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**BRAZILIAN TAX REFORM**

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# I. Introduction

## A. Tax classification

Theoretically, there are three classic bases of taxation: income, property and consumption. The remaining are variations or combinations of those classic bases, with the exception, naturally, of regulatory taxes, payable on international trade and on financial operations.

Taxes are divided in two great groups: direct and indirect. Direct Taxes are those theoretically supported by the own taxpayer, for example income tax and tax on property. On the other hand, indirect taxes are those which the taxpayer can transfer the cost to the final consumer, which many times may be reflected in the price of goods and services. These are called taxes on consumption.

Taxes can also be classified as either progressive or regressive. The progressiveness is the extent to which there is proportionately high taxation on the highest incomes and smaller - or no taxation - on the lowest incomes. In order to be progressive a tributary system should have its collecting base coming from direct tributes. In Brazil, due to the need of increasing the tributary revenue the Federal Government has been creating some Contributions, which, even not being part of the theoretical division above, they represent considerable portion of the tributary revenue.

## B. The Brazilian Tributary System

The current structure of the Brazilian Tributary model originated from the constitutional and tributary reform of 1966, the year of consolidation of the military government's reforms. At that time the model supported the cycle of the Brazilian economy of the 60's and 70's.

Starting from 1988 a new Federal Constitution, propitiated the decentralization of the tributary revenues and began a process of important changes in this area. One of these changes as tributary reform, which admittedly is limited regarding the number of embraced taxes. In addition to being limited in scope, tributary reform was also limited in content and was soft in its implementation.

That doesn't eliminate, however, the additional need for broad changes, mainly arising from the government incapacity to collect sufficient funds to finance public expenditures. This inability is most evident in the years of crisis, when the government lost its capacity in articulating and implementing public politics and tried to look for a larger slice of the collection in a concentrated way in oligopolized segments of the national industry imposing a heavy burden of indirect taxes.

Furthermore, absurd tributary resources as several tributes in cascade that have been introduced, through normative acts, are still contributing more to turn the current Brazilian tributary system in anachronic and dysfunctional way. Such a system, as we know, has been harmful to the competitiveness of the Brazilian economy.

### 1. The Brazilian Federation

Brazil is the largest of the Latin American countries. Covering nearly half (47.3%) of the continent of South America, it occupies an area

of 3,286,470 Sq. miles (8,547,403 Sq. Km). With a population of 157,070,163 inhabitants. It is the fifth largest country in the world after the Russian Federation, Canada, China and United States. The Federative Republic of Brazil is divided into three government tiers:

- Union (Central Government)
- 26 states and the Federal District (Intermediary Governments)
- 5507 municipalities (Local Governments)

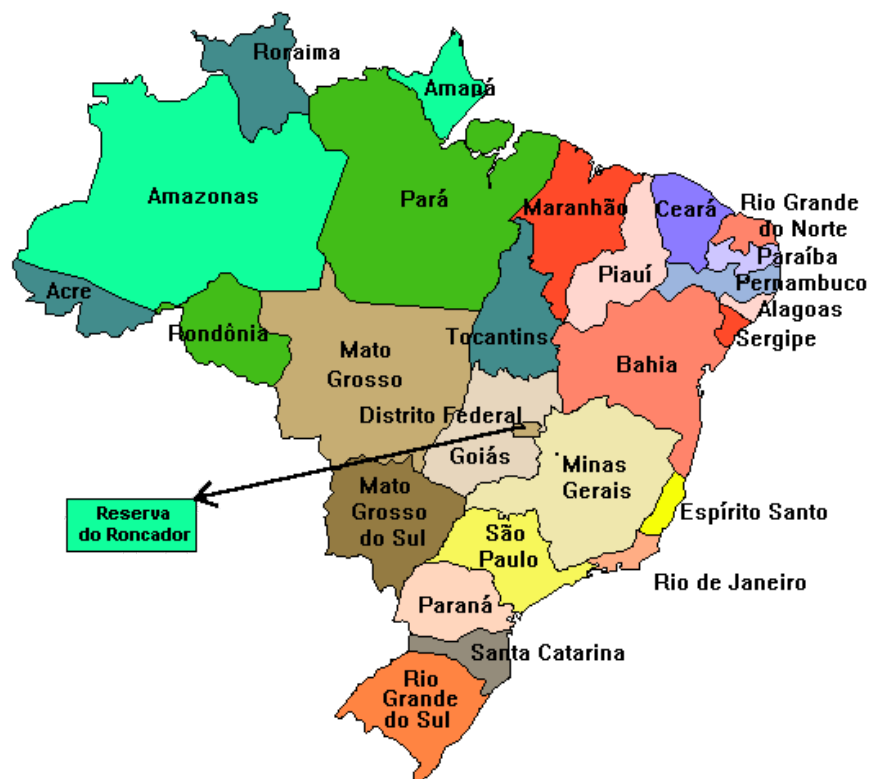
The country is divided in five regions:

- North: Rondonia, Acre, Amazonas, Roraima,  
Para, Amapa e Tocantins.
- Northeast: Maranhão, Piauí, Ceará, Rio Grande do  
Norte, Paraíba, Pernambuco, Alagoas  
Sergipe e Bahia.
- Center-West: Goiás, Mato Grosso, Mato Grosso do  
Sul e Distrito Federal.
- Southeast: Minas Gerais, Rio de Janeiro e Sao  
Paulo e Espírito Santo.

- South: Rio Grande do Sul, Santa Catarina e  
Parana.

Although Brazil is the fifth most populous nation, its nationwide demographic density is low compared to other countries. The population is concentrated along the Atlantic coastal areas of the southeastern and northeastern states.

Industrial activity is concentrated in the southeastern region, with 50% of the industrial production located in the state of Sao Paulo. Migration from the northeast to the southeast, as well as from rural to urban areas, has been heavy since 1970. Actually, about 45% of the total population of Brazil is concentrated in this region.



The Brazilian Federation, highly decentralized, presents all the government tiers with political, financial and administrative autonomy. Thus, each government tier has its own tributary competence which is defined constitutionally.

The following tables will present the existent taxes and contributions nowadays in Brazil, as well as the percentage of distribution of the revenue collected among the different government levels.

1. Taxes and contributions levied by the Federal Government and percentages of revenue distribution (%)

TAX			F.G.	STATES	MUNICIPALITIES
IE	Imposto sobre as Exportações	Export Tax	100	-	-
II	Imposto sobre as Importações	Import Tax	100	-	-
IR	Imposto sobre a Renda	Income Tax	78.5	21.5	-
IPI	Imposto sobre Produtos Industrializados	Industrialized Products Tax	56	21.5	22.5
IOF	Imposto sobre Operações Financeiras	Financial Operations Tax	100	-	-

ITR	Imposto Territorial Rural	Rural Property Tax	50	-	50
	Contribuição sobre Folha de Pagamentos	Contribution on Payroll	100	-	-
CSLL	Contribuição sobre o Lucro Líquido	Contribution on the net profit of companies	100	-	-
COFINS	Contribuição Social para Financiamento da Seguridade Social	Social Contribution for Social Welfare Financing	100	-	-
PIS	Plano de Integração Social	Social Integration Plan	100	-	-
PASEP	Program de Assistência ao Servidor Público	Assistance Program for Civil Servant	100	-	-
CPMF	Contribuição Provisória sobre Movimentação Financeira	Temporary Contribution on Financial Checking Transaction	100	-	-

## 2. Taxes levied by the states and percentages of revenue distribution (%)

Tax			F.G.	STATES	MUNICIPALITIES
ICMS	Imposto sobre a Circulação de Mercadorias e Serviços	Circulation of Goods and Services Tax	-	75	25
IPVA	Imposto sobre a Propriedade de Veículos Automotores	Tax on the ownership of Automotive Vehicles	-	50	50
ITCMD	Imposto sobre Transmissão <i>Causa Mortis</i> e Doação	Heritage and Endowment Tax	-	100	-

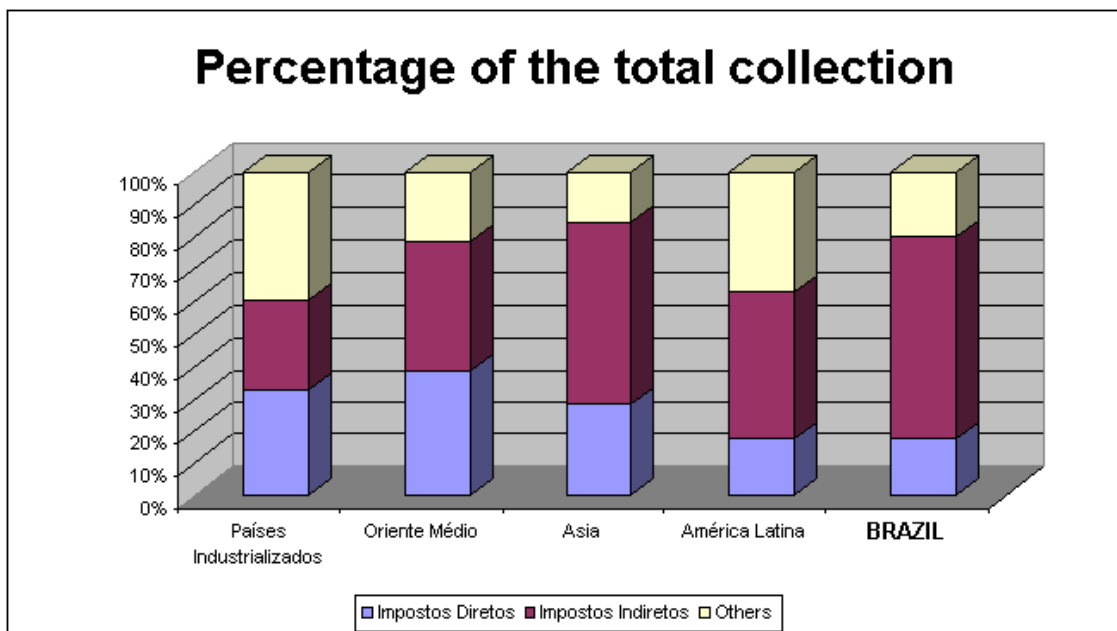
## 3. Taxes levied by the municipalities and percentages of revenue distribution (%)

Tax	F.G.	STATES	MUNICIPALITIES
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ISS	Imposto sobre Serviços de Qualquer Natureza	Tax on services	-	-	100
IPTU	Imposto sobre a Propriedade Territorial Urbana	Tax on Urban Property	-	-	100
ITBI	Imposto sobre a Transmissão de Bens <i>Inter-vivos</i>	<i>Inter-vivos</i> Transfer of Goods Tax	-	-	100

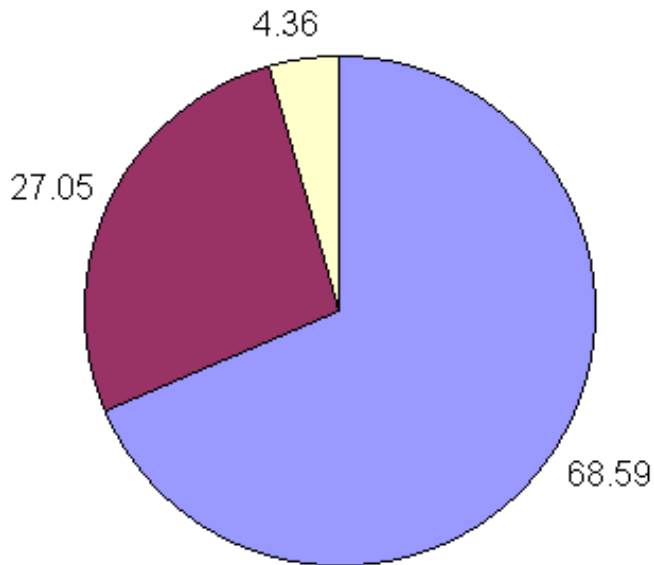
## II. The Current situation in Brazil

### A. Composition of Brazilian Tributary Burden



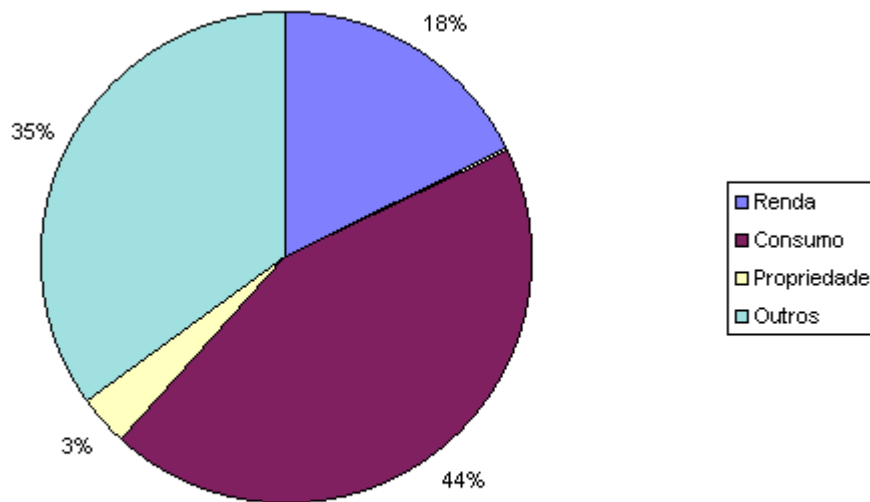
<b>Brazilian Tributary Burden - 1997</b>			
<b>Level</b>	<b>R\$ (billion)</b>	<b>%</b>	<b>% GDP</b>
<b>FEDERAL</b>	<b>165.34</b>	<b>68.59</b>	<b>19.17</b>
<b>Fiscal</b>	<b>62.56</b>	<b>25.95</b>	<b>7.25</b>
<b>Social Welfare</b>	<b>87.07</b>	<b>36.12</b>	<b>10.10</b>
<b>Others</b>	<b>15.70</b>	<b>6.51</b>	<b>1.82</b>
<b>STATES</b>	<b>65.20</b>	<b>27.05</b>	<b>7.56</b>
<b>MUNICIPALITIES</b>	<b>10.51</b>	<b>4.36</b>	<b>1.22</b>
<b>TOTAL</b>	<b>241.05</b>	<b>100.00</b>	<b>27.95</b>

Brazilian Tributary Burden - 1997



<b>Brazilian Tributary Burden - 1997</b>		
<b>By type of Taxation</b>		
<b>Type of Taxation</b>	<b>R\$ (billion)</b>	<b>%</b>
<b>Income</b>	<b>42.82</b>	<b>17.75</b>
<b>Consumption</b>	<b>105.86</b>	<b>43.92</b>
<b>Property</b>	<b>7.72</b>	<b>3.20</b>
<b>Social Contribution</b>	<b>61.75</b>	<b>25.62</b>
<b>Others</b>	<b>22.90</b>	<b>9.50</b>
<b>Total</b>	<b>241.05</b>	<b>100.00</b>





### A. Distribution of Revenues

As it was said previously, the new Federal Constitution of 1988 propitiated significant decentralization of tributary revenues. This established specific approaches in the destination of the revenue among the different government tiers, considering, mainly socioeconomic conditions of each state or region. The three previous tables show generically the percentage of distribution of the taxes and contributions among the Federal Government, States and Municipalities.

The Federal Government's participation in the total of the tributary revenue decreased about 5.5% from 1988 to 1995. Nowadays 55% of the Federal Government revenue is provided by several existent Social Contributions. ICMS represents about 93% of the states' revenue and ISS 50% of the Municipalities' revenue.

Two funds represent the main instruments of revenue partition: FPE - FUNDO DE PARTICIPAÇÃO DOS ESTADOS (States Participation Fund) and the FPM - FUNDO DE PARTICIPAÇÃO DOS MUNICÍPIOS (Municipalities Participation Fund).

FPE consists basically of 21.5% of the net revenue generated by the collection of IR (individual and Business) and IPI. The distribution of this revenue is made according to criterion which attribute different weights based on the degree of poverty of the states in agreement with the "per capita" income of the same ones. Thus, the regions North, Northeast and Center-west receive larger portions, relatively. The State of Bahia, for example, the largest and most populous state of the Northeast region, has a coefficient of 9.4% while the coefficient of the State of São Paulo, the largest "per capita" income of the country, is 1%. The three poorest regions receive 85% of the total funds.

In a similar way FPM consists of 22.5% of the net revenue generated by the collection of IPI, and 10% of the total Fund is distributed among the capital cities of each State. Eighty six percent goes to the municipalities with population up to 156,000 inhabitants and the remaining 3.6% to all the other municipalities of the country. In the same way as FPE, the location of the Municipalities is also considered in the distribution criterion. In this case, however, the amount of population has more importance. The municipalities of the three

poorest regions of the country (42% of the country population) in this case, receives 51% of the total amount of the Fund.

The Federal Constitution still determines that 10% of IPI are transferred to the States to compensate the loss of resulting revenue exemption from the ICMS granted to the manufactured products destined to export. As well, 3% of IPI is reserved to finance investments in the private sector of the three poorest regions of the country.

Still, constitutionally, the revenues generated by the collection of

IOF on operations with gold must be integrally restored to States and municipalities where such operations occurred. Fifty percent

of the revenues generated by ITR should be restored to the municipalities where the land is located.

Regarding to the revenue transfer between States and its Municipalities, the Federal Constitution of 1988 increased the percentage of collection of ICMS to be transferred from 20% to 25%, according to the value added. The remaining 75% is to be distributed among the several secretaries of government according to the state budget.

## B. Recent Changes and General Comments

In this section some comments about the current situation in different taxation segments in Brazil, as well as comments about some changes already introduced will be presented.

### 1. The Taxation of Income

#### A. Individual Income Tax - IRPF

- Introduction to the simplified discount

- Elimination of all forms of exception in the legislation

- Reduction in the brackets (formerly 15, 26,6 and 35% and now 15 and 25%)

- Integration with Corporate Income Tax

#### B. Corporate Income Tax - IRPJ

- Elimination of monetary correction, the main obstacle to the simplification of the system

- Reduction of the brackets (formerly of 25 to 43%, now of 15 to 25%)

- Relative equality between individual capital and that of others, with the introduction of the remuneration for the individual capital

- Relative equality between taxes for resident and non-resident (a differentiation being maintained only in case of stock market applications)

- Taxing levels on a worldwide basis

- Creation of the transfer price institute

## 2. Property Tax - ITR

- Making it a declaratory tax

- Linking the tax value declared with data for the appropriation process

- Raising of the brackets, up to 20% for large non-productive estates

## 3. Consumer Taxes

This is the segment that has the most problems which are complex and difficult to resolve. This is because, besides including a high number of overlapping taxes, (ICMS, ISS, IPI, PIS and COFINS), they are charged in the three federative tiers, transforming the tributary problem into fiscal and political questions. In addition PIS and COFINS are contributions collected in cascade.

The most significant of them – ICMS has already received important changes by means of complementary legislation, leading among them the exemption for manufactured products destined for export. However, this exemption is extremely complex, having different brackets linked to the type of product or to the state of origin or destination, and differentiated brackets covering internal and interstate operations. This makes it one of the main reasons for considerable evasion. The ICMS combines complex institutes such as a reduction of the basis

for calculation, presumed credit, postponements, and partial or total exemption .

Regarding IPI, the major problem is the multiplicity of brackets according to the classification of goods, ISS characterized by the degree of diversity of brackets from one city to another

## 4. The Simplified Tax - "SIMPLES"

This is another important change introduced recently, which fulfills the constitutional principle of propitiating favorable conditions to small and micro-enterprises. It includes income and consumption taxation with one single calculation basis – the company's invoicing – and has brackets ranging from 3 to 10%. It substitutes the Corporate Income Tax, the CSLL, the PIS, the COFINS, the IPI, the management's contribution on payrolls, the quasi-fiscal contributions and, depending on the adhesion of the states and municipalities, the ICMS and the ISS, respectively. Some 1.6 million taxpayers have already adhered to it, among those 170,000 new corporations and corporations that have left the informal economy.

## C. Economic Aspects

During the 1970's Brazil, like many other countries in Latin America, absorbed excessive liquidity from U.S., European, and Japanese banks. Huge capital inflows were directed to

infrastructure investments and state enterprises were formed in areas that were not attractive for private investment. The result of this capital infusion was impressive: Brazil's Gross Domestic Product - GDP increased at an average rate of 8.5 percent *per annum* from 1970 to 1980 despite the impact of the 1970's world oil crisis. *Per capita* income rose fourfold during the decade to a level of US\$ 2,200 in 1980.

In early 1980's, however, a sudden, substantial increase in interest rates in the world economy coinciding with lower commodity prices precipitated Latin America's debt crisis. Brazil was forced into strict economic adjustments which brought about negative growth rates. The unexpected suspension of capital inflows reduced Brazil's capacity to invest. The burden of its affected public finances contributed to an acceleration of inflation. In 1987, the government suspended Brazilian interest payments on its foreign commercial debt.

The 1980's crisis signaled the exhaustion of Brazil's Import Substitution Model and it contributed to the opening up of the country's economy. (Import Substitution is a policy that nurtures local industry by prohibiting the purchase of certain manufactures abroad). In the early 1990's Brazil's economic policy centered on three main areas: 1- economic stabilization, 2 - moving the country away from protectionism toward a more open, market-driven, economy, and 3 - normalizing relations with the international financial community. In the first area - economic stabilization - the country has followed strict discipline, adopting tax reforms and measures to enforce tax compliance, carried out programs of deregulation and privatization, reducing price controls in 1992 and, in order to establish a true market economy and eliminating them altogether in 1993. For the first time, Brazil adopted limits to its issuance of currency. With the introduction in July of 1994 of Brazil's new currency, the *Real*, the annual inflation rate fell from 2,568% in 1993 to 19% in 1995, and to 9.4% in 1996.

The abrupt fall of the inflation caused by *Real* Plan, which made possible the maintenance of the real value of the basis of calculation of the taxes and contributions, provoked increment in the tax revenue. The net revenue of the Federal Government (treasure, Welfare and Central Bank), in prices of December 1995, increased 29,6% in 1994, in real terms, bringing up the collection to the value of R\$ 92,5 billion. In 1993, this revenue was R\$ 71,4 bilhões. Federal Government presented, in 1994, primary surplus of US\$12,7 billion, in prices of December 1995. This represented increment of 67,9%, in relation to the result of 1993. In 1995, collection continued improving. Between January and December of 1997, the total net revenue reached R\$ 106,2 billion, in prices of December, increasing 14,7%, in relation to the same period of 1994.

The fiscal situation, however it is not so satisfactory. The net debt of the public sector has been suffering significant increase. From 1996 to 1997 comprised from 33.3% to 34.3% of GDP. The operational deficit grew from 3.8% to 4.3% of the nation's GDP and the nominal deficit increased from 5.9% to 6.1% of GDP. Simple observation of the government's bills shows clearly that the focus of the fiscal unbalance is in social security. Both years 1997 and 1996 social security had its debts partially covered by resources of the national treasury.

Federal collection, in spite of having presented significant growth of 9.77% in this period, has depended substantially on temporary revenues from CPMF and telephone concessions, for example, in order to balance its bills avoiding a true economic and financial catastrophe.

In October of 1998 the Federal Government proposed to the Congress a Fiscal Stability Program that will demand, measures at federal and state levels.

The Government cannot make changes in about 75% of the budget. The constitution doesn't allow the government to alter the expenses with the Welfare, nor with the wages and benefits of civil servants. The transfers to the municipalities are also defined in the Constitution. The Executive branch is allowed to reduce expenditures in less than 25% of the budget. This is called funding, and half of these resources refers to health, education and social attendance, that are basic needs of the population.

The Government is proposing to Congress a cut in these areas of 8.7 billion for 1999, but this is not enough to balance the bills of the country in the short run.

The Government is also proposing, to increase the contribution of the civil servants for their social security system. The COFINS can be increased and CPMF will have raised its brackets of 0.20% to about 0.35%.

According to the Government, these emergency measures will be suspended as soon as the balance is recuperated in the bills. This depends also on the conclusion of the reforms as soon as possible. Not only the Tax and Administrative Reforms but mainly the Social Security System Reform which has been compromising the situation of States excessively.

Projections indicate that most of the states will have very serious problems to pay their bills next year. Six States probably can begin 1999 without conditions to pay their payrolls. Worse than that, the debts are very high, the collection is falling and just a few state companies remain to be privatized. Moreover, every month States must alleviate part of the revenue (between 11% and 15%) to decrease its debt with the Union. With the Fiscal Stability Program this picture can become worse.

It seems that the only way for that States to avoid the bankruptcy would be to make some adjustments too. There would be three alternatives to balance the accounts: to dismiss public sector employees, to reduce wages or to collect a contribution of the servants. Dismissing takes much time and emergency measures are necessary. Decreasing wages is prohibited by the Constitution. The only option that remains, then, is to extract more contributions from the active and inactive civil servants.

That measure was already taken by the Federal Government, which included the increase of the social security contribution of the civil servants in the package of fiscal adjustment announced after the elections. Public employees of the Union that earn up to R\$ 1,200 should continue contributing 11% for their retirement. Those who receives more, will start to committ the same percentage up to R\$ 1,200 plus 20% on the surpassing value. For while, that is decided as just for active public employees, but the idea is also to extend the contributions for inactive ones. In the case of the States, with some exceptions, civil servants don't contribute anything for their retirement.

The most critical situation, now, are the states of Espírito Santo, Alagoas, Santa Catarina, Minas Gerais and Pernambuco, where resources for payment of the thirteenth wage<sup>1</sup> do not exist much less an for investments for next year.

Alagoas, Santa Catarina and Pernambuco still suffer the consequences of the episode of the "precatórios". In those States, the governments emitted public titles for the payment of judicial debts (the "precatórios"), but they allocated the money for elsewhere. Only in 1999 the state of Alagoas will have to pay R\$ 800 million, the equivalent to the almost ten months of the State tax collection. Complicating the situation is the state of Minas Gerais where it consumes 78% of revenue just to pay its monthly payroll.

However, the situation of State Espírito Santo is the worst: Its payroll consumes 95% of the revenue and 60% of the employees have not received wages for three months. The

revenue doesn't surpass R\$ 100 million, insufficient for paying off the R\$ 135 million of late wages.

The situation is not so better in Goiás, Paraná, Rio de Janeiro, Rio Grande do Sul, Amazonas and Acre. Due to the commitment of the payrolls, the debt a fall in the revenue these states will mean beginning the year in troubles. In Mato Grosso do Sul, for example, the collection revenue is frightening. The State has one of the worst collections of the Country. In October of 1998, it just collected R\$ 55 million for a payroll of R\$ 45 million. A low revenue is attributed to the fiscal privileges given to the most productive sectors: the agriculture and cattle culture. In Goiás, the collection has also dropped and the total debt reached R\$ 4.8 billion for a monthly revenue of only R\$ 155 million. In Rio Grande do Sul and Paraná the payroll is more worrisome: it is consumed, respectively 81% and 72%. The elected government is against the privatizations, but even they want there would have just a few companies to be sold. The more lucrative state companies were already negotiated by the current government, which used a great part of the total of R\$ 5 billion of the privatizations to pay its debt.

Paraná will have to face the expenditures of the retired civil servants and pensioners, which consumes 30% of the whole payroll. The idea is to create a pension fund with the government's properties and the some state companies' stocks, which could create up to 1 billion in assets to compose the initial capital.

The same project is being studied in another States as São Paulo, Bahia and Ceará that, despite having balanced finances, continue to be worried about the growth of the payroll. Cutting investments and even the possibility of dismissing employees are now being talked about.

The most common opinion, even so, it would be the contribution of the active and inactive servants to provide superavit in the primary bills. Thus, States would be, in fact, participating in the fiscal adjustment, with the Union, and the situation would tend to change.

#### D. Rampant tax evasion

Nobody likes to pay taxes in Brazil or anywhere. The taxpayer's aversion to those that collect tributes is universal, but in Brazil it was taken to the maximum limit. Tax evasion has become a state of art fraud - before being an exception, it has turned into the norm. There are two classes in Brazil: The ones that pay and the ones that do not pay taxes.

In the business world, the first category is a minority. Included are foreign companies ones that have stocks in the market and the great companies of national capital. The organized companies cannot take the risk of having a parallel cashier. From a certain size and complexity, to defraud means to lose the control of the company.

In Brazil who pays tax, pays a lot. And, besides having a heavy tax burden, the companies that act in the legality must face competitors that, do not to pay or pay just a little tax. These evaders can offer lower prices and they benefit from higher profits. Thus, the tax evasion turned into a competitive advantage in Brazil. It can determine the success or the failure of a business.

About 60% of cattle slaughtering in Brazil are clandestine, made at municipal slaughterhouses and for small and medium butcher shops. This means that, of the 26 million heads abated annually, at least 15 million don't pay any taxation. The damages for the public coffers are visible: the meat is exempt from IPI but is taxed in 20%, considering

ICMS and COFINS. For the organized companies, the equation translates itself into a very serious damage.

The recent history of the meat sector shows clearly up to where the damage provoked by the tax evasion can get. The illegal market made disappeared all the great foreign meat companies. Pressure by the remaining ones, the government of the State of São Paulo tried to restraint the defraudments. One of the providences demanded the installation of electronic devices in the slaughterhouses. The idea was to count each abated animal, what would facilitate the calculation of the due tax. In a very short time, however, 45 of the 80 meat companies from São Paulo transferred to States as Mato Grosso and Goiás, where they also benefit of smaller brackets of ICMS.

Similar situation can be verified in the market of chickens, whose annual sales arrived at 6,8 billion dollars last year. Of the total of 1,6 billion tons of chickens produced, a little more than a third don't get inspected by federal sanitation authorities. This is a serious indicative of tax evasion. Little sanitary concern generally implies little or no fiscal concern. Due to the tax evasion, about 200 million dollars in taxes were not picked up in 1995, a year considered a record for sales of the sector.

Not by chance, the feeding section is considered the lowest taxpayer in Brazil, according to research made among 214,000 companies of all the activity branches. The work, presented in the final report of the Parliamentary Commission of Inquiry of the Fiscal Evasion, supported by the Senate in 1994, shows that in the feeding sector 98% of IPI were not paid by the companies. Following close behind are the: chemical (59%), textile (54%) and metallurgist (51%). That evasion, according to the technicians of the Ministry of Finance, is attributed to pure and simply fraud, the inadimplency<sup>2</sup> and, also, the fiscal elision.

Regarding elision is framed a range of legal resources for the non payment of tributes. Also known as tributary planning, that practice is controversial. There is a very fine line between the fiscal elision and the tax evasion. Among the entrepreneurs, this is seen as middle of self-defense. They say that "the tributary planning is a weapon of the organized companies to defend themselves against disloyal competition from fraudulent ones".

At first sight, the numbers of the research seem exaggerated. Actually, as happens with most statistics in Brazil, the indicators are imprecise. For a long time it was supposed, with basis in estimates of the revenue office, that for each each dollar collected in tax another one would correspond in tax evasion. The Federal Revenue Secretary refutes this supposition. It is alleged that this is idea of easy assimilation which turned into a thesis. Perhaps a more consistent approach is the one made by the Secretary of Finance of São Paulo. Of the forecast collection for 1995, the Treasury of São Paulo obtained 67%, an evasion of at least a third of the potential revenue.

In 1995, the sum of the federal tributes reached 84 billion dollars. Added to state and municipalities tributes would get to 173 billion dollars. Considering the relationship 1 for 1 was true, it would mean that other 173 billion dollars went to the parallel accounting. This is a high figure. If the thesis of the third is adopted, it would drop for 57 billion dollars, what is still considered a lot. To find the exact figure is almost impossible, but, in any way, some data help to show that the evasion is high. According to the Secretary of Federal Revenue, about 2,5 million companies for more than 5 years don't pay tax of income. Among them, 99% would owe some money to the Federal Revenue.

Another question is the enormous concentration of the payment of taxes in Brazil. There are few taxpayers and the ones pay, pay a lot, because the brackets are considered very high. Recent research shows that the 30,000 larger Brazilian companies (revenue upper to

1,8 million dollars) are responsible for 85,20% of all the collection of the federal government. Moreover, the 150 largest taxpayers pay 50% of practically the whole of income tax, and 70 companies pay half of the IPI. The concentration degree doesn't reflect the reality of the generation of national income. The participation of these great taxpayers' revenues in GDP is much smaller than its tributary obligation.

The same happens regarding the tributes collected by the States. In São Paulo, where 20 billion dollars is collected each year in taxes, 50 major taxpayers take part in 30% of ICMS. Opening a little more the fan, it can be verified that the 1600 larger companies participate with 60%. On the other hand, 344,000 companies contribute with just 15% of the collected.

For the true tax dodger, the objective is to pay nothing in taxes. In that case, s/he simply stops emitting the receipt. One of the most common form of tax evasion, however, is to use half receipt: the tax dodger registers in the receipt the physical volume of the goods, but with a smaller value, on which are levied the taxes. Even in the case of being caught in the act by inspection, there is no problem, because of the difficulty in verifying the true price of of the product. The question is that who sells with half the receipt also purchases with half the receipt. Thus, the production costs and the sales prices in semi-illegality becomes unbeatable. A consequence of that combination is that the companies of the informal pole get to place its production in a very low price compared to its competitors. Besides the pain of those who pays taxes, tax evasion also degrades the distribution chain.

An identical situation is experienced by the garment sector. Equipment such as sewing machines, for example, are relatively cheap. Thanks to this, thousands of small companies appeared in the last years. Ironically, the restructuring and the shrinking promoted by the great companies of this sector ended, in a certain way turning against them. According to estimates, a little more than 35% of the national production of garment are informal: of the 840,000 tons of raw materials supplied annually by weavings, only 540,000 reappear in the sales of the legalized companies.

The substitution of the institutionalization of the roguery for the instutionalization of the contribution necessarily goes by a revision of the charged brackets. It is not to continue infringing the call Law of Lafer, formulated by the American economist Arthur Lafer, from the University of Stanford. " An unit more in tax can result in a n unit less of revenue ", says the law. James Mead, Nobel prize of Economy in 1977, still reinforces the Lafer thesis in a simpler form. It is " intelligent to tax less on more", Mead says. The question is summarized in finding a taxation level capable to be bearable for the group of the companies and to make tax evasion uninteresting the tax evasion without damage for collection.

## E. The Need for Reform

The Brazilian tributary system, in general terms, can be considered: obsolete, too complex, structurally unfair, characterized by high tributary burden, not propitious to harmonization with other tax systems and an inductor of evasion, even the unintentional one.

The simple existence of tributes collected in "cascade", for example: PIS, COFINS, IOF, CPMF, can be considered effective exports barriers once taxing the national production and non taxing the foreigner ones places the first one in clear disadvantage in relation to the imported product. It is harmful for the competitiveness of the national production.

The productive chain is onerated simultaneously with two taxes on the same generating fact: IPI, which is payable up to a certain point, and ICMS that is payable in the whole chain. This makes Brazil, possibly, the only country in the world that has two value added taxes, one under the federal government's competence and another of States.



A tax, whose effects surpass the border of the federated unit should have its competence attributed to the federal government. The ICMS, for having its competence attributed to States, has been an instrument of "fiscal war" among States, which grant fiscal benefits with the objective of developing its industrial park. That industrial decentralization could be considered positive for the country if, with the decrease of the revenue of the developed states, the other states had increased its revenues. What happens, however, is that the revenue received by the states that grant such benefits is a fictitious revenue. The same taxpayer that pays ICMS for that State receives back, as an incentive, almost all of the tax paid as a financing, in a long run, without interest and without indexation.

In the decentralization of the development, done by means of tributary artifices, what decreases is the private cost, increasing, obviously the social cost, called "Brazil's cost", compromising clearly the competitiveness of the national production.

Another subject to be considered is the current low taxation on income in the Brazilian tributary system. There is a much higher taxation on the consumption than on the income. It is easier to tax consumption, once all the consumers are included, but to tax income is more difficult, not only by the characteristic selectiveness of that taxation but, mainly by existing elevated concentration of income in the country.

Regarding the tributary burden it can be said that there is not a high tributary burden or low. Either the tributary burden is fair or unfair. To get this definition it is necessary to consider the other side of the public sector: the one that renders services to the society. If the rendered services are satisfactory in amount and quality terms, there is not the sensation of a high tributary burden. However, analyzing the Brazilian tributary burden in function of the rendered public services, it can be considered very high.

Another fact to be considered in the analysis of the tributary burden is the tax evasion level. The nominal burden, the one that it is in the tributary legislation, is larger than the one that indeed enters the public coffers.

Another criticism that is made of the Brazilian tributary system is regarding the regressiveness of it. A system is considered progressive if its main collection basis come from direct tributes. In Brazil about 70 to 75% of the outturn is based on indirect taxes, which are easier to be collected. The Brazilian Income Tax is also regressive because its collection basis comes almost totally from wages and not from profits or dividends.

The abrupt fall of the inflation provoked by the Real occasioned an increment in the collection, in real terms. The need of adoption of concrete measures to consolidate in an effective and responsible way what indeed matters to facilitate the preservation of the sustained growth of the Brazilian economy and the significant and continued reduction of the expressive fiscal unbalance of the public sector completely as a whole is evident.

In addition, new changes should happen in the wake of a very accelerated process of transformation in the economic, political and social spheres: the Globalization, requires integration agreements that propitiate a harmonization among several tributary systems.

Another important element is the need for integration of the tax collections among the states. The existence of separated fiscalizations of the federal government, state governments and even the municipalities propitiates, given the structural disharmony, decrease in the revenue with an increase of tax evasion.

The national tax reform is urgent and necessary, specially considering the unanimous consciousness of the strong stress on the taxpayers, reflecting an impositive burden

derived from serious distortions and badly distributed, even in its philosophical conceptions as in the economic and social aspects of fiscal justice.

## II. Main Proposals of Tax Reform

There are basically three proposals of tax reform. The first, coordinated by the Ministry of Finance and sent to the National Congress in the second semester of 1995, where by having been designated as reporter Deputy Mussa Demes, it received such denomination. That proposal is limited to the dispositions contained in the chapter that deals with the national tributary system in the Federal Constitution, not presenting great innovations. It registers the beginning of the reform process planned by the government.

In the following period much was said about the government's proposal, which provoked a lot of discussions among representatives of the states, people and entities linked to the fiscal and tributary areas.

Other ideas and pretentious proposals of reform appeared, and one of them, here denominated "Ponte Amendment", by the designation of Deputy Luís Roberto Ponte as its reporter, caught more attention. It proposes a great simplification of the system with the reduction of practically the whole current tributary structure for only one tax: the "Single Tax".

In the continuity of the discussion process the government, through the Ministry of Finance, returns to the scene presenting a new proposal, different from the first. It is being coordinated by the Secretary-executive of that organ and it received the denomination of "Pedro Parente Proposal".

After that, most of the discussion has been about the changes imposed on the states, the ones which, mainly those with more economic-financial autonomy. They have zealously acted in conjunction with the ministry of Finance in order of to make it uniform conciliating the interests of the different tiers of government involved.

Thus, now it is spoken in an alteration of the "Pedro Parente Proposal", which, even not yet having been officially submitted to the National Congress for evaluation has been having its main points informally presented to parliamentarians and disclosed through the press.

### A. The "Mussa Demes Proposal"

#### 1. Main Points

- Consistency of the legislation all over the country.
- Elimination of IPI and creation of national ICMS, divided in federal ICMS and state ICMS.
- Adoption of the principle of destination without need of border adjustment.
- All the brackets would be determined by the Senate.
- Non incidence of ICMS and IPI on Capital Goods.
- Linking the collection of federal ICMS payable on fuels to the application in construction and conservation of highways.

#### 2. Pros and Cons

- The consistency of the legislation and the fact that the brackets would be determined by the Senate would eliminate the fiscal war among the states.

- New ICMS should be payable in two documents, one for the state and another for the union.
- The sum of the brackets of two ICMS would be the same in the internal operations and in the interstate ones.
- It doesn't simplify the current model and has the problem of the brackets calibration once with the application of the collection in the destination. There would be significant losses of revenues for some states which would probably imply a significant increase of the brackets on the value added in order to maintain the same revenue.
- The exemption of capital goods would bring the credit accumulation in producing sectors of those goods.
- It doesn't eliminate the incidence of the taxes in cascade.

## B. The "Ponte Amendment"

### 1. Main Points

- Creation of a excise tax on the production, circulation, distribution or consumption of drinks, vehicles, tobacco, petroleum and fuels, services of electrical energy and telecommunications whose estimated collection would be of 15% of GDP if the prices of the cigarettes, drink and vehicles were maintained, and the prices of the fuels and services of electrical energy and telecommunications were increased 25%.
- Creation of a tax on financial transactions, which would consist of a small bracket of 0.2% on the bank operations of credit and debit, or 0.4% only for debits which would provide an estimated revenue of about 5.2% of GDP and it would be totally destined to finance programs of social security.
- Creation of a tax on International Trade (Import and export) and another on the property (urban and rural), the ones which, together, would provide a revenue estimated in 1% at GDP.
- Creation of a tax on the profit of Brazilian companies with foreign capital in equivalent value to which those companies would be able to deduce from the income tax they should pay at the originating countries. There is not estimate on the amount to be collected, however it is supposed that would not represent a lot.
- Creation of a tax on the payroll destined to finance retirements. A rate of 10% up to a maximum value of 10 minimum wages would be charged. The estimated collection would be about 2.7% of GDP.
- The social security would be financed by society with resources of the budget of the union, states and Federal District and municipalities and from the social contributions on the employees' wages and on the income of the competition of various different lotteries.
- The system, according to the reporter of the proposal, would collect a total of 24% of GDP providing a decrease of the tributary burden of the current system between 4 and 5%.

### 2. Pros and Cons

- It is an extremely simplified system once it decreases in a significant way the number of current taxes.
- The basis of taxation is payable practically on the consumption and the financial transactions, however, the tax is payable equally on taxpayers with different levels of income, characterizing

the inequity of the system.

- The profit is not taxed as a form of income, except that of the foreign companies.
- Property and income are slightly taxed.
- There is no statistical data and reliable simulations on the necessary brackets to maintain the current collection in terms of GDP.

### C. The "Pedro Parente Proposal"

#### 1. Main Points

- Extinction of tributes on the Consumption (IPI, CSLL, COFINS, PIS and PASEP).
- Transformation of ICMS in Value Added Tax - Federal VAT, payable on goods and services under a unique and inferior bracket in relation to the current ones of ICMS.
- Creation of Retail Sales Tax - State IVV payable on all the products under a unique bracket.
- Creation of the Tax on Services under the municipalities' competence, payable under a unique bracket on final services.
- Creation of the Excise Tax, under State competence, payable on sales to the final consumer on a limited number of goods with high capacity of collection and with difficult level of tax evasion, as: tobacco, drinks, telecommunications, energy and fuels.
- Maintenance of IR, with brackets adjusted in function of the extinction of CSLL, and maintenance the regulatory taxes: IOF, II and IE.
- Creation of a National Fund for compensation of the losses of collection of the States in the transition phase.

#### 2. Pros and Cons

- Simplifies the system once it unifies the internal and interstates brackets, eliminates the discussion on origin and destination putting an end to the "fiscal war" among States.
- It allows to accomplish the tributary harmonization with others countries since many countries use VAT as a form of taxation on consumption.
- It centralizes the taxation system on consumption, thwarting the federalist character, and increasingly distances taxpayers.
- It presupposes impracticability, under the political point of view, concerning the necessary magnitude of the National Fund of compensation.
- States lose political and financial autonomy, starting to depend on Federal Government resources.
- It demands the adoption of high taxation brackets on consumption to compensate the maintenance of the low collection of taxes on the income and property.

### D. The Current Proposal of the Government

The government's economic team has not yet concluded the new proposal of tax reform that it will send to the National Congress in the year of 1998. The constitutional amendment is being formalized parallel with discussions among representatives of the Ministry of Finance and of States and these are the main points of the reform negotiation:

- Creation of the Excise Tax, which will be payable on a group of goods and services. Initially thought as a state tribute, the Excise Tax should be Federal.
- Creation of the Value Added Tax - VAT, resultant of the union of the Tax on the Circulation of Goods and Services - ICMS and the Tax on Industrialized Products - IPI. VAT will be collected by States, although the definition of brackets is the position of federal law.
- Creation of the Retail Sales Tax - IVV, whose autonomy will be guaranteed to States, but in federal legislation will establish the brackets. The possibility to suppress municipal IVV (Tax on Services), giving to the city halls the possibility of participating in the state collection of that tribute by means of a pre-defined margin has been studied. Municipal IVV is being considered a tax of low collection potential and difficult to inspect.
- Extinction of the Tax on Services - ISS, PIS, PASEP and Social Contribution for the Financing of Social Welfare - COFINS.
- Definition as permanent the CPMF, which would work as an anticipation of the Income Tax with an aliquot of 0,50%.

According to the Ministry of Finance the four basic principles that are being adjusted and should be respected in the proposal are: guarantees for the maintenance of States revenue, compensation for losses of States, concession of fiscal incentives in order to maintain the policy of attraction of investments (fiscal War), simplification, transparency and combating tax evasion.

#### **IV. Final Remarks**

In August of 1995, the government sent its proposal of tax reform to Congress. As short-term measures, the project proposed the exemption of ICMS on export and reduction of taxes on capital goods. A compensation fund was created for the states exporters and ICMS was reduced on the basic basket of necessary goods. It incorporated the Tax on Industrialized Products (IPI) to ICMS with federal and state bracket and it transferred to States and municipalities the collection of the Rural Territorial Tax (ITR).

After almost a year of discussion of the proposal in the House of Representatives, when the reporter Deputy Mussa Demes, assumed the role of mediator of the divergent interests in the reform, the Federal Government decided to reject its opinion. The pretext was the preservation, by the deputy, of the fiscal incentives of the Zona Franca of Manaus and the creation of a fund for recovery of the federal highways.

A lot was discussed in that period about alternative proposals that could assist the interest of the nation. The "Single Tax Proposal", formalized through the "Ponte Amendment" stood out itself for its singularity, not being seriously considered.

In September of 1997 the secretary-executive of the Ministry of Finance, Pedro Parente, presented to the house of representatives a new proposal, radically different from the first one and that produced a great shrinking of the current tributary structure. The proposal foresaw the creation of a Value Added Tax - IVA, federal, which would substitute the ICMS, and the IPI. It was also foreseen the Retail Sales Tax - IVV, under state competence, and the Excise Tax on some products. During that time, a bill of responsibility of the minister Antonio Kandir, granted the exemption of taxes on the exports and on the import of capital goods.

In May of 1998, eight months after the declaration of intentions, Parente announced the presentation of the project to the reporter, with the increment of a tax, the Temporary Contribution on Financial Checking Transaction (CPMF). As the own name says it is temporary and everybody had assumed it would eventually be eliminated with the new tributary system.

The proposal of the government's economic team was well received in the sense of disburdening the productive chain, but it needed to be well negotiated regarding the tributary competence.

The basic premise for the new proposal was that any State would not lose revenue. Three alternatives were proposed in the case of revenue lost: in the creation of a compensation fund, the alteration of the tributary competence through an increase in the transference of the Union to the States and municipalities, and the calibration of brackets.

Fiscal incentives, however, would demand delicate negotiation. The project of Tributary Reform would not be able to put an end to the fiscal war. Both Federal and State of Sao Paulo governments, main opponents of the intensification of the offer of fiscal incentives used by States to attract private investments, agree with the maintenance of that policy for a period that can extend for more than four years. Even after ending the ICMS, for the current proposal, the states would continue to be able to maneuver regarding incentives, but only in the period of transition of the new tributary model, whose period is not still defined.

Using the possible artifices of the fiscal war, States without productive tradition got, in the last years, to install in its territories great factories, especially in the automobile sector. This threatened the industrial hegemony of São Paulo. To compensate the lack of infrastructure, governments as the ones of Rio de Janeiro, Minas Gerais, Paraná and of States of the Northeast region offered extensions in the period for payment of ICMS which, in practice, corresponded to exemptions of taxes in the first years of the investment.

With the substitution of ICMS for VAT, what will be put together is a federal tribute, the IPI and a municipal one, the ISS. The collection would be completed in the destination of goods (local of the consumption) and not in the production origin. With that, the States exporters would lose, in practice, autonomy to offer benefits in its territories. The new model would calibrate the brackets, nowadays differentiated in each State, and it would create, firstly, a chamber of compensation, to avoid collection loss.

With the recent announcement of the Program of Fiscal Stability, the Federal Government turned to appeal to the National Congress to accelerate the program of reforms. The Ministry of Finance, convinced of the difficulties that the "Pedro Parente Proposal" imposed the approval of the intended changes. After discussions with representatives of the States, has been disclosing informally the probable changes which there should be made in the in the proposal of the government.

The rejection of the text presented in September of 1997 has decreased more with the changes recently defined, as the transfer of IVA to the States and the creation of an independent agency to discuss the losses.

There are still some unsolved questions. The main resistance point is the difficulty for States in granting incentives to companies with the collection of the VAT, the main source of resources for States, in the consumption zone (in the destination) and not in the production of origin, as it happens nowadays with the ICMS.

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