benefits and other forms of social support. In Brazil, the category social contribution, in legal terms, includes other calculation bases. However, in accordance with the methodology of the IMF and other bodies, we will deal here with just the traditional contribution format: in line with the pattern of the wealthier countries, in 2005 they represented an important portion of the overall tax burden (22 percent), yielding the equivalent of 8.6 percent of GDP, of which 5.6 percentage points was channeled into the general welfare regime and 3 percentage points went to the specific regimes of the public

²⁶ An exception is the exporting of hides, with raw hides taxed at a rate of 9 percent and leather and tanned hides at a rate of 7 percent until the end of 2006 and at 4 percent to the end of 2007, after which the tax is supposed to be abolished.

employees and the establishment of a worker's compulsory savings scheme. The size of these revenues would appear to reflect the imposing of an extremely heavy aggregate burden on the payroll, in excess of the norm for the majority of emerging economies and close to the total burden imposed in the European countries that give the greatest priority to the welfare state.

3.6.1 General Welfare Contributions

Of the total amount paid into social security, 44 percent comes from employers' contributions (companies pay a rate of 20 percent and financial institutions the rate of 22.5 percent of the payroll, with no ceiling for the amount of the contribution) and 18 percent from wage earners (rates vary from 7.65 percent up to 11 percent of monthly earnings, on a progressive scale, but with a ceiling of one contribution salary (which is also the ceiling for normal retirement benefit) – currently set at R\$ 2,802 a month (just under US\$ 1,300)). This system means that the charges on higher incomes are proportionally much higher for the employer than for the employee, thus discouraging the formal hiring of higher income employees and frequently stimulating the dismissal of such employees, for subsequent re-engagement as service providers, either as private enterprises or as self-employed professionals (nevertheless, this last segment represents less than 4 percent of the total revenue collected). Attention is drawn to the fact that around one third of the social security revenue comes from sources other than the above-mentioned standard contributions – among which are the contributions of the owners of micro and small businesses under the 'Simples' regime, whereby a rate is paid on the company's turnover; amounts retained at source by the hirers of services provided by third parties (20 percent of the amount paid to individual workers and 15 percent in the case of cooperatives); and amounts retained at source against transfers of federal taxes to the majority of state and municipal governments that had not paid in their social security contributions in the past. It should be pointed out that this general welfare regime applies to workers with signed work papers, the vast majority being in the private sector plus a few public employees (in the rare cases of local governments that haven't organized a specific regime for them). Rural workers and self-employed professionals get differentiated treatment: with the former, the employer contributes at the rate of 2 percent of the gross income from the sale of his/her rural products, and workers can retire on a pension of one minimum wage (if

they wish to receive more, they can contribute at a rate of 20 percent of the desired amount, up to a ceiling); in the case of the self-employed, they must pay a higher rate (20 percent) than wage earners, and this encourages a large proportion of this segment to remain outside the state system.

3.6.2. Other Social Contributions

Another social contribution levied on the payroll and due only from the employer (at a rate of 8 percent) is the FGTS (Length of Service Indemnity Fund), which brings in the equivalent of 1.8 percent of GDP, but is of a quasi-fiscal nature: although it is set down in law, its revenue is not included in the public budgets, because it is credited on a monthly basis to the individual accounts of the workers, held at an official lending institution (the CEF – Federal Savings Bank). It was introduced in 1966, as a kind of reserve fund, to be drawn down in the event of the worker being dismissed without just cause: in which case the employer would have to pay an additional fine, equivalent to 40 percent of the balance of the worker's FGTS account, as a way of discouraging a high labor turnover.²⁷

The majority of the country's government tiers have organized their own social security regimes for their public employees (known as the RPPS), but an adequate actuarial assessment has never been performed and the charging of contributions from those covered was only normalized following the constitutional reform approved towards the end of 2003. It is estimated that the contributions, including the employer's portion, yield the equivalent of 1.2 percent of GDP. In the case of the federal government, active public employees contribute at a rate of 11 percent – inactive employees also contribute, under special conditions.²⁸ The lower tiers of government have the freedom to introduce different rates for their own regimes, just as long as these are not inferior to that adopted for the federal regime.

²⁷ Workers' FGTS balances can also be drawn down in the event of their employer's bankruptcy, the death of the title holder, their retirement, if they are diagnosed with AIDS or malignant neoplasia, for the acquisition of their own home or if the account receives no contributions during a continuous period of 3 years. The account balances are corrected monthly according to the savings account index plus interest of 3 percent per year. The resources are invested in financing housing, basic sanitation and urban infrastructure projects.

²⁸ Retired public employees started to pay social security contributions in 2003, as a result of Constitutional Amendment n° 41/03. However, the rate is not levied on the full amount of the benefit, but just on the portion in excess of 50 percent of the RPPS ceiling, in the case of former central government employees, and 60 percent of the RGPS ceiling, in the case of former state or municipal government employees.

4. Other Issues

Having described the characteristics of the main taxes and other charges, it would be a good idea to address two issues, in order to develop an awareness of all the aspects of the country's pattern of taxation: the most recent issues that affect fiscal federalism and are fundamental to an understanding of the taxation system, and the regressive nature of Brazilian taxation, whose effects are as harmful as they are unknown, being rarely addressed in the domestic literature.

4.1. Dilemmas of Federalism

In recent years, the Federation has ceased to be a thorn in the side of the so-called economic order, to the point that it has become a factor contributing to the success of short-term macroeconomic policy (at least in terms of managing the debt and surplus targets). However, there is still a long list of questions that need to be faced by the Brazilian Federation in the coming years. While there are still old 'structural' problems that need to be resolved, new issues have arisen in recent years, among which is a gradual recentralization of control. This was most evident in the exercising of taxation authority, with actions that have progressively contaminated the federal transfers (depleting the bases of the stakeholder funds and reducing the transfers linked to the Kandir Law). It also affected the payment of expenses, pushing into the background some programs for structuring activities in partnership with local governments (such as giving attention to health), in preference for direct action (such as the 'popular pharmacy' and hospital care, in the same area of health).

It is a mistake, commonly made by analysts, to think that the Federation is a great hindrance to reform, as if the federative allocation of tax revenues had remained constant since the implementation of the system determined by the 1988 Constitution. On the contrary, in the last few years, important changes have been made in the pattern of financing and public spending, with the increasing influence of the central government. Recent taxation measures have taken to the extreme the option of raising unshared contributions, while focusing the granting of benefits on those taxes that are shared with the states and municipalities, thereby throwing the federative structure into disorder. Between 2002 and 2005, the overall taxation burden increased by the equivalent of 2.3

percentage points of the GDP. State ICMS accounted for 12 percent of this rise, but the effect of the increase in the PIS/ COFINS was three times greater. Even though the increased total goes some way to attenuating the impact on budgeting, the allocation of the revenue (after constitutional transfers) shows a significant increase in the federal share, which in the last five years has grown by 1.8 percentage points, from 55.8 percent to 57.6 percent of the total taxation revenue. Taking 1991 as a base (the year of the lowest federal share, since the 1988 Constitution), one can see that the federal share has increased by 2.9 percentage points, and that of the municipalities has grown by 1.5 percentage points, while the share of the states has shrunk by 4.4 percentage points (see Table 2).

Seen from a longer perspective, after four decades, the municipalities have assumed the position of the states as the dynamic force of Brazilian federalism, judging by the changes in the federative allocation of the available taxation revenues. The state governments have had 10 percentage points cut from their share – which fell from 35 percent of total revenues in 1965, prior to the reform carried out by the military government, to around 25 percent forty years later. The municipal governments, meanwhile, have seen their share grow from 10 percent to 17 percent of the overall revenues.

An area in which little or no progress has been made is that of the so-called fiscal war between the states, conducted by manipulating their respective ICMS rates and the granting of benefits (especially the refunding of that portion of the tax that was due to other states) disguised as subsidized loans and even shareholdings. The principal effect has been to reduce the overall effectively available state revenue, and to increase the fiscal pressure of these government tiers on the central government, as well as diluting the historical tendency towards regional economic decentralization. The recent case of the automobile assembly plants is a typical example: given the generalized concession of incentives, the most developed states ended up making the most of their obvious advantages – market location and better economic and social infrastructure, in comparison with the less developed ones.²⁹

²⁹ One indication of the brake on the natural historical tendency towards economic decentralization is revealed when comparing real GDP growth rates in the period following the Real Plan (during which the fiscal war was most intense): between 1994 and 2005, the national GDP expanded by 29.7 percent, and that of the state of São Paulo by 31.5 percent (according to figures from the IBGE and SEADE, respectively). The economy of that state managed to grow significantly faster than the national average during periods of acceleration (as in 2004 and 2005), which more than offset the inverse tendency, to shrink faster than the national average in periods of decline, during the short economic cycles.

The implications of the ICMS war extend beyond the fiscal sphere, as it has a lot to do with the direction of the industrial and foreign trade policies. These, in turn, are essential to a stable upturn in economic growth. In a more open economy, there is less solidarity and more variation in interests and outlooks between the more and less developed regions, especially in terms of trade and industrial policy.

4.2. Taxation Regressiveness

One particularly weighty consideration in the analysis of taxation is the question of its distribution according to the different population strata, but in Brazil this rarely gets much attention in political and technical debate. Recent data reveals one awful aspect of the sheer size and recent increase in the taxation burden in terms of a large and growing level of regressiveness.

As has already been mentioned, the taxation burden is largely based on the indirect levying of taxes. This is true even in the case social contributions, whose effects are possibly even more harmful than those of the taxes. However progressive may be the levying of taxes on income and assets, the impact is very small in comparison with the enormous weight of the indirect taxes. Studies show a direct and continuous relationship between family income and the impact on it of indirect taxes: it is estimated that the average burden on a family in the lowest decile, with average monthly income of less than two minimum wages, is three times that on those in the highest decile, with a monthly income of more than 30 minimum wages.³⁰ The same estimate shows that the recent increase in the burden, being more strongly backed by indirect taxes than by direct ones, means that this increase proportionally affects the lower income families more – see (FECOMERCIO, 2006).

³⁰ See (FECOMERCIO, 2006)

Table 4– Impact of Direct and Indirect Taxation on Total Household Income: 1996 and 2004

Monthly Household Income	In % of the Household Income						Tax Burden Addition (in percentage points)
	Direct Taxes		Indirect Taxes		Global Tax Burden		
	1996	2004	1996	2004	1996	2004	
Up to 2 MW	1,7	3,1	26,5	45,8	28,2	48,9	20,6
2 to 3	2,6	3,5	20,0	34,5	22,6	38,0	15,4
3 to 5	3,1	3,7	16,3	30,2	19,4	33,9	14,5
5 to 6	4,0	4,1	14,0	27,9	18,0	32,0	14,0
6 to 8	4,2	5,2	13,8	26,5	18,0	31,7	13,7
8 to 10	4,1	5,9	12,0	25,7	16,1	31,6	15,6
10 to 15	4,6	6,8	10,5	23,7	15,1	30,5	15,4
15 to 20	5,5	6,9	9,4	21,6	14,9	28,5	13,5
20 to 30	5,7	8,6	9,1	20,1	14,8	28,7	13,9
over 30	10,6	9,9	7,3	16,4	17,9	26,3	8,4

Elaboration: (Zockun, 2006). Primary Sources: POF/IBGE; Viana et. Alii (2000)

MW = Minimum Wage

5. Tax Reform

For years, taxation reform has been on the agenda for national political and economic debate, so it is appropriate to provide an opinion as to the reasons behind the failure of so many projects and why such an overhaul is becoming ever more necessary. I would emphasize that the opinions expressed in this section of the conclusion are personal ones.

5.1. Disruptive Adjustment

Fiscal discipline has never been a simple consensual issue in Brazilian history, which has thrown up examples of moratoria: international, in the case of the central government, but also by the lower tiers of government. Concern over the matter, which was ignored by the 1988 reform, only came to the surface with the introduction of the Real Plan: the diagnosis was that the inflation masked a structural public account deficit and that, as long as no long-term reforms were put forward and implemented, it would be necessary to effect a provisional fiscal adjustment. This adjustment would involve a temporary increase in the burden of taxation, particularly through social contributions, and the creation of a mechanism for unlinking these revenues, so that additional sums from these same

contributions could be utilized for other purposes. Despite being introduced as temporary constitutional rules, their validity has been successively extended and they will continue to be in force until 2007, if they are not extended beyond that limit.

In practical terms, the consequences have been the opposite of those originally intended: a vicious circle has been created, wherein the very emergency measures themselves have led to a relaxing of the federal authorities' efforts and the delaying of the restructuring of public spending; in other words, the measures focused on the continuous increase of the tax burden have ended up provoking imbalance and got stuck in a cycle whereby the adjustment causes maladjustment.

At the heart of the concept of fiscal adjustment as a necessary evil are two structural issues that date back to the constitutional reform of 1988: the need to cater for the expansion of social security and, at the same time, try to reduce or even partially reverse the decentralization of taxation. To begin with, federal spending was affected by the increase in pension benefits, within the general regime and also for its own public employees (and much more recently, in welfare benefits), to which it responded by increasing the contributions. Next, the federal accounts, which had been under pressure since the creation of the Real Plan, due to the growing cost of public debt brought about by the extremely high real interest rates, began to require ever greater primary surpluses, following the eruption of the external crisis of 1998. This also led to an increase in the tax burden, although of a different nature and without depending on the unlinking of the federal revenues³¹ – now, the sources originally linked to social security were beginning to generate surpluses that were used to finance the burgeoning fiscal spending, not only on retired public employees, but on servicing the public debt.

5.2. Reform Proposals and the Reasons for their Failure

The 1988 constitutional reform had been in effect for just a few years when projects to change the taxation system started to appear, advocated in large part by segments close to the taxpayers who were given little elbow room in the Constitutional debates, which, as mentioned before, had focused attention on the federative issue. Among others, one that

³¹ It is important to bear in mind that the links to social security are generic (and not for specific purposes, unlike many taxes). Moreover, only pension contributions and part of the CPMF are linked to specific ends and are therefore not covered by the DRU. Even the CIDE, a portion of which is shared with the states, came under the umbrella of the DRU.

gained considerable attention was an unusual project with popular appeal that proposed replacing all the taxes with a single tax on financial transfers. The idea was so strongly defended that the federal government ended up proposing and approving the creation of a provisional tax of this kind, which was introduced only in 1994; later, it was to be reintroduced as a contribution to finance health spending (CPMF), also on a provisional basis.

The first important project for reforming the taxation system, proposed by the federal government in 1995, explicitly rejected the idea of promoting the recentralization of revenues. The main objective was to consolidate the national VAT legislation, thwart a fiscal war and create a federal tax that was identical to the state one (same base, justification and legislation), as well as to unify the present social contributions and replace their base, levied on the total sales turnover, with value added, with a view to eliminating its negative impact on the economy's competitiveness. With the prospect of establishing a VAT model with collection shared between the federal government and state governments, the simultaneous application of two rates was provided for, permitting the introduction of the principle of destination in inter-state transactions. This would avoid the evasion stemming from the mere elimination of the charge on the shipping of goods to other states, as well as stopping the predatory fiscal war between Brazilian states. The core of the proposal developed in Brazil, based on what was termed Dual VAT, was to be an ICMS that would be shared between the federal and state governments: it became known as the *little boat model*, due to the innovative treatment proposed for inter-state transactions – according to Varsano (1999).

However, the best opportunity in recent years to push through a sweeping revision of the country's taxes was wasted, because the federal government was afraid of jeopardizing its short-term fiscal efforts, aimed at mitigating the severe external crisis. The government had introduced a program of fiscal stabilization that, in reality, was founded on a sharp and rapid increase in the overall burden of taxation, especially through contributions on turnover, profits and financial transfers that would be altered, merged or eliminated in the reform that was before Congress.³² The fear of assuming very short-term risks led to the

³² In 1999/2000, the federal authorities broke off the agreement that had been made in the “Câmara dos Deputados (House of Representatives)”, as well as with the state and municipal authorities, regarding what was known as the Mussa Demes amendment, despite the fact that it would bring about an undeniable and deep rooted improvement in the system

abandonment of the process, on the only occasion that an agreement had been reached to introduce changes in the taxation that were authentically structural and long term – see (Dain, 2005). A short time afterwards, alleging once again the lack of tax reform, the government sought and gained approval for the extension of the unlinking of revenues (DRU) and the provisional taxation of bank account transfers (CPMF).

In 2003, the new President of the Republic of Brazil also presented a reform project to Congress, which, essentially, had the same long term objectives. This time, state governors were mobilized, amid much fanfare ensued that taxation reform would be pushed through, but the proposed constitutional amendment to reform the state ICMS, so as to nationalize the legislation and standardize the rates, was not approved and until today is circulating within the House of Representatives (Câmara dos Deputados). The same fear of losing control over the short-term adjustments was seen again in 2003, despite the change in government and arguments. In truth, the project only touched, and even then only partially modified, the state ICMS, but even so it did not get through. Yet again, what was necessary to a more immediate fiscal adjustment was passed unanimously – the extension of the CPMF and DRU, though in enlarged form (the DRU was extended to cover economic contributions and the CPMF rate was constitutionalized) and supplemented by other measures that would lead to a further increase in the tax burden (notably, the contributions on turnover were extended to cover imports).

The only consolation is that, during this post-constitution period, though there was no change in the constitutional framework, significant changes were made in the supplementary legislation, especially once the economy had stabilized. Following important modifications, such as doing away with monetary correction on company balance sheets and the creation of a simplified system of federal taxation on micro and small businesses (the “Simples”), the federal government supported the changes in the state ICMS forwarded by the Kandir Law and the social contributions on sales (the PIS and, later, the COFINS).

From a federative viewpoint, the measure that had the most direct impact was established by the Kandir Law, a supplementary law of September 1996, which eliminated the direct imposition of ICMS on all exports, including those of primary and semi-prepared

of taxation and that its implementation would be gradual and the effects only felt in the long term. The federal government feared that this reform would hinder or even cancel out the endeavors it was making in the very short term.

manufactured products. The states only agreed to surrender their power to tax exports in return for financial support from the federal government, agreed at the time as a transitory system (for a maximum of twelve years), in the form of a revenue guarantee (with resources passed on only to those states that suffered a reduction in their revenues, and proportional to that loss); this was subsequently converted into a federal transfer (about R\$ 4 billion a year), with predetermined apportionment, in the nature of compensation.

The Kandir Law ended up generating two on-going causes of friction that impair federative relations and economic competitiveness. On the one hand, the transfers are subject to annual renegotiation, during the process of approving the federal budget, because there are no clear principles to govern the determining of the overall amount to be transferred, nor adequate criteria for the distribution of the resources among the neediest states. On the other hand, the fact that exoneration is not automatic (no transfers to third parties or cash indemnification) has meant that, depending on the state authority in question, exporters can accumulate large ICMS credit balances, in contravention of the spirit of that law and even of the Constitution itself (since a partial reform, in 2003, elevated the principle previously declared in the Kandir Law to the Constitutional level). What is more, it disseminated among the state governments the idea that exporting is bad, as it generates no revenues but nevertheless generates expenses: some governors not only hold up or refuse the repayment of credits, but sometimes also resist the granting of incentives and infrastructural support to new projects aimed largely at foreign markets.

5.3. The Need for More Widespread Reform

The Brazilian taxation system has become a singular case: it is the only one in the world in which revenues from contributions exceed those from taxes, because it is the only one in which contributions are not levied exclusively on payrolls. According to the law, we have two systems of taxation. In fact, there is a single system in which the contribution is simply a legal short cut to enable the compulsory extraction of resources from society in a manner that is much quicker and easier than the traditional form of taxation.

The prolonged use of a strategy for short-term fiscal adjustment based on raising the burden of taxation has hindered economic growth. It is important to make clear that this is not a case of arguing that a high tax burden is, in itself, something that slows down the economy – indeed, if this were the case, the countries of western Europe would not have

grown, and they are still growing. Nevertheless, it cannot be denied that the tax burden became a problem in Brazil as from the second half of the 1990s, breaking with the historical post-war tradition whereby the burden of taxation would rise during the upside of the economic cycle (when the expansion of revenues tended to exceed the rate of GDP growth) and would remain stable during the downside. Despite some oscillations, the economy has grown rather slowly since the introduction of the Real (about 2.2 percent a year, on average), while at the same time, the average annual growth of national taxation revenues has been close to three times that figure. In such a peculiar scenario, it is inevitable to suppose that taxation has been an important factor in slowing down or braking economic growth, particularly when the taxing of exports has been retained and the charges on capital goods have been increased.

It is time to abandon the strategy of conducting tax reform through a process of gradual change and minimalist projects and face up to the basic issues, which points towards discussion and changes in social security (including addressing the thorny question of pensions) and in the federation itself (whose spending is also on the table for discussion).

It is in the area of taxation that the most concrete and effective steps can be taken to curb the growth of public spending and, if such be the case, to initiate a reduction. Restricting the use of provisional measures (temporary laws) in dealing with taxation issues (limited, in exceptional circumstances, to handling the few regulatory taxes), giving the same treatment to contributions and other types of charges as that given to taxes, and beginning the gradual depletion of the CPMF and the DRU, are the shortest routes to, first of all, slowing down the propagation of spending, and secondly, if possible, starting to reduce it. Not to mention the CPMF trap, which means that, when real interest rates are finally reduced to a sensible level (the bank rate is presently 6 times the average level for emerging economies), the current rate of 0.38 percent on bank transfers will discourage financial intermediation, in addition to the other problems associated with this type of charge – see (Campodonico, 2006)

It is undeniable that the weight of the tax burden has been defined by the amount of spending, but it does not mean that that is the cause. Ever since it became easier, as well as seductive, to create and inflate unshared federal taxes (since the two transitory regulations mentioned earlier came into effect), public spending in Brazil started to grow – and not only pulled up by the increase in taxes and the cost of servicing the public debt. For this

reason, the unlinking of revenues was never a solution for controlling spending, and as it has changed over the last few years, it has even induced the augmenting of spending. Budgetary rigidity is merely a symptom of the disease, not the cause of the infection, the origin of the uncontrolled spending and finances. It is necessary to reverse the trend, making it harder to increase and use tax revenues, in order to force a review of the pattern of spending.

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List of Acronyms:

CEF	Caixa Econômica Federal	Federal Savings Bank
CIDE	Contribuição sobre Intervenção no Domínio Econômico	Contribution on Intervention within the Economic Domain
COFINS	Contribuição para o Financiamento da Seguridade Social	Contribution to Finance Social Security
CONDECINE	Contribuição para o Desenvolvimento da Indústria Cinematográfica Nacional	Contribution for the Development of the National Cinematographic Industry
CONFAZ	Conselho Nacional de Política Fazendária	National Council on Fiscal policy
CPMF	Contribuição Provisória sobre Movimentação Financeira	Provisional Contribution on Financial Transfers
CSLL	Contribuição Social sobre Lucro Líquido	Social Contribution on Net Income
DPVAT	Seguro Obrigatório contra Danos Pessoais Causados por Veículos Automotores de Vias Terrestres	Compulsory Third-Party Motor Vehicle Insurance
DRU	Desvinculação das Receitas da União	Disengagement of Central Government Revenues
FGTS	Fundo de Garantia por Tempo de Serviço	Length of Service Indemnity Fund
FGV	Fundação Getúlio Vargas	Getúlio Vargas Foundation

Finsocial	Fundo de Investimento Social	Social Investment Fund
FISTEL	Fundo de Fiscalização das Telecomunicações	Telecoms Supervision Fund
FPE	Fundo de Participação dos Estados	State Allocation Fund
FPM	Fundo de Participação dos Municípios	Municipal Allocation Fund
FUST	Fundo de Universalização dos Serviços de Telecomunicação	Fund for Universal Access to Telecom Services
ICM	Imposto sobre Circulação de Mercadorias	Value Added Tax on Goods
ICMS	Imposto sobre Circulação de Mercadorias e Serviços	Value Added Tax on Goods and Services
II	Imposto de Importação	Import Duty
IMF	Fundo Monetário Internacional	International Monetary Fund
INSS	Instituto Nacional de Seguridade Social	National Institute of Social Security
IOF	Imposto sobre Operações Financeiras	Tax on Financial Operations
IPI	Imposto sobre Produtos Industrializados	Excise Tax on Manufactured Products
IPMF	Imposto Provisório sobre Movimentação Financeira	Provisional Tax on Financial Transfers
IPTU	Imposto Predial e Territorial Urbano	Municipal Real Estate Tax
IPVA	Imposto sobre Propriedade de Veículos Automotores	Vehicle Tax
IR	Imposto de Renda	Income Tax
IRPF	Imposto de Renda da Pessoa Física	Income Tax on Private Individuals
IRPJ	Imposto de Renda da Pessoa Jurídica	Income Tax on Legal Entities (Corporate Income Tax)
IRRF	Imposto de Renda Retido na Fonte	Income Tax Deducted at Source (Withholding Tax)
ISS	Imposto sobre Serviços	Tax on Services
ITBI	Imposto sobre Transmissão de Bens Inter-vivos	Real-Estate Conveyance Tax
ITCMD	Imposto sobre Transmissão Causa Mortis e Doação	Tax on Transfers as a result of Death (Death Duties) and Donations
ITR	Imposto Territorial Rural	Rural Real Estate Tax
IVA	Imposto sobre Valor Agregado	Value Added Tax
LDO	Lei de Diretrizes Orçamentárias	Law of Budget Guidelines
LRF	Lei de Responsabilidade Fiscal	Law of Fiscal Responsibility
Mercosur	Mercado Comum do Cone Sul	Common Market of the Southern Cone of the Americas
OECD	Organização para Cooperação e Desenvolvimento Econômico	Organization for Economic Cooperation and Development
PASEP	Programa de Formação do Patrimônio do Servidor Público	Public Service Employee Savings Program
PIN	Programa de Integração Nacional	National Integration Program
PIS	Programa de Integração Social	Social Integration Program
PPA	Plano Plurianual	Multi-Year Program
PROTERRA	Programa de Redistribuição de Terras e de Estímulo a Agroindústria do Norte e do Nordeste	Program of Land Redistribution and the Fostering of Agribusiness in the North and Northeast of Brazil
RGPS	Regime Geral de Previdência Social	General Social Security Regime
RPPS	Regime Próprio de Previdência Social	Specific Social Security Regime
SEADE	Fundação Sistema Estadual de Análise de Dados	Foundation for the State System of Data Analysis
SRF	Secretaria da Receita Federal	Federal Internal Revenue Department

STN
TEC

Secretaria do Tesouro Nacional
Tarifa Externa Comum

National Treasury Department
Common External Tariff