THE GEORGE WASHINGTON UNIVERSITY
SCHOOL OF BUSINESS
INSTITUTE OF BRAZILIAN ISSUES – IBI
THE MINERVA PROGRAM – SPRING 2014

TAXATION AND DEVELOPMENT IN BRAZILIAN STATE TAX SYSTEM: SENATE RESOLUTION 13/2012 AND "FISCAL WAR OF PORTS".

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WASHINGTON, DC
APR-21-2014

Abstract

When the year 2013 ended, just a few months ago, Brazilians had at least one more great reason to celebrate: the first anniversary of the well succeeded Brazilian Senate Resolution 13/2012 (R13). Briefly, R13 is a Senate act aimed to put an end to the so-called “Fiscal War of Ports” (FWP). Although R13 was an unquestionable success, it has left a great discussion on whether or not the benefits of investments attracted to a particular state exceeds the costs to that state of giving up tax revenues due to the FWP tax benefits. An answer to that question cannot be given without addressing the relationship among taxation, economic efficiency, and economic development. Our objective at this research paper is to present an introductory discussion of the relationship between taxation and economic development, considering the figures generated by R13 impact over interstate sales of imported products. As we will see, targeted tax benefits conceded over interstate sales taxation on imported goods, that emerges from the complex Brazilian state tax system, presents a negative effect over resource allocation and economic efficiency of the Brazilian importing sector. More importantly, the Brazilian state tax system plays a major role in the regional economic development, which is ought to be accurately assessed. Therefore, the assessment of that role will ultimately bring forth evidence on the relationship between taxation and economic development.

Key words: Taxation, Tax System, Tax Reform, Economic Development, Targeted Tax Benefits, Fiscal War of Ports, Brazilian Senate Resolution 13/2012.

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INTRODUCTION

When the year 2013 ended, just a few months ago, Brazilians had at least one more great reason to celebrate: the first anniversary of the well succeeded Brazilian Senate Resolution 13/2012 (R13). Briefly, R13 is a Senate act aimed to put an end to the so-called “Fiscal War of Ports” (FWP), a competition among the states of the federation to attract investments through the concession of tax benefits. Although R13 was an unquestionable success, it has left a great discussion on whether or not the benefits of investments attracted to a particular state exceeds the costs to that state of giving up tax revenues. An answer to that question cannot be given without addressing the relationship among taxation, economic efficiency, and economic development.

Brazilian states, in order to attract investments from companies that otherwise, for economical reasons, would decide to settle their subsidiaries in another state, have offered to such companies special tax regimes in which substantial tax benefits are conceded. These tax regimes would take the form of tax credits over interstate sales of imported goods, reducing considerably the amount of sales taxes that would be due by those firms.

Accepting those special tax regimes, firms need only to change the original port through which they imported their goods to the port of the conceding state. Doing that, sales tax over importing goods operations that would be owed to the state of the original port are then collected to the conceding state, which earns the difference between tax revenue collected and credit tax benefit conceded. Therefore the original state looses all tax revenue from that operation, and firms earn the tax benefit, paying less sales tax eventually.

Several issues have arisen from these special regimes regarding cost benefit analyses to the public point of view, but also related to the fact that Brazilian courts have been considering them to be illegal, implying lawsuits among importing firms and damaged states.

R13, aiming to cease "Fiscal War of Ports", has decreased the tax rate applied over imported products in interstate sales in order to reduce the amount of tax revenues that these operations generate. Thus, R13 has decreased the profits that could be extracted from the operations in the form of tax benefits, diminishing the firms' willingness to accept those special regimes.

Resolution 13, intended to be part of a major reform in Brazilian state tax system, brought forth evidence of the taxation effects over economic efficiency and, ultimately, over economic development, which has been for more than ten years the main issue in the Brazilian political agenda, and became as well the main issue driving the tax reform discussions.

In fact, tax reform is a priority in the Brazilian political agenda, and it has been driven mainly by the discussions about the burdensome economic effects tax systems can create. There is no doubt that taxation plays an important role in the economic efficiency and growth determination. Reforming tax systems has its motivation based generally upon bringing the law into closer adherence to certain economic principles and goals. Nevertheless, there is either no or very little understanding of how much taxation would imply economic development.

Depicting briefly the modern literature on development economics and recent academic works on taxation and development, our objective here is to present an introductory discussion of the relationship between taxation and economic development, considering the figures generated by R13 impact over interstate sales of imported products.

As we will see, targeted tax benefits conceded over interstate sales taxation on imported goods, that emerges from the complex Brazilian state tax system, presents a negative effect over resource allocation and, thus, economic efficiency of the Brazilian importing sector. More importantly, the Brazilian state tax system plays a major role in the regional economic development, which is ought to be accurately assessed. Therefore, the assessment of that role will ultimately bring forth evidence on the relationship between taxation and economic development.

To perform this task the research paper will be structured in the following way:

1. First, in chapter one, an overview of the Brazilian state tax system will be presented specially regarding the interstate sales taxation and the “Fiscal War of Ports”;
2. Second, in chapter two, the main ideas regarding economic development will be discussed, as well as the most accepted contemporary strands of thought that can illuminate the path to a more clear understanding of the role that taxation plays in the development process. Also, the discussion about the usefulness of tax benefits to affect economic development will be addressed considering some economic important concepts.
3. Finally, in chapter three, the figures from R13 impact on the “Fiscal War of Ports” will be analyzed, demonstrating the negative effect of FWP targeted tax benefits on resource allocation and economic efficiency, and, equally important, bringing forth evidence to the negative relationship between targeted tax benefits and economic development.

At the conclusion, the precedent findings will be revisited in order to outline relevant points that must be addressed in the Brazilian state tax system reform.

1. BRAZILIAN STATE TAX SYSTEM

1.1. A Glance at Brazilian State Tax System

The 1988 Brazilian Constitution was the legal mark of a new, though extremely complex, tax system.

The 1988 Constitution split tax competencies among all Federal units, assigning different kinds of taxes to each one, for instance: the Union is allowed to levy an income tax, whereas the states and the Federal District levy a kind of consumer tax, which in Brazil is named, freely translating, the Tax over Operations on the Circulation of Merchandise and Services (ICMS - in Brazilian initials).

As the Constitution states, there are also complementary and ordinary laws that establish tax norms. In regulating those laws there is a whole sort of sublegal acts.

The complementary laws establish general norms with regard to the definition of taxes, tax bases, taxpayers, and tax obligations, whereas the ordinary laws impose taxes in a detailed manner. Brazilian Congress votes on both complementary and ordinary laws regarding federal taxes, however the former requires a qualified quorum and the latter a simple quorum of absolute majority.

The states, in turn, can pass only ordinary laws in order to impose their own taxes. At last, there is also taxation at the federative local level, called the municipal level, which will not be addressed at this work.

The Brazilian federation is comprised of 26 states plus the Federal District of Brasilia, and of more than 3,000 municipal units, each of them also imposing their own taxes.

Based on a 2013 research study, the Brazilian Institute of Planning and Taxation (IBPT) accounted[1] that since 1988, Brazilian congressmen, legislative officers and executive officers passed 4,785,194 laws, comprising of complementary and ordinary laws, decrees, executive provisory acts, constitutional amendments and others, representing a daily production of 784 laws. Tax laws amounted to 309,147 in the same period, corresponding to 6.5% of the total laws passed.

Complexity is a key word defining the Brazilian tax law system, not only in terms of the huge quantity of tax laws, but also in terms of the highly unsystematic arrangement among them, leading to a chaotic scenery.

Brazilian geography, human aspects and natural aspects are elements that impose more complexity to the system.

The country is divided geographically into five different regions: North, Northeast, Southeast, South, and West-Central. The Southeast region is the most prosperous and most highly industrialized, comprising of the states of São Paulo, Rio de Janeiro, Minas Gerais, and Espírito Santo.

Conversely, the Northeast region is the least developed due in part to its harsh physical conditions and to its particular historical process of formation. In addition, there is a lack of investment in the Northeast region due to the fact that the South and Southeast regions have better physical infrastructure to attract capital inversions from both internal and foreign investors.

This present work will focus on the Brazilian state taxation system from which emerges the "Fiscal War of Ports" issue, specifically due to the imposition of the ICMS tax.

ICMS, as previously mentioned, is the initial letters in Portuguese of what in English could be translated, freely, as Tax over Operations on the Circulation of Merchandise and Services.

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[1] In "*Normas Editadas no Brasil: 25 anos da Constituição Federal de 1988*", Brazilian Institute of Planning and Taxation - IBPT, data collected until September, 30th, 2013.

There is a never-ending discussion over the legal meaning of the word merchandise in the ICMS tax name. In this work, for the sake of simplicity, we will treat merchandise and goods interchangeably. Nonetheless, that treatment will not cause any relevant loss for the discussion due to the fact that there will be no difference in the interstate trade analysis regarding the type of goods traded.

Here, thus, we are interested in one type of transaction: the interstate trade of imported goods. Among other transactions, the ICMS is applied to the trading of goods from one state to another. For those operations the tax rate changes depending on the states involved and is defined by the Brazilian Senate.

In fact, state ordinary laws establish the tax rate over operations that occur within the state borders, whereas the Brazilian Senate, by means of a resolution, defines the tax rate over operations that cross state borders.

For example, in the state of São Paulo the internal flat tax rate over the majority of operations is 18%, whereas in other states the internal flat tax rate is 17%.

In interstate operations though, the tax rate depends on both the state of origin and the state of destination. For instance, in operations between states from the South and Southeast regions, which include the state of São Paulo, the interstate tax rate is 12%, and between a state from either the South or Southeast region and the Northeast one is 7%.

Furthermore, the Brazilian Senate, by means of Resolution 13, passed in 2012, aiming to cease the "Fiscal War of Ports", has created a new distinction[2] among interstate tax rates. It lowered the tax rate over interstate operations of imported goods to 4%. As a result, when a company is selling its products to a client from another state it is mandatory to separate the sales of goods produced in Brazil from the

[2] For the sake of simplicity, we will avoid to address too much detailed issues regarding Resolution 13.

sales of imported goods from abroad, applying to the former a tax rate of either 12% or 7%, and to the latter a tax rate of 4%.

Before we explain the reasons behind Resolution 13, which will be discussed in a detailed manner only in the chapter three, we need to understand the most important feature of the ICMS tax: its non-cumulative calculation.

The ICMS tax rate is applied over the invoice face value of the acquisition and paid by the selling company, whereas the purchasing company registers this same value, paid by the selling company, as a credit in its ICMS assessment account.

Now, when this former purchasing company sells the same product it will apply the tax rate over its selling price, which will be presumably higher than the acquisition price, giving that it makes profit. As a result, the amount o ICMS levied is equal to the tax value paid in the acquisition plus the tax rate over the value added (profits) in its current operation.

However, the non-cumulative feature determines that this company pays an amount correspondent to the total amount of tax calculated in the sales operation minus the value appropriated as a credit in the ICMS assessment account, which is exactly the total amount of tax calculated in the precedent acquisition.

At the end of the day, the company will pay ICMS only over the value that it has added, avoiding double counting, or, in other words, cumulative taxation. This is named the ICMS non-cumulative principle.

In the firms' accounting book will appear a credit corresponding to the tax paid for the acquisition of goods and a debit corresponding to the tax paid for sales of that same goods. The balance debit vs. credit will result, in a monthly basis, in the amount that will be owed and effectively paid to the state authority.

In the table below we present an example of two firms, a producer and a retailer, trading one particular type of good over which the ICMS tax rate is equal, lets' say, to 20%. At the end of this two firms chain the total amount of ICMS paid will be $300, the firma A paid $200, and the firm B paid $100, corresponding to an incidence over only the value added by this last firm.

Table 1: ICMS non-cumulative principle example.

First seller (producer) – firm A	
Price of the good: $1,000	
ICMS tax rate*: 20%	ICMS paid by firm A: $200

Second seller (retailer with 50% profit margin) – firm B	
Price of acquisition: $1,000	
ICMS paid by firm A: $200	Register an ICMS credit of: $200
Price of the good: $1,500	
ICMS tax rate*: 20%	Register an ICMS debit of: $300
	ICMS paid by firm B: $100

* Effective tax rate includes itself in its tax base. This detail was omitted here for the sake of simplicity.

1.2. The “Fiscal War of Ports”

Broadly speaking, fiscal war could be defined as a sort of contest among Federal Units, such as the Brazilian states, to attract to their territories either new factories or old ones already settled in another state.

According to Castilho and Silveira[3], there are two types of fiscal war in Brazil: the industrial and the commercial. The former is designed to attract physical capital either abroad or from another

[3] In “*A guerra fiscal não interessa a ninguém*.”, CAT Report (CAT - Taxation Management Coordination of São Paulo Finance Secretariat), São Paulo, n 48, 2005, p. 29-33.

Federal Unit, the latter is mainly focused on deviating the flux of commerce to pass within the conceding states territories in order to grab on part of the tax revenues that could be extract from the trade chain.

The “Fiscal War of Ports” (FWP), by its turn, could be defined as a competition among Brazilian states to attract investments to their territories by means of conceding fiscal incentives to either Brazilian or foreign trading companies under the condition of proceeding their importing operations through the conceding state harbors.

However, what is the nature of the FWP tax incentives? The ICMS non-cumulative principle is on the background of the tax benefits like the FWP ones in the sense that either one or both debit or credit accounts can be managed with government privileges received.

In fact, targeted tax breaks can be either one or both of two forms: direct concession of ICMS credits, increasing the credit account; or, in an indirect manner, postponing tax payment, which could be effectively done in small monthly parts for a long period of time, lets say 20 years.

To understand that mechanism we must present a numerical example. The following tables show two firms trading, firm A selling to firm B, each one in different states, in two different situations: in table 2, there is no tax benefit conceded; in table 3, firm A gets tax benefits in the form of direct concession of ICMS credits and in the form of tax payment postponing.

In that examples, for the sake of simplicity, we consider internal tax rates to be of 20%, as well as the ICMS over imports tax rate, and the interstate tax rate to be 10%. We also assume a credit benefit of 8% over the value of acquisition.

The first situation, presented in table 2, shows the interstate sale of imported goods from abroad in which there is no tax benefit conceded to the importing company. As we can see in the table, the trading company A pays to the State X the amount of $200 correspondent to the ICMS over the import operation, plus the amount of $100 correspondent to the ICMS over the interstate operation, minus the amount of $200 correspondent to the ICMS paid over the import operation trade due to the non-cumulative ICMS feature, corresponding to a balance of $300 eventually.

Table 2: Interstate sale of imported goods without tax benefits.

Firm A (trading company, importing goods) – State X	
Price of imported goods: $1,000	Paid by firm A due to imports: $200
ICMS over imports tax rate*: 20%	Registered as credit by firm A
ICMS over imported goods: $200	(non-cumulative principle): $200
Price of the good sold to firm B: $1,000	
ICMS interstate tax rate*: 10%	Registered as debit by firm A: $100
	ICMS owed by firm A to State X (200 + 100 - 200): $300

Firm B (acquiring imported goods from firm A) – State Y	
Price of acquisition: $1,000	Registered as debit by firm A
	equals to a credit registered by firm B
	(non-cumulative principle) : $100
Price of the good: $2,000	
ICMS tax rate*: 20%	Registered as debit by firm B: $400
	ICMS owed by firm B to State Y (400 – 100): $300

The firm B, located at State Y, which buys the imported product from the trading company A, located at State X, will pay a balance of $300 to the State Y.

Therefore, at the first situation, on table 2, both States X and Y will receive an amount of $300 as tax revenue.

At the second situation, presented in table 3, the State X concedes a tax benefit to the trading company A corresponding to a credit of ICMS of 8% over the value of the imported good and to postpone the payment of the ICMS incident over the importing operation.

As one can sees, the State Y will receive the same amount of tax revenues as in the previous situation.

Table 3: Interstate sale of imported goods with tax benefits.

Firm A (trading company, importing goods) – State X	
Price of imported goods: $1,000	Paid by firm A due to imports: $200
ICMS over imports tax rate*: 20%	Registered as credit by firm A
ICMS over imported goods: $200	(non-cumulative principle): $200
Price of the good sold to firm B: $1,000	
ICMS interstate tax rate*: 10%	Registered as debit by firm A: $100
	ICMS owed by firm A to State X (200 + 100 - 200): $300
	Direct credit conceded to firm A by State X (8%): $80
	ICMS over imported goods postponed: $200
Firm B (acquiring imported goods from firm A) – State Y	
Price of acquisition: $1,000	Registered as debit by firm A
	equals to a credit registered by firm B
	(non-cumulative principle) : $100
Price of the good: $2,000	
ICMS tax rate*: 20%	Registered as debit by firm B: $400
	ICMS owed by firm B to State Y (400 – 100): $300

* Effective tax rate includes itself in its tax base. This detail was omitted here for the sake of simplicity.

Notwithstanding, at this second situation, the State X will receive of tax revenues the amount of $20, corresponding to the amount of $300 originally owed minus the tax benefit conceded of $80 and minus the amount of $200 of the ICMS over imported goods that was postponed as part of the tax privilege.

The firm A will pay less ICMS due to the direct credit of $80 and will need to pay the ICMS incident over the importing operation in small payments for a long period of time.

The rationale for that is the willingness of states to attract investments by offering tax benefits like that. In the FWP context, trading companies will be attracted to conceding state territory and will start importing goods through the conceding state harbors.

FWP was originally thought to be an industrial type of fiscal war, by attracting investments in terms of physical capital, however it turn out to be in most of the cases just a commercial kind of fiscal war featuring no capital inversions at all.

Gaining rents and not having to invest at all, Firms will only be constrained to go for another state if operational costs of changing are higher than the benefits gained. However, empiric evidence shows that the "Fiscal War of Ports" has increased dramatically among several Brazilian states.

In fact, according to MACEDO (2006, p. 96), the state of Espírito Santo, the first to come up with this sort of tax benefits by 1970, has seen the increase of the number of trading companies settled within its boarders, from 21 in 1971, to 257 in 2000. Furthermore, during that period, the number of states that actively engaged in this type of fiscal war increased to at least ten, eventually.

During the year 2013, Senate Resolution 13 (R13) decreased the tax rate applied over imported products in interstate sales in order to reduce the amount of tax revenues that these operations generate for the states and, thus, the profits that could be extracted from firms in the form of tax benefits, diminishing their willingness to accept that kind of special tax regime.

Lets say that the original interstate tax rate is 10%, like in the previous examples, and that R13 has decreased that tax rate to 4%. The states conceding tax benefits of 8% will not have room to do it anymore at this same level of benefit. In fact, 4% is maximum rate that states could give as benefits, which would imply a total exemption of tax. However, that wouldn't be interesting to conceding states due to the fact that the concession is worthless to them if they cannot get any tax revenue of it. For that reason, conceding states will have room to concede tax benefits of only 3% or less.

By its turn, firms will make a decision to move to the conceding state only if the revenues they could extract from tax benefits are higher than the costs of moving. Firms would certainly incur in operational higher costs to start importing through a harbor that is more distant from the consumer market of its products, such as transportation costs. They will also incur in administrative extra costs to settle an operation in another state.

Eventually, the profits that could be extracted from, lets say, 3% of tax benefits rate would not be attractive to embark in an operation that relies on a fiscal war largely reproved by Brazilian society and effectively often condemned by Brazilian courts.

2. TAXATION FOR DEVELOPMENT

2.1. Brief Discussion on Development

At this chapter we intend to introduce a discussion about the theoretical foundations that could explain why the FWP is either a good or a bad tool for economic development. At this present subchapter we will discuss briefly the concepts of economic development that we will use throughout this work, and in the next subchapter the relationship between development, taxation, and tax benefits. In the last subchapter we will borrow the main lines from the interesting economic concepts of targeted tax benefits, rent seeking and others to build a major criticism on FWP benefits.

The economic and social development has been a priority at the agenda of most countries during the past centuries.

According to TODARO (2013, p. 111), the post-World War II literature on economic development has been dominated by four major strands of thought: (i) the linear-stages-of-growth model, (ii) the theories and patterns of structural change, (iii) the international-dependence revolution, and, (iv) the neoclassical, free-market counterrevolution.

Linear-stages-of-growth theorists view the process of development as a series of successive stages of economic growth through which all countries must pass. It was only a matter of choosing the right amount of savings, investment and foreign aid in order to proceed along an economic growth path that historically had been followed by more developed countries. The main models behind this theory are the Rostow's Stages of Growth and the Harrod-Domar Growth Model.

In 1970's, a sector of economic theorists came up with the idea that economic growth depends largely on structural changes inside the developing country. This strand of economic thought, as well as the previous one, indentified economic development with rapid economic growth.

Conversely, the international-dependence school enlarged the concept of development to hold, no only economic growth objectives, but also the idea of poverty eradication and income inequalities reduction. That school of economic thought viewed underdevelopment in terms of international and domestic power relationships, institutional and structural economic rigidities, and the resulting proliferation of dual economies and dual societies within and among the nations of the world.

For them, underdevelopment is thus seen as an externally induced phenomenon, in contrast to the linear-stages and structural-changes theorists stress on internal constraints such as insufficient savings and investments or lack of education and skills.

The fourth approach to development, the neoclassical counterrevolution, which dominated the scene of the 1980's and 1990's, argued that the failure to develop is not due to exploitive external and internal forces as expounded by dependence theorists, but primarily the result of too much government intervention and regulation of the economy. The neoclassical approach emphasizes the beneficial role of free markets, open economies, and the privatization of inefficient public enterprises.

Traditional neoclassical models of growth are direct outgrowth of the Harrod-Domar and Solow models, which both stress the importance of savings. The Solow neoclassical growth model in particular represented the seminal contribution to the neoclassical theory of growth.

The poor performance of neoclassical theories in illuminating the sources of long-term economic growth has led to a widespread dissatisfaction with traditional growth theory.

The free-market reforms adopted by Less Developed Countries during the 1980s and 1990s, liberalization of trade and domestic markets, which were intended to imply higher investment, rising productivity, and improved standards of living, eventually resulted in either little or no growth and failed to attract new foreign investment or to halt the flight of domestic capital in those countries.

The anomalous behavior of developing-world capital flows, from poor to rich nations, helped to provide the impetus for the development of the concept of endogenous growth, persistent GNP growth that is determined by the system governing the production process rather than by forces outside that system.

Currently there is a growing feeling among theorists that all of these approaches to understanding economic development has something to offer.

International-dependence theory alerts us to the importance of structural economic problems and the many ways in which decisions made in the developed world can affect lives of millions of people in the developing world.

Although a good deal of conventional neoclassical economic theory needs to be modified to fit the unique social, institutional, and structural circumstances of developing nations, there is no doubt that promoting efficient production and distribution through a proper functioning price system is an integral part of any successful development process.

As a result, because both market and government can fail, that provides space for defendable contemporary conceptions of development in which there is market mechanisms empowerment balancing with oriented state interference in economy towards economic development targets with economic efficiency promotion though.

Currently, sophisticated approaches such as the one led by Daron Acemoglu has posed more importance to the role of institutions and individuals to build their own path to economic development.

In ACEMOGLU and ROBINSON (2012, pp. 398, 460) own words: "*Nations fail economically because of extractive institutions. These* *institutions keep poor countries poor and prevent them from embarking on a path to economic growth. [...] What can be done to kick-start or perhaps just facilitate the process of empowerment and thus the development of inclusive political institutions? The honest answer of course is that there is no recipe for building such institutions. Naturally there are some obvious factors that would make the process of empowerment more likely to get off the ground.*".

Finally, in Amartya Sen's (1999, p. 14) words: "*Development has to be more concerned with enhancing the lives we lead and the freedoms we enjoy. Expanding the freedoms that we have reason to value not only makes our lives richer and more unfettered, but also allows us to be fuller social persons, exercising our own volitions and interacting with – and influencing – the world in which we live.*".

Although introducing a broad concept of development, Sen, as well as Acemoglu and Robinson, makes a point that there is a whole sort of human problems and necessities that must be taken into account in order to set a development policy.

2.2. Taxation and Tax Benefits for Development

As stated previously, this work is intended to be also an introductory discussion about the role that taxation plays in the economic development process.

As we have seen, development is a complex issue not only in terms of what it really means but also in terms of the real possibilities to attain it. So far we have discussed about those different views and difficulties that it involves.

However, whether positively or negatively, there are no major dissidences about the important role that taxation plays in the development process.

According to DAVIS and TREBILCOCK (2008, p. 02), over the past two decades there has been a resurgence of interest, on the part of both academics and practitioners, in using law to promote development in Latin America, sub-Saharan Africa, Central and Eastern Europe, and Asia.

In the early stages of the law and development studies though there was an excessive focus on the establishment and enforcement of the rule of law.

Notwithstanding being an important component of the law systems, taxation has never been effectively studied until recent years as instrument for economic development.

Indeed, tax law is not only part of a necessary rule of law adoption but also plays a direct role into the economy efficiency as a whole. Both these aspects are evidently crucial ingredients in any development recipe.

The Organization for Economic Co-operation and Development (OECD) task force on tax and development stated the following five reasons why taxation plays a central role in promoting sustainable development:

i) Tax revenue provides developing countries with essential and sustainable funding;
ii) Tax revenue reduces aid dependency;
iii) Stable and predictable tax systems provide a key platform for trade and investment;
iv) A fair, transparent and credible tax system has a positive impact on accountability and effectiveness in other parts of government;
v) Dependence on citizens' tax revenues for social and public services strengthen the accountability of governments to their citizens.

From the list above one can see clearly the importance that the OECD task force poses over taxation to provide substantial and accountable funding for developing countries.

Notwithstanding, one important feature of tax privileges granted in the "Fiscal War of Ports" is that it waves tax revenues in order to benefit just a particular company or industry sector. In other words, the benefits conceded in the FWP are indeed a way of resigning revenues in favor of some sort of an allegeable higher objective such as regional development stimulation.

Whether waiving revenues or, as we will see later, directly affecting economic allocation of resources, the FWP is an instrument of taxation policy for state governments to be used carefully, otherwise its costs could be carelessly easily understated when compared with its intended benefits.

In conclusion to this section, whether negative or positive, there is strong evidence of the important role that taxation and tax benefits play in determining conditions a healthy economic environment and to economic development.

2.3. Targeted tax benefits in “Fiscal War of Ports”

Now that we presented our assumptions in the previous sections, based on the main strands of the economic thought, we can better understand the issues related to the particular case of the “Fiscal War of Ports”.

The main feature of the “Fiscal War of Ports” benefits is that they are not intended to provide an overall lowering of taxation. They are targeted tax benefits, though.

In fact, the special tax regimes granted to trading companies on the fiscal war context are a sort of targeted tax relieves that either provide direct reduction of the amount of tax owed or at least postpone the payment flow of the tax obligations. Only companies importing goods from abroad are gifted with this sort of tax revenue waiving.

Indeed, special tax regimes of ICMS cannot be considered to be part of an overall reduction of taxation level, which has a positive implication in the private investment growth in macroeconomic terms.

Nonetheless, tax benefits conceded to trading companies are targeted tax brakes, they are indeed tax privileges, which have negative implications to investment and growth.

In fact, as MITCHELL (2012, p. 14) states, there are several economic and social costs associated with tax privileges, such as monopoly costs associated, productive inefficiencies, rent-seeking, distributional effects, unproductive entrepreneurship, loss of innovation and diminished long-run economic growth etc.

In order to discuss some of these issues, lets imagine that the economy is comprised of only a group of producers that is importing only one particular good from abroad. Following the concession of tax benefits by a particular state, due to a number of reasons that do not matter for the purposes of this analysis, not all but some of the producers decide to import the good from abroad through the harbor of the conceding state, earning tax privileges.

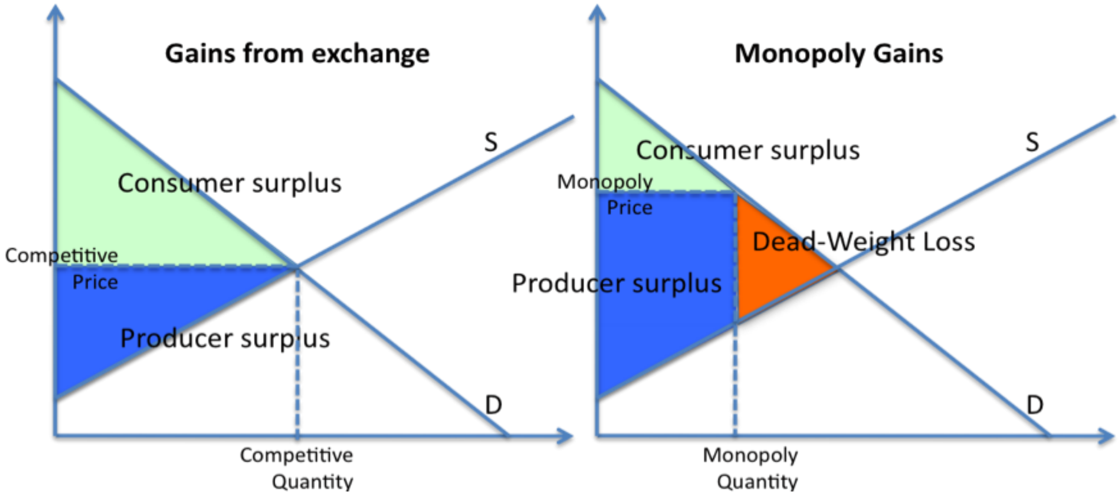
Some of the tax benefit concession effects that will take place are as follows:

i) Firstly, the gifted firms will possess pricing power that wouldn't exist in a competitive market without targeted tax benefits. If we suppose profit-maximizing firms then the gifted firms will set higher prices accruing the monopolistic rents.

As we can see in chart below, firms with monopolistic power gain more from exchange than in a competitive arrangement. Also, consumers loose part of their surplus due to the fact that prices will be in a higher level. Would-be competitors, those not blessed with monopoly privilege, lose out on the opportunity to gain from exchange. Lastly, total sales decrease and monopolist's gains are less than losses of consumers and would-be competitors, implying deadweight loses. Hence, society as a whole is worse off.

The chart below shows the change in consumer and producer surpluses due to the monopolistic power gained.

Chart 01: Changes in consumer and producer surpluses.



ii) Secondly, firms are willing to go to some effort to obtain and maintain tax privileges due to the substantial monopolistic rents they can provide.

It costs money to producers to obtain and maintain monopolistic powers. They will donate to political campaigns, sponsor studies and advertisement, maintain expensive lobbying operations, and go to great lengths to curry favor with politicians.

Economists refer to these activities as "rent-seeking". Because it requires time, money, and efforts and it does not create any value to consumers, it is another social cost of government-granted privilege.

The resource costs associated with rent-seeking can be substantial. As mentioned by ROSEN and GAYER (2014, p. 124), referring to a survey released in the Wall Street Journal in 2010, was found that 89 executive lobbyists in Washington, DC, earned more than $1 million dollars, with the head of a drug-industry lobby earning nearly $4.5 million and the leader of a business lobbying group earning over $5.5 million.

iii) Third, targeted tax benefits shift signals in the economy, and affect innovation. While interfering in the price system, tax privileges change the incentives for innovation, creating the so-called unproductive entrepreneurs.

As referred by MITCHELL (2012, p. 19), the New York University economist William Baumol hypothesized that when governments hand out rents, talented people will be less likely to engage in productive entrepreneurism and more likely to engage in unproductive or even destructive entrepreneurism by focusing efforts to rent-seeking innovation, such as discovering previously unused legal gambit able to divert rents to the first who exploit it.

iv) Finally, rent-seeking firms are less likely to innovate, and thus affect long-run economic growth negatively.

As referred by MITCHELL (2012, p. 20), empirical research supports this claim. He cited two of them: the first, lead by economists Stefanie Lenway, Randall Morck, and Bernard Yeung, found that the most active lobbyers companies, among 130 steel firms, tend to be larger, older, less diversified, and less profitable that non-lobbyers companies; the second, lead by economists Mara Faccio, Ronald Masulis, and John McConnell, concluded that among bailed-out firms, those that are politically connected exhibit significantly worse financial performance than their nonconnected peers.

There is no doubt that economic growth will be affected negatively as protected firms become less innovative.

In fact, in Mitchell's words: "*Whatever its guise, government-granted privilege is an extraordinarily destructive force. It misdirects resources, impedes genuine economic progress, breeds corruption, and undermines the legitimacy of both the government and the private sector*".

As a result, there are a number of good reasons and strong evidences for not accepting target tax benefits as a way to promote economic development.

3. THE FWP NEGATIVE ECONOMICAL EFFECTS

3.1. Structuring the Problem

At this chapter we will present and analyze foreign trade figures from the most engaged Brazilian states on the “Fiscal War of Ports” that bring forth evidence on the FWP negative economical effects, especially over resource allocation and over the efficiency of the economy as a whole. It also brings forth evidence on the negative relationship between FWP benefits and economic development ultimately.

The figures that will be presented and analyzed at this chapter, as we will see, demonstrate that the application of Senate Resolution 13 during the year 2013 has shifted foreign trades back to the state of São Paulo from some other states like Santa Catarina and Espírito Santo, which were the most active states in conceding special tax regimes in the FWP context.

In fact, according to MACEDO and DE ANGELIS (2013, p. 200), animated by the liberalization of Brazilian foreign trade constraints during the 1990’s, the state of Espírito Santo actively engaged in the concession of FWP tax benefits to progressively increase its share on Brazilian imports from 3% to more than 4.5%. Also, the state of Santa Catarina, which has engaged in the FWP more recently, increased its share on Brazilian imports during the 2,000’s from 2% to more than 6%.

As we’ve seen in the first chapter, during the year 2013, R13 decreased the tax rate applied over imported goods in interstate sales in order to reduce the amount of tax revenues that these operations generate and, thus, the profits that firms could extract from them in the form of tax benefits, diminishing their willingness to accept those special regimes.

As a result, before R13, these special regimes have distorted the firm's allocation of their foreign trade operations among the Brazilian ports. However, after R13, without those tax benefits, there was no more incentive to comprise the decision making process with such privileges, implying a shift back of trading companies to the state through which their import operations would generate an optimum level of profits.

The observed figures of 2013 show that R13 triggered a shift back of imports from some states as Santa Catarina to the state of São Paulo, demonstrating undoubtedly that FWP targeted tax benefits were effectively distorting firms decisions before R13. Such observed shift back on imports also demonstrates that after R13 firms started to consider in their decision process more economical reasons of efficiency.

3.2. Figures from Resolution 13

As stated previously, attempting to cease FWP, R13 has decreased the ICMS tax rate over interstate operations with imported goods. By doing that, it took out of the scene distorting incentives to resource allocation and triggered up a shift back of the volume of foreign trade of goods to the state of São Paulo.

The following table presents the figures of foreign trade imports in the four most active Brazilian states in conceding FWP benefits as well as the figures in the state of São Paulo state, during the last 10 years.

The columns show the amount of foreign trade imports in millions of Brazilian Reais (R$) of each of the five states most engaged in the FWP, including the state of São Paulo, and the percentage share that each one represents in terms of the total Brazilian foreign trade imports during the year, which is shown in the last column.

It is also worth to mention that we have selected for this study only the states of Santa Catarina, Espírito Santo, Paraná and Goiás, due to the fact that they were some of the most engaged states in the Fiscal War of Ports and due to its geographic proximity to the state of São Paulo, which undoubtedly leads to a higher likelihood of competition among the formers and the latter states.

The period of 10 years was chosen due to the fact that since 2004 the FWP faced a dramatically increase as either new states got into the war or old ones enhanced their pace.

Table 4: Foreign trade imports figures for states engaged in the FWP.

	São Paulo	%	Santa Catar.	%	Goiás	%	Paraná	%	Espír. Santo	%	Brazil
2004	27,104	43.13	1,509	2.40	626	1.00	4,026	6.41	3,011	4.79	62,836
2005	30,492	41.43	2,189	2.97	724	0.98	4,527	6.15	4,089	5.56	73,600
2006	37,047	40.55	3,469	3.80	993	1.09	5,978	6.54	4,896	5.36	91,351
2007	48,419	40.14	5,000	4.15	1,702	1.41	9,018	7.48	6,638	5.50	120,617
2008	66,351	38.36	7,941	4.59	3,050	1.76	14,570	8.42	8,607	4.98	172,985
2009	50,488	39.53	7,288	5.71	2,853	2.23	9,621	7.53	5,484	4.29	127,722
2010	67,787	37.29	11,978	6.59	4,175	2.30	13,957	7.68	7,595	4.18	181,768
2011	82,184	36.32	14,841	6.56	5,728	2.53	18,768	8.30	10,738	4.75	226,247
2012	77,826	34.87	14,552	6.52	5,125	2.30	19,388	8.69	8,698	3.90	223,183
2013	89,759	37.46	14,779	6.17	4,840	2.02	19,344	8.07	7,436	3.10	239,627

Source: MDIC.

As we can see from the table, foreign trade import figures during the past 10 years show a steady shift on the importing operations share among some Brazilian states.

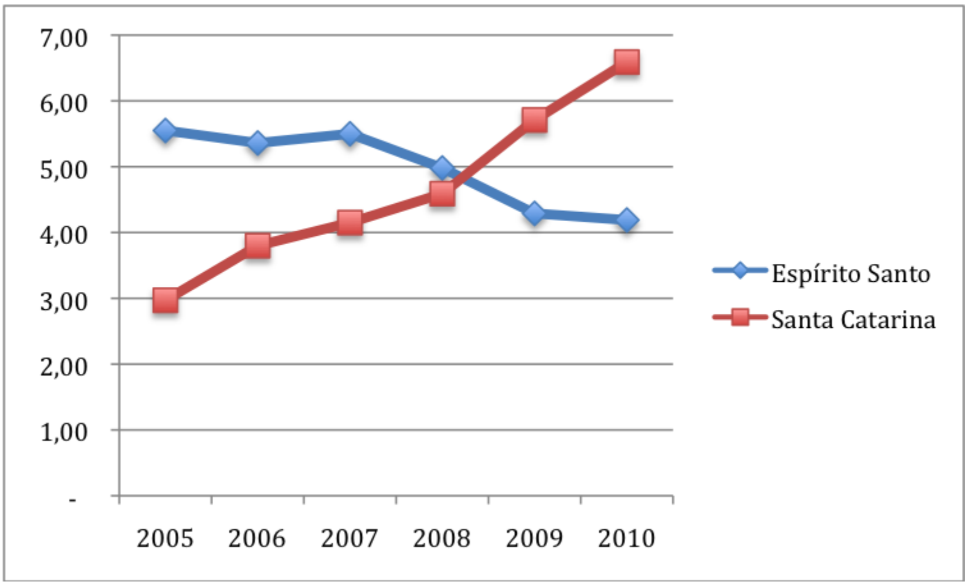
For instance, there was a steady increase in the state of Santa Catarina share of Brazilian imports until year 2012, whereas on the same period there was a steady decrease in the state of São Paulo share of imports.

The state of Goiás is another example of an increasing share trend on the national foreign trade import figures during that same period.

Noticeably, the state of Espírito Santo, one of the major FWP players, faced a steady decrease in its share of Brazilian imports since

2005 until 2010 due to a negative shift effect towards the most actively state in the FWP at that period, the state of Santa Catarina.

The following chart shows the shift effect of import towards the state of Santa Catarina until the year 2012. The vertical axis is marked in percentage of share.



In fact, the state of Santa Catarina presented an aggressive program of incentives, attracting towards its territories a major part of the trading companies that have moved in the past to either the state of Espírito Santo or to other states involved in FWP. In 2011 though, the state of Espirito Santo recovered the growth of its import figures.

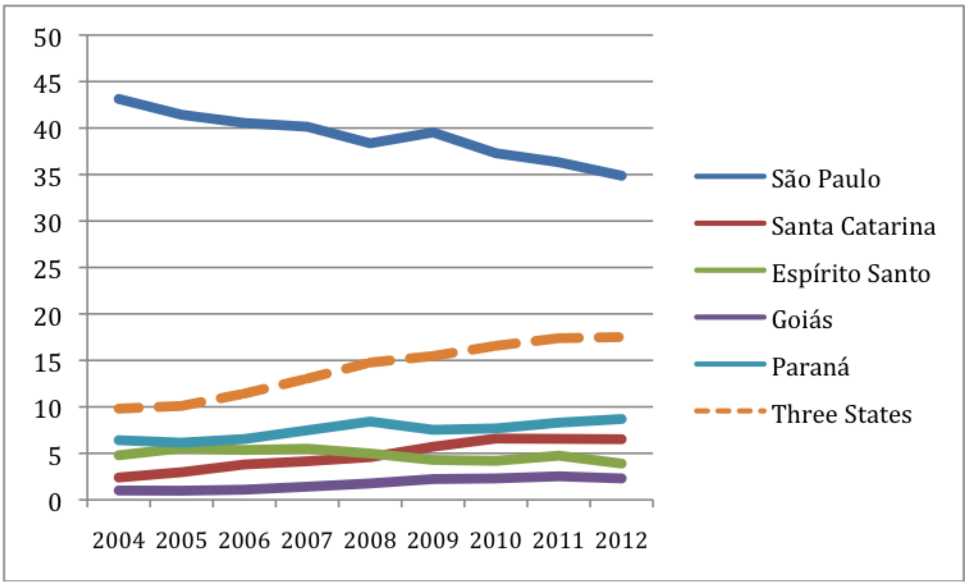
During those 10 years, the state of Paraná presented an increase in its share on imports, oscillating at that period a little bit though.

The following chart presents the evolution from 2004 to 2012, showing a gradual lost of participation over Brazilian imports of the state of São Paulo to other states.

The vertical axis is marked in percentage of the Brazilian imports share.

As we can see, there was a steady decrease in the state of São Paulo share of national imports and, conversely, an increase in the share of the states of Santa Catarina, Paraná and Goiás. The state of Espirito Santo, as we have already explained, presented an oscillating pattern during that period. Finally, the dashed line shows the sum of the three states share: Santa Catarina, Paraná and Goiás.

The graph reflects the fact that the state of São Paulo has consistently lost participation for other states until 2012.



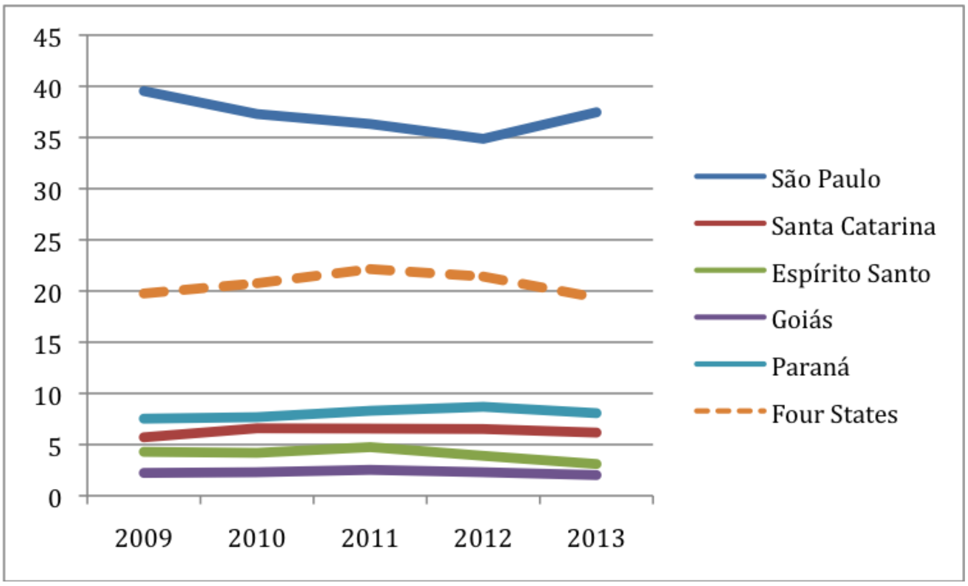
Now, lets analyze what happened in 2013. As we have already anticipated, there was as shift back of foreign trade operations to the state of São Paulo. Indeed, as we can see in the table 05, the state of São Paulo increased its share in the Brazilian foreign trade figures, whereas the states of Santa Catarina, Paraná, Espirito Santo and Goiás faced a decrease in its share.

Table 5: Five year share evolution.

	São Paulo %	Santa Catarina %	Goiás %	Paraná %	Espír. Santo %
2009	39.53	5.71	2.23	7.53	4.29
2010	37.29	6.59	2.30	7.68	4.18
2011	36.32	6.56	2.53	8.30	4.75
2012	34.87	6.52	2.30	8.69	3.90
2013	37.46	6.17	2.02	8.07	3.10

Source: MDIC.

The following chart shows the evolution in the past five years, from 2009 to 2013. The vertical axis marks the percentage of participation on Brazilian imports.



As we can see on the graph above, the year 2013 was marked by a reversion on the trend of decreasing participation on Brazilian imports for the state of São Paulo. Conversely, the major targeted tax benefits conceding states faced a decrease in its importing shares. This reversion is likely to be occurred due to Senate Resolution 13 that effectively was put in operation during the year 2013.

That demonstrates, undoubtedly, that FWP targeted tax benefits were effectively distorting firms decisions before R13. During the year 2013, there was a massive shift of import operations back to the state of São Paulo, from the states of Santa Catarina, Paraná, Goiás, and Espírito Santo, implying that firms were now not willing to accept target tax benefits and were making decisions based on economical efficiency considerations solely.

CONCLUSION

At the conclusion, the precedent findings will be revisited in order to outline relevant points that must be addressed in any Brazilian state tax system reform. As we have seen in the previous chapters:

First, in chapter one, the “Fiscal War of Ports” is a competition among Brazilian states that emerges from a complex tax system.

Second, in chapter two, we show that the most accepted contemporary strands of economic development thought points out the existence of several important issues for the concept of development such as the role of institutions and the broadly speaking commitment with freedom. Those strands of though also emphasize the important role that taxation plays in the development process, especially regarding the distortion of markets as well as the negative economical negative effects of taxation.

Finally, in chapter three, we analyzed the figures from R13 impact on the “Fiscal War of Ports”, demonstrating that after R13 was passed at the Brazilian Senate there was a shift back to the state of São Paulo on the increasing importing trend.

As a conclusion based on the previous findings, targeted tax benefits conceded over interstate sales taxation on imported goods, that emerges from the complex Brazilian state tax system, presents a negative effect over the resource allocation and the economic efficiency of the Brazilian importing sector.

In fact, as demonstrated, FWP targeted tax benefits were effectively distorting firms decisions before R13.

In other words, R13 impact on the “Fiscal War of Ports” brought forth evidences on the negative effect of taxation over resource allocation and economic efficiency. Equally important, R13 brought forth evidence on the strong relationship between taxation and development.

This is indeed a strong evidence of the important role that taxation and tax benefits play in determining conditions to a healthy economic environment and to economic development.

As a result, the Brazilian tax system plays a major role in the regional economic development, which is ought to be accurately assessed. The proper assessment of that role, that must be in any tax reform agenda, can either point out the types of acceptable tax benefits in terms of economic development generation or at least show accurately the tradeoff that we could be facing in implementing a non economic development generating tax benefit.

Furthermore, any intended tax reform must take in account not only the idea that taxation plays a crucial role in the economy, but also the idea that tax incentives may harsh the economy instead of promoting economic development.

As a suggestion for further research on this theme, it would be of great importance to study the types of tax incentives conceded in Brazil, categorizing them in terms of their impact over economic development and assessing the possible tradeoff between their negative and positive economic effects.

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