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ASPECTS OF SUBNATIONAL TAXATION IN BRAZIL

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INTRODUCTION

Subnational taxation in Brazil has to take into account the several different and unequal Brazils, spread out through the immense national territory. This paper examines those Brazils, not as a theoretical and academic exercise, but as the product of over twenty years' experience of its authors as fiscal auditors of two Brazilian states. The first section addresses the specific federal arrangement in Brazil, where municipalities enjoy prerogatives as entities of the federation. Nonetheless, the analysis and statistical reference shall focus mainly on the states.

Taking into account a simple view of the division of powers and authorities in the Brazilian federation, the first section discusses to what extent the formal decentralisation introduced by the 1988 Constitution resulted in more autonomy for states – and municipalities. These decentralisation measures included the freedom to generate their own revenues, the increase of the ICMS tax base (state tax on the circulation of goods and services) and of the percentage of transfers received from the central government. However, these new tax and transfer measures were significantly affected by the renegotiation of the states' debt in the early 90s, thus, compromising their spending capacity and practically making new investments unviable.

Section 2 shows that the decentralisation consolidated by the 1988 democratic Constitution, a consequence of the definition of tax-related authorities and of the increase of central government transfers to states and municipalities, has slowed down. This is mainly due to the increase of the central government's tax base, overlapping that of the states by adding a charge for the so-called "social contributions" on transactions of goods and services. While the overall tax burden went up from 22.4% of GDP in 1988 to 35.1% in 2010, the states' available tax revenues dropped from 26.6% to 24.7% in the same period. By concentrating its tax collection on contributions with prejudice to shared taxes, the central government negatively affects subnational governments' revenues.

Finally the "fiscal war," a subject addressed in section 3, offers a perspective on the taxation of production and consumption in Brazil, particularly in relation to ICMS. This VAT-type tax has been used by subnational governments in Brazil since 1967. Its interstate rates, combined with a mixed origin and destination system have provided a favourable environment for fiscal wars among states. The model in force has led to fiscal wars, in which fiscal benefits have been offered in order to attract private investments, a practice that has continued with higher or lower intensity since the mid 90s. Considering that in aggregate terms, ICMS is Brazil's biggest tax, with the largest share of state taxes and the highest absolute amount of collection among all taxes, in Brazil, it seems that the centralisation of this tax by the federal government is not a feasible alternative to this "race to the bottom." In addition, the states do not wish to renounce part of their autonomy over their main tax in favour of harmonisation, restricting the possibility of awarding unilateral benefits, without the guarantee that the central government will fund regional development policies and compensate probable losses. Faced with this deadlock, the central government proposed that the tax reform be "sliced," the term used by the central government since 2011 to propose that each matter be assessed separately. Is there another solution? Without the aim of proposing specific formulae, this paper's final considerations address subjects that were part of the 2011 federal agenda, from the perspective of a few experts.

KEYWORDS: Brazil, fiscal war, VAT, federalism, state taxes, municipal taxes, tax harmonisation, tax harmonization, tax competition, tax sharing, ICMS

1. Changes In The Federal System And Subnational Autonomy

Brazilian federalism has alternated between periods of centralisation and decentralisation since it was formally established by the 1891 Constitution. Even during the monarchy, both due to the model of colonisation and to the size of the country, regional oligarchies used to hold a considerable share of power. The shock of the conflict of interests between those oligarchies and the empire was well used by the republicans and was a crucial factor in bringing down the emperor. The adoption of a federal system accommodated the interests of these regional oligarchies under a republican central government, still weak in those days, through the power of regional oligarchies, whose strength helped to bring down the empire. The 1891 Charter, inspired by liberal ideals, restricted central power by granting reserved powers to states. It also made municipalities into autonomous entities, although this transformation was not truly put in practice. [1] Ana Maria Baiano (1974) refers to this stage as "isolation or dual federalism" with "predominance of the Member State [...], emphasis on local autonomy and obstacles to cooperation, particularly financial...". In addition, these factors also contribute to the "powerful States" dominating regional policy, which "fuelled the unequal development process amongst the regions". [2]

Brazil's redemocratisation process followed the military regime that lasted from 1964 until 1985. Between the adoption of federalism and the redemocratisation process in 1985 – – leading to the approval of the 1988 Constitution, federalism was buffeted by centrifugal and centripetal movements. Therefore, the never-before-seen decentralisation process, which started in the 80s [3] (Lobo, p. 56)

1 Brasileiro, Ana Maria O Federalismo Cooperativo," *Revista Brasileira de Estudos Políticos,* Belo Horizonte, Brazil, n.38, 1974.

2 Regional inequality is pointed out by states as one of the reasons for fiscal war, issue that will be addressed by this paper.

3 For further information on decentralisation after the 1988 Constitution, see Dain, Sulamis. *Federalismo e Reforma Tributária*. Afonso, Rui; Barros Silva, Pedro (orgs.), "A Federação

strengthened states and municipalities, having as its peak the 1988 Constitution which established the current political division of the Federative Republic of Brazil in 26 states and the Federal District. [4] Along with municipalities, the states began to enjoy more political, normative, administrative and financial autonomy. In most federations, the dual distribution rule governs the parallel action of just two spheres of power in the same territory – the government and the provinces or states. In Brazil, however, municipalities were also granted the capacity of autonomous entities. Consequently, like states, municipalities have not only their own organisations and governments, but also have exclusive authorities and literally speaking, as far as the Constitution is concerned, are components of the federation. [5]

However, did the 1988 Constitution elevate municipalities to the level of federated units? Doctrine diverges in this specific point. [6]

According to José Afonso da Silva [7] "On the contrary, the Constitution provided for the demands of advocates of municipal status in the more classical meaning of the term [...] who insistently and vigorously defended the inclusion of municipalities in the concept of our federation. […] Could they be (second class) Member States [...]? Where would each level's federative autonomy be found, as it presupposes own and not shared territory?"

Therefore, in relation to this particular issue, what has in fact changed since 1988?

Previously, municipal autonomy relied on states granting it to

em Perspectiva – Ensaios Selecionados," FUNDAP, 1995 and Afonso, José Roberto et al. "Municípios: Arrecadação e Administração Tributária - quebrando tabus", *BNDES* Magazine, V. 5, n. 10, December 1998.

4 Brazil is divided in five regions. Those do not work as levels of government, but exist basically to organise actions and entities to promote development as well as to guide the sharing of federal revenue. The regions are made up by the following states: North - Amazonas (AM), Pará (PA), Tocantins (TO), Amapá (AP), Rondônia (RO) and Roraima (RR); Northeast - Maranhão (MA), Piauí (PI), Ceará (CE), Rio Grande do Norte (RN), Paraíba (PB), Pernambuco (PE), Alagoas (AL), Sergipe (SE) and Bahia (BA); Southeast - São Paulo (SP), Rio de Janeiro (RJ), Minas Gerais (MG) and Espírito Santo (ES); South – Paraná (PR), Santa Catarina (SC) and Rio Grande do Sul (RS); Central West - Goiás (GO), Mato Grosso (MT) and Mato Grosso do Sul (MS). The Federal District has state status and is in the Central West Region in area taken inside Goiás. The 1988 Constitution granted state status to the territories of Roraima, Amapá and of the Island of Fenando de Noronha - then the only territories the country had (arts.14 and 15 of ADCT) returned to be part of Pernambuco. 1988 Constitution also created the state of Tocantins by the division of Goiás. The Constitution still allows the creation of new territories, as well as the subdivision or merger of states (art. 18, §3º).

5 1988 Constitution, art.1.

6 Alexandre de Moraes defends the position that municipalities are federated units. *Direito Constitucional*, São Paulo, 2009, p. 280,

7 *Curso de Direito Constitucional*, José Afonso da Silva, São Paulo, 2005, p. 475.

municipalities. As long as they complied with constitutional limits, states had the power to create and organise their municipalities. The 1988 Constitution limited the interference of states on municipal matters and awarded direct command to municipalities, granting them the ability of organising themselves - based on their own laws. The constitution also granted municipalities self-administration for the rendering and upkeep of local services; their own governments, with elected mayors, as well as their own legislative power. This power is vested in a Municipal House of Representatives, able to fulfil its legislative role on matters constitutionally addressed as exclusive or supplementary duty.

Even so, when compared to states and the central government, the municipalities' field of action is restricted. It is limited to common and exclusive authorities listed in the Constitution and to fulfilling supplementary duty. Municipalities do not have their own judicial power and rely on state judicial branches for resolving legal issues in their territories. External control of municipal financial and budgetary activities is overseen by each state's court of audit, except in very few cases, such as that of the city of São Paulo, where municipal courts of audit had already been created before the approval of the Constitution.

In practice, it does not seem relevant to determine whether Brazilian municipalities are federated units or only a "political division of the member states." [8] The fact that the 1988 Constitution is excessively detailed and, in thesis, grants municipalities a high degree level of autonomy, is reflected in the financial arrangements, such as the capacity of local governments to collect their own revenues and manage their own budgets. Nonetheless, most municipalities raise no own revenue and are totally dependent on federal transfers. It is not unusual for the federal government to use its financing power to bargain municipal support. This has led to a direct relationship between municipalities and the central government, minimising the role of state governments and opening room for a new centralisation process. The truth is that the constitutional status reached by Brazilian municipalities in 1988 as federated units is likely to be politically irreversible. However, a certain degree of asymmetry [9] among Brazil's 5,565 very diverse municipalities

8 As concluded by José Afonso da Silva, *op. cit*. p. 101.

9 Sérgio Prado shows that this symmetry distorts the spending capacity and the rendering of public services as a result of the differences in the ability to collect own revenue and of distortions in the allocation of transfers.

[10] *vis-à-vis* the current uniformity provided in the constitution would be desirable because political and financial capacity as well as other features are completely different among municipalities. Considering that, in order to increase local government control and efficiency, strengthen the whole of the states and restrain centralisation trends, a decision to set rules to establish a balance between political and fiscal autonomy and revenue raising capacity might be useful.

Whether or not the issue related to the status of municipalities in the federation has been settled, in theory, the division of authorities in the Brazilian constitutional context follows standards recommended by good public finance and fiscal federalism techniques, having as a guiding principle the predominance of interest: general or national (federal), regional (state) and local (municipal). There are not many differences in relation to most international experiences. Nevertheless, in practice, complex relations, overlapping duties (Table 1), administrative and management inefficiencies are features of the past and current experience. Deep intra- and inter-regional asymmetries – economic, social and financial as well as efficiency of state and municipal offices – require a certain degree of flexibility. Therefore, in practice, the list of authorities does not (and could not) follow strict distribution patterns.

10 IBGE/ Census, Brazilian Institute of Geography and Statistics, August 2010.

TABLE 1 – DISTRIBUTION OF THE MAIN AUTHORITIES AND POWERS PER GOVERNMENT SPHERE

<table>
<tr><td colspan="3">Common Authority
Central Government –States - Federal District and Municipalities</td></tr>
<tr><td colspan="3">Economic – Social - Financial</td></tr>
<tr><td colspan="3">Public health and care. Education, culture, teaching and sports. Protection of the environment and fight against pollution. Preservation of forests, fauna and flora. Foster agricultural and livestock production and organisation of food supply. Building houses, improving housing conditions and basic sanitation. Fight against poverty.</td></tr>
<tr><td colspan="3">Concurrent Authority
Central Government - States - Federal District</td></tr>
<tr><td colspan="3">Legislative</td></tr>
<tr><td colspan="3">Legislate by supplementing general norms edited by the central government, including tax law, financial and budgetary matters.</td></tr>
<tr><td colspan="3">Sole Authority of the Central Government</td></tr>
<tr><td>Economic</td><td>Social</td><td>Monetary and Financial</td></tr>
<tr><td>Deliver and draft national and regional economic development plans.

Set taxes beyond those set in the Constitution, but only where the base applied to is other than that of the taxes already set (residual authority).

Explore as a monopoly:

a) oil research, exploration and refinement;

b) directly or indirectly, research and mineral resources mining and water power;

c) research, mining, enriching, reprocessing, industrialisation and trade of mining ore and nuclear minerals and derivatives;

d) maritime and national transport of crude oil and basic derivatives produced in Brazil.</td><td>Deliver and draft national and regional social and economic development plans.

Organise social security.

Regulate, oversee and control health actions and services.

Establish the unified health system.

Establish and deliver social security plans.

Establish the national plan and guidelines for national education.</td><td>Draft general financial, tax and budgetary norms.

Issue currency.

Administer exchange rates´ operations and reserves.

Create the taxes under its authority according to the Constitution.

Formulate the multi-year plan, budget guidelines law and the annual budget.</td></tr>
<tr><td colspan="3">Sole Authority of States and the Federal District</td></tr>
<tr><td>Economic</td><td>Social</td><td>Financial</td></tr>
<tr><td>Listed authorities.

Remaining Authorities not reserved to the Federal Sphere or Municipalities.

Collect taxes listed in the Constitution.</td><td>Education, particularly primary and secondary education and health.

Social assistance.</td><td>Draft own multi-year plan, budgetary guidelines law and annual budget.</td></tr>
</table>

Sole Authority of Municipalities		
Economic	**Social**	**Financial**
Create and collect taxes listed in the Constitution.	Education, particularly primary and early childhood education. Health and social assistance with technical and financial cooperation from the federal and state spheres.	Draft own multi-year plan, budgetary guidelines law and annual budget.

Source: Authors

In theory, the original distribution of powers and authorities reflects the level of autonomy granted to federated units. However, in practice, the level of this autonomy may be deeply affected by subsequent arrangements and decisions. In the case of Brazil, as a corollary of political, administrative and financial self-organisation powers, states and municipalities have the autonomy to make decisions in relation to their own budgets, which are submitted to their own legislatures or city councils for approval. Furthermore, they are free to hire their employees and define their respective wages. Nonetheless, from a fiscal and budgetary point of view, binding revenues and expenditure have led to heavy restrictions to autonomy, above all for states and municipalities.[11] In the case of these two government spheres, 25% of their tax revenues and intergovernmental transfers should be used in education. States have to commit 12% of their net revenues from taxes plus constitutional and legal transfers to health[12], while municipalities commit 15%. Considering the volume of state expenditure allocated to these expenses and for paying its debt with the federal government [13], the states were the most affected by the decentralisation of duties after the 1988 Constitution and had their investment capacity seriously hindered.

Brazil's states and municipalities can generate their own revenues because both levels of government have ample autonomy in tax matters. This autonomy leaves room for the use of the Tax on the Circulation of Goods and on Services of Communication and Interstate and Intermunicipal Transportation (ICMS) as an instrument of "fiscal war" (subject of section 3). To do so, however, means to ignore the national legal framework approved by the federal deputies and senators of the National Congress, who set rules on ICMS incentives and benefits. On the other hand, in budgetary terms the autonomy enjoyed by states and municipalities is considerably restrictive,

11 For the federal government this situation has been mitigated since 1994. Since then, successive constitutional amendments have authorised free spending of 20% of the tax revenues (less transfers to states and municipalities) and of the social and economic contributions (except the education-Salaries and social contributions on company payrolls).

12 ICMS, ITCMD, IPVA, IRFF (withholding income tax of respective staff); FPE, FPEx and transfers from Complementary Bill 87/96 deducted of constitutional transfers to municipalities.

13 In 1996 the states renegotiated all their debts with the federal government.

especially after the approval of Complementary Bill No 101 in 2000, the Fiscal Responsibility Law (LRF).

The LRF was implemented in Brazil in 2000, after a context of macroeconomic crisis. It was conceived in the set of the macroeconomic adjustment instruments of the 90s[14], together with the fiscal adjustment of the states and municipalities, and the renegotiation of state debt with the federal government. Together with the binding constitutional revenue transfers, these factors have restricted significantly the autonomy of subnational governments. Even though debts were renegotiated, almost all states had and continue to have difficulty in complying with the limits and rules of indebtedness as a result of the budgetary revenue percentage that began to be committed for repayment of their debt. This difficulty is a consequence of high interest rates, which have risen to between 6% and 9% a year and is also a consequence of the index adopted in those agreements (IGP/DI) [15], which has shown better performance than states´ tax collection. The federal government, however, is not subject to any indebtedness related restrictions.

The variation of the net current debt in relation to the states' real net revenue (RNR) shows that their revenues have increased more than GDP, proving that there has been an effective fiscal effort aimed at paying the debt. Nonetheless, even with the debt being paid on due time, and with an increasing amount of payment the net debt stock grew in absolute and relative terms. In other words, instead of diminishing, the debt stock increased, as shown in Table 2.

14 In July 1994 Brazil adopted the Real as its currency as part of its bold successful plan against inflation.

15 IGP/DI: General Price Index, Domestic Availability set by the Getúlio Vargas Foundation-FGV. This index is based in the prices of the economy: 60% weight is given to wholesale prices and 30% to consumer prices.

TABLE 2 – PAYMENT OF THE DEBT BY STATES TO THE FEDERAL SPHERE

Federal Unit	% Committed RNR	Monthly Average RNR Dec/2010	Initial Contract Value	Payments (until 30/04/11 and 30/06/11)	Current Debt Balance (in 30/04/11 and 30/06/11)	Debt Growth Rate	% of Initial Debt Paid
São Paulo	13.0%	6,758.5	46,585.1	68,570.6	167,090.5	259%	147%
Minas Gerais	13.0%	2,332.5	11,827.5	12,802.9	40,223.7	240%	108%
Rio Grande do Sul	13.0%	1,462.8	9,859.2	12,554.2	38,493.0	290%	127%
Santa Catarina	13.0%	841.3	2,760.5	6,487.2	10,155.4	268%	235%
Paraná	13.0%	1,297.2	5,665.1	8,682.0	8,984.6	59%	153%
Alagoas	15.0%	330.3	2,224.8	2,558.7	6,076.0	173%	115%
Bahia	13.0%	1,304.8	2,312.7	5,167.0	4,644.3	101%	223%
Goiás	15.0%	707.4	930.4	1,589.4	4,007.4	331%	171%
Pernambuco	11.5%	957.8	1,924.8	3,769.2	2,782.8	45%	196%
Mato Grosso	15.0%	493.8	775.1	1,532.7	2,751.8	255%	198%
Distrito Federal	13.0%	810.4	513.8	822.8	1,144.6	123%	160%
Espírito Santo	13.0%	617.7	595.3	974.3	1,140.1	92%	164%
Pará	15.0%	744.1	388.6	803.2	883.4	127%	207%
Paraiba	13.0%	384.3	375.2	697.4	703.3	87%	186%
Piauí	13.0%	341.2	388.4	1,040.3	443.5	14%	268%
Acre	11.5%	189.1	163.0	268.8	313.9	93%	165%
Rio Gr. do Norte	13.0%	418.8	56.5	173.1	30.2	-46%	307%
Amapá	15.0%	166.0	N/A	N/A	N/A	N/A	N/A
Amazonas	11.5%	580.5	N/A	N/A	N/A	N/A	N/A
Ceará	11.5%	754.5	N/A	N/A	N/A	N/A	N/A
Maranhão	13.0%	564.7	N/A	N/A	N/A	N/A	N/A
Mato Gr. do Sul	15.0%	370.8	N/A	N/A	N/A	N/A	N/A
Rio de Janeiro	13.0%	2,475.9	N/A	N/A	N/A	N/A	N/A
Rondônia	15.0%	293.1	N/A	N/A	N/A	N/A	N/A
Roraima	11.5%	130.0	N/A	N/A	N/A	N/A	N/A
Sergipe	13.0%	327.5	N/A	N/A	N/A	N/A	N/A
Tocantins		285.7	Did not uptake	Law 9,496/97			
TOTAL		25,940.6	87,346.2	128,494.1	289,868.7	232%	147%

Source: Confaz/Gefin-Group of Managers of State Finances.

The states have requested that the rules provided by Law 9,496/97 be reviewed. This Law addresses the consolidation, assumption and refinancing, with a 30 year maturity period, of public debt securities and debt existing as of 1996 resulting from internal and external credit operations of the states by the federal government. The states are asking for the debt index to be changed from IGP-DI (subject to price shocks) to IPCA16; for interest rates to be reduced to 2% a year; and for the commitment to repay level to be reduced to 9% of the real net revenue of each state.

2. REVENUE AND EXPENDITURE PER GOVERNMENT LEVEL

The political strengthening of states and municipalities that resulted from the country's re-democratisation process was confirmed by the 1988 Constitution, which maintained the trend towards revenue decentralisation. Subnational governments, including municipalities, were given higher tax autonomy through the new constitution's definition of taxes that the federal, state and municipal levels can levy, as well as the sharing arrangement of tax revenues. . Subnational governments were granted a bigger share of federal revenue, and in theory reasonable freedom on the spending side. From the perspective of the states, the increase of their main tax base, then the ICM, was very significant. In addition to communication and transportation services, that base began to include old federal taxes on electricity, fuels, lubricants and minerals, giving birth to the current ICMS, which will have some aspects addressed in this paper.

As in most countries, income, assets and consumption are traditionally the tax bases used in Brazil for a variety of taxes levied by the three government spheres. They are classified as taxes, duties, social contributions, and contributions on the intervention in the economy. These government levies have, to a higher or lower extent, direct, indirect, cumulative and non-cumulative tax related features. Four VAT-type taxes and social contributions are levied on production and consumption – IPI, ICMS, Cofins and PIS – with different value-added

16 IPCA: Broad Consumer Price Index set by the Brazilian Institute of Geography and Statistics - IBGE. The IPCA is based upon prices of products, services, rents and fees paid by families living in the main metropolitan regions that earn up to 40 minimum wages. Changes in the weight of each item on a family budget are levied each five years.

levels and definitions throughout the chain. Table 3 shows the taxes per government sphere, their respective base, the amount collected in the most recent period in billions of reais, the tax burden as a share of GDP and as a share of the total tax collected.

TABLE 3 – TAX REVENUE PER TAX AND TAX AUTHORITY IN 2010

Tax and Tax Authority	Tax base	Value R$ Billion	% of GDP	% of Total
TOTAL		**1,292.1**	**35.16**	**100.0**
FEDERAL TAXES		**876.1**	**23.84**	**67.9**
IR – income tax	Income, profit, asset gain	190.5	5.19	14.7
IPI – tax on manufactured products	Goods and services	37.3	1.01	2.9
IOF – tax on financial transactions	Financial transactions	26.5	0,72	2.1
II and IE – import and export tax	Foreign trade	21.1	0.57	1.6
ITR – rural territory t	Property	0.5	0.01	0.0
Fees	Goods and services	5.9	0.16	0.5
Social Security Contribution	Salaries and wages	210.4	5.73	16.3
Cofins – contribution for the financing of the social security	Goods and services	138.6	3.77	10.7
CSLL – social contribution on net income	Income, profit, asset gain	45.2	1.23	3.5
PIS and Pasep – social contributions for the Social Integration Programme (PIS) and the Civil Servants´ Equity Programme(Pasep)	Goods and services	40.0	1.09	3.1
Social Security Contribution of the Civil Servants	Salaries and wages	11.3	0.31	0.9
Other Social Contributions	Salaries and wages	9.0	0.25	0.7
FGTS – workers indemnity fund	Salaries and wages	61.8	1.68	4.8
Economic Contributions (includes «Royalties from Itaipu»)	Goods and services	44.9	1.22	3.5
Social Contribution for Education	Goods and services	11.0	0.30	0.9
Private Sector contributions for the respective organisations of companies and workers - «S» System	Salaries and wages	10.3	0.28	0.8
Fines and Overdue Tax Liabilities	Others	11.7	0.32	0.9
STATE TAXES		**338.0**	**9.20**	**26.2**

ICMS – tax on the circulation of goods and on services of communication and of interstate and intermunicipal transportation	Goods and determined services	264.7	7.20	20.5
IPVA – tax on motor vehicles	Property	21.3	0.58	1.6
ITCD – tax on gratuitous and *causa mortis* transfers	Property	2.5	0.07	0.2
IRRF – withholding personal income tax of respective civil servants	Income, profit, asset gain	12.2	0.33	0.9
Duties	Goods and services	10.4	0.28	0.8
Contribution for the Social Security of Respective Civil Servants	Salaries and wages	17.5	0.48	1.4
Assessment for benefits	Goods and services	0.7	0.02	0.1
Other (fines, interest rate, overdue tax liabilities)	Other	8.6	0.23	0.7
MUNICIPAL TAXES		**77.9**	**2.12**	**6.0**
ISS – municipal tax on services	Goods and services	30.4	0.83	2.4
IPTU – urban real state tax	Property	16.0	0.44	1.2
ITBI – tax on the nongratuitous *inter vivos* conveyance of real estate	Property	5.4	0.15	0.4
IRRF – withholding personal income tax of respective civil servants	Income, profit, asset gain	5.4	0.15	0.4
Duties	Goods and services	4.2	0.11	0.3
Contribution for the Social Security of respective civil servants	Salaries and wages	5.8	0.16	0.4
Assessment for benefits	Goods and services	3.1	0.09	0.2
Other (fines, interest rate, overdue tax liabilities)	Other	7.6	0.21	0.6

Source of data: RFB, STN, ANP, ANEEL, CONFAZ, IBGE.

Source of tax calculation: José Roberto Afonso, and Kleber Castro, "Overall Tax Burden in Brazil in 2010."
http://www.joserobertoafonso.com.br/index.php?option=com_content&view=article&id=2101:carga-global-2010-afonso-castro-el-al&catid=36:assuntos-fiscais&Itemid=37
The tax burden was calculated using a GDP of R$ 3,675 billion.

Table 4 shows how the revenue has evolved per government sphere between 1960 and 2010. Own revenue is shown, as well as revenue available, which in total reflects the spending capacity of each government sphere after intergovernmental transfers. Tax arrangements after 1988 have favoured municipalities, the main winners in the

process of decentralisation of revenue. Their share in ICMS went up from 20% to 25% and the (municipal) service tax (ISS), which was at first intended to be merged with the state ICMS, was kept separate. In 2010, municipalities had 18.3% of total tax revenues available for spending, whereas in 1988 and 1960 their share was only of 13.3% and 6.4% respectively. The states, whose share of total revenues in 1988 was 26.6%, had their share increased in the first few years after 1988. Later, these states suffered a reduction in their share of taxes for reasons that will be addressed in this article. In 2010, their share of the available revenue was only of 24.7%, lower than in the period before 1988 and even lower when compared to 1960, when their share was 34.1%. Soon after the 1988 Constitution was approved, the federal government reduced its share, but it was partly recovered, reaching 57% of total revenues in 2010, still much lower than during the centralising stage of the military regime.

TABLE 4 – OWN TAX REVENUE AND AVAILABLE REVENUE PER GOVERNMENT SPHERE

	Burden - % of GDP				Makeup - % of Total			
	Federal	States	Municipalities	Total	Federal	States	Municipalities	Total
DIRECT TAX COLLECTION								
1960	11.1	5.5	0.8	17.4	64.0	31.3	4.7	100
1980	18.3	5.3	0.9	24.5	74.7	21.6	3.7	100
1988	16.1	5.7	0.6	22.4	71.7	25.6	2.7	100
2005	24.3	8.9	2.1	35.3	68.9	25.2	5.9	100
2007	24.3	8.9	2.1	35.3	68.9	25.2	5.9	100
2008	24.5	9.2	2.1	35.8	68.5	25.7	5.8	100
2009	23.7	9.1	2.2	35.0	67.9	26.0	6.1	100
2010	23.8	9.2	2.1	35.2	67.9	26.2	6.0	100
AVAILABLE REVENUE								
1960	10.4	5.9	1.1	17.4	59.5	34.1	6.4	100
1980	16.7	5.7	2.1	24.5	68.2	23.3	8.6	100
1988	13.5	6.0	3.0	22.4	60.1	26.6	13.3	100
2005	20.2	8.8	5.9	35.0	57.8	25.2	17.0	100

2007	20.4	8.7	6.2	35.3	57.8	24.6	17.7	100
2008	20.3	9.1	6.5	35.8	56.6	25.3	18.1	100
2009	19.7	8.8	6.5	35.0	56.3	25.2	18.5	100
2010	20.0	8.7	6.4	35.2	57.0	24.7	18.3	100

Source: José Roberto Afonso. Presentation at IPEA Seminar, 22/09/2010.

National accounts methodology: includes taxes, duties, contributions (including CPMF - tax on financial transactions) FGTS, and overdue tax liabilities.

The revenue availabwle in 2010 according to Table 4 is detailed in Table 5, which shows vertical transfers of revenue in Brazil from the federal government to states and municipalities, and from states to municipalities.

TABLE 5 – INTERGOVERNMENTAL TRANSFERS IN 2010

AVAILABLE REVENUE	R$ Billion	% of GDP	% of Total
Total Available Revenue	1,292.10	35.16	100.00
Federal	736.50	20.04	57.00
States	319.70	8.70	24.70
Municipalities	235.80	6.42	18.30
TRANSFERS			
Federal to States	**73.80**	**2.01**	**5.70**
FPE	39.00	1.06	3.00
FPEx	2.90	0.08	0.20
IOF GOLD	0.00	0.00	0.00
ICMS loss compensation	1.20	0.03	0.10
FUNDEB	11.30	0.31	0.90
SOCIAL CONTRIBUTION FOR EDUCATION	7.40	0.20	0.60
FEX	1.50	0.04	0.10
CIDE	1.30	0.04	0.10
AFE	0.80	0.02	0.10
ROYALTIES AND SHARES	8.40	0.23	0.60
Federal to Municipalities	**65.80**	**1.79**	**5.10**
FPM	43.10	1.17	3.30
ITR	0.40	0.01	0.00
IOF GOLD	0.00	0.00	0.00
ICMS loss compensation	0.40	0.01	0.00
FUNDEB	15.30	0.42	1.20
FEX	0.50	0.01	0.00
CIDE	0.40	0.01	0.00
AFM	0.50	0.01	0.00
ROYALTIES AND SHARES	5.30	0.14	0.40

States to Municipalities	**92.10**	**2.50**	**7.10**
ICMS	51.90	1.41	4.00
IPVA	10.60	0.29	0.80
FPEx	0.70	0.02	0.10
FUNDEB	28.80	0.78	2.20

Source of raw data: STN, ANP, ANEEL.

Source of tax burden calculation: José Roberto Afonso, and Kleber Castro, "Overall Tax Burden in Brazil in 2010."

http://www.joserobertoafonso.com.br/index.php?option=com_content&view=article&id=2101:carga-global-2010-afonso-castro-el-al&catid=36:assuntos-fiscais&Itemid=37

The tax burden was calculated using a GDP of R$ 3,675 billion.

The decentralisation of revenues triggered by the 1988 Constitution was followed by a redistribution of duties between the different government spheres – duties which did not always correspond to the most appropriate level. Municipalities became expressly in charge of nursery and fundamental education, mainly; states were assigned secondary education, mainly. The health system was unified but with a highly decentralised administration. Pre-established percentages of the main taxes and transfers have to be spent on education and health by the three levels of government. Finally the central government was in charge of providing equalisation payments in both cases. After funding these main functions and paying off their debt, the states, in particular, have faced budget restrictions that have affected their investment capacity.

Tables 6, 7 and 8 show the distribution of expenditure per government sphere in 2010 in different disaggregate levels. The values in the tables correspond to budget execution, thus, they are committed values, which differ from effectively spent values. Table 6 separates

the 2010 expenditure per government sphere in two components: expenditure including government debt related charges and expenditure exclusive of interest rates, fees, and paying off the debt. It allows for the fiscal effort to be identified, particularly at the federal level, aimed at paying off the debt.

TABLE 6 – PUBLIC EXPENDITURE IN 2010 (fiscal budget and social security)

Government level	Inclusive of Debt Related Charges			Without Interest, Duties and Paying off the Debt		
	R$ billions	% of GDP	% of Total	R$ billions	% of GDP	% of Total
Federal	1,505.0	41.0%	65.1%	868.5	23.6%	53.2%
States	510.7	13.9%	22.1%	478.3	13.0%	29.3%
Municipalities	295.5	8.0%	12.8%	285.0	7.8%	17.5%
Total	2,311.1	62.9%	100.0%	1,631.8	44.4%	100.0%

Source: Secretariat of the National Treasury. National Public Sector Balance Sheet – Fiscal Year 2010. Brasília. Available at: http://www.tesouro.gov.br/contabilidade_governamental/relatorios_demonstrativos.asp

The expenditure burden was calculated using a GDP of R$ 3,675 billion.

Table 7 shows the expenditure in 2010 per government sphere and per type. Among many other aspects, it is worth stressing that the fiscal effort for paying off the debt makes investments difficult, particularly in the case of the federal level. Only states and municipalities achieved a budget surplus in 2010. Table 4 points out that the tax burden in 2010 was 35.2% of the GDP and Table 7 shows that total government spending was 62.9 of the GDP. The difference is the federal debt which is refinanced by government bonds, not by tax revenues (domestic credit from the federal government in 2010 was R$ 544.4 billions). Another relevant factor is the fact that the federal level has a primary surplus but a nominal deficit, precisely because of rollover debt.

TABLE 7 – PUBLIC EXPENDITURE PER TYPE AND GOVERNMENT LEVEL IN 2010 (FISCAL BUDGET AND SOCIAL SECURITY)

	IN R$ BILLIONS				% OF	% OF
EXPENDITURE TYPE	FEDERAL	STATE	MUNICI-PALITY	TOTAL	GPD	TOTAL
RECURRENT EXPENDITURE	**901.3**	**436.5**	**255.6**	**1,593.4**	**43.4%**	**68.9%**
STAFF AND SOCIAL DUTIES	183.3	197.6	126.8	507.6	13.8%	22.0%

	R$ BILLION				% IN TOTAL			%	% OF
ROLE	FEDE-RAL	STATE	MUNICI-PALITY	TOTAL	FEDE-RAL	STATE	MUNICI-PALITY	GDP	TOTAL
LEGISLATIVE	5.0	9.8	7.2	22.0	23%	45%	33%	0.6%	1.0%
JUDICIAL	19.8	21.4	0.7	41.9	47%	51%	2%	1.1%	1.8%
SPECIAL FEES	830.7	117.0	12.6	960.3	87%	12%	1%	26.1%	41.6%
SOCIAL SECURITY	325.8	62.0	14.5	402.4	81%	15%	4%	10.9%	17.4%
EDUCATION	44.1	75.3	73.4	192.8	23%	39%	38%	5.2%	8.3%
HEALTH	60.6	55.7	67.0	183.3	33%	30%	37%	5.0%	7.9%
ADMINISTRATION	17.7	24.9	35.8	78.4	23%	32%	46%	2.1%	3.4%
TRANSPORTATION	20.5	29.3	8.6	58.4	35%	50%	15%	1.6%	2.5%
SOCIAL ASSISTANCE	39.1	4.0	8.9	51.9	75%	8%	17%	1.4%	2.2%
PUBLIC SAFETY AND SECURITY	9.0	37.9	2.3	49.2	18%	77%	5%	1.3%	2.1%
URBANISM	4.8	5.8	31.2	41.8	11%	14%	75%	1.1%	1.8%
WORK	31.2	1.1	0.8	33.1	94%	3%	2%	0.9%	1.4%
NATIONAL DEFENSE	31.8	-	0.0	31.9	100%	0%	0%	0.9%	1.4%
AGRICULTURE	14.2	4.9	2.2	21.3	67%	23%	10%	0.6%	0.9%
RELATED TO COURT SYSTEM	4.7	10.0	0.4	15.0	31%	66%	2%	0.4%	0.7%
SANITATION	1.7	3.3	8.8	13.8	13%	24%	64%	0.4%	0.6%
SCIENCE AND TECHNOLOGY	7.3	2.7	0.1	10.1	72%	26%	1%	0.3%	0.4%
ENVIRONMENTAL MANAGEMENT	3.6	3.2	2.4	9.1	39%	35%	26%	0.2%	0.4%
RIGHTS IN CITIZENSHIP	1.8	5.3	0.3	7.4	24%	72%	4%	0.2%	0.3%
CULTURE	1.3	2.5	3.2	7.0	19%	36%	45%	0.2%	0.3%
TRADE AND SERVICES	3.8	1.8	1.3	6.9	55%	25%	19%	0.2%	0.3%
HOUSING	0.2	3.0	3.3	6.5	3%	47%	51%	0.2%	0.3%
SPORTS AND LEISURE	1.0	1.0	2.7	4.7	22%	21%	57%	0.1%	0.2%
AGRARIAN ORGANISATION	4.2	0.2	0.0	4.4	95%	5%	0%	0.1%	0.2%
INDUSTRY	1.7	1.5	0.3	3.6	48%	42%	10%	0.1%	0.2%
COMMUNICATION	0.9	0.9	0.4	2.2	43%	40%	17%	0.1%	0.1%

FOREIGN RELATIONS	1.8	0.0	0.0	1.8	99%	0%	0%	0.0%	0.1%
ELECTRICITY AND FUEL	0.6	0.3	0.7	1.6	39%	18%	43%	0.0%	0.1%
intra-budget EXPENDITURE	15.9	25.9	6.4	48.2	33%	54%	13%	1.3%	2.1%
GENERAL TOTAL	**1,505**	**511**	**295**	**2,311**	**65%**	**22%**	**13%**	**62.9%**	**100%**

DEBT RELATED INTEREST AND DUTIES	122.4	16.9	4.3	143.6	3.9%	6.2%
OTHER OPERATING EXPENDITURES	595.6	222.1	124.5	942.2	25.6%	40.8%
Direct Expenditure	391.9	132.4	115.2	639.5	17.4%	27.7%
Retirement plans	163.8	28.0	6.8	198.6	5.4%	8.6%
Other pension plans	61.9	10.6	1.5	74.0	2.0%	3.2%
Social security benefits	72.5	0.4	0.5	73.5	2.0%	3.2%
Others	93.7	93.4	106.3	293.4	8.0%	12.7%
Transfers	202.9	87.9	8.6	299.4	8.1%	13.0%
Others	0.8	1.7	0.7	3.3	0.1%	0.1%
CAPITAL EXPENDITURE	**603.7**	**74.2**	**39.8**	**717.6**	**19.5%**	**31.1%**
Physical INVESTMENTS	53.4	49.3	32.2	134.8	3.7%	5.8%
FINANCIAL INVESTMENT	36.2	9.4	1.4	47.1	1.3%	2.0%
PAYINF OFF/REFINANCING OF DEBT	514.0	15.5	6.2	535.7	14.6%	23.2%
Direct Expenditure	514.0	15.5	6.2	535.7	14.6%	23.2%
Paying off	140.6	15.2	4.5	160.3	4.4%	6.9%
Refinancing	373.4	0.3	1.4	375.2	10.2%	16.2%
Others	0.0	0.0	0.2	0.2	0.0%	0.0%
TOTAL	**1,505.0**	**510.7**	**295.5**	**2,311.1**	**62.9%**	**100.0%**
SURPLUS	**0.0**	**2.1**	**5.1**	**7.2**	**0.2%**	**0.3%**

Source: Secretariat of the National Treasury. National Public Sector Balance Sheet – Fiscal Year 2010. Brasília. Available at: http://www.tesouro.gov.br/contabilidade_governamental/relatorios_demonstrativos.asp

The expenditure burden was calculated using a GDP of R$ 3.675 billion.

Table 8 specifies the expenditure in 2010 per government role and level. The first two lines, list expenditures of the legislative and judicial branches and the following lines list expenditures of the executive power,

organised in a decreasing order. Expenditure of the three government levels in the roles "special duties" (which includes interest, duties and paying off the debt) and "social security" correspond to 59% of public expenditure in the whole country. "Education" and "health" amount to a less important level in relation to the total expenditure, corresponding only to 8.3% and 7.9% respectively of the total spending.

TABLE 8 – PUBLIC EXPENDITURE PER GOVERNMENT ROLE AND SPHERE IN 2010 (FISCAL BUDGET AND SOCIAL SECURITY)

Source: Secretariat of the National Treasury. National Public Sector Balance Sheet – Fiscal Year 2010. Brasília. Available at: http://www.tesouro.gov.br/contabilidade_governamental/relatorios_demonstrativos.asp

An analysis of federal relations in Brazil should approach, even if briefly, the great intra and inter-regional discrepancies, expressed both in economic and social conditions and in the executive and financial administrative efficiency of states and municipalities. Tables 9 and 10 as well as Graphs 1 and 2 (own formulation) show inequalities in the spending capacity of municipalities and states, taking into consideration the size and characteristics of the population.

A useful indicator points out the spending capacity of municipalities in per capita terms. After all, the rendering of services has a strong relation to the number of inhabitants. Local governments' own tax and available revenue in per capita terms were grouped and ordered per population size. A descending curve can be seen as public spending capacity is higher in very small municipalities while there is a slight recovery in municipalities with over 500 thousand inhabitants and in capital cities. This is partly the result of formula determining the sharing of the Municipality Participation Fund (FPM), the main federal transfer to local governments, which on the one hand is proportional to the population size, but subject to determined floor and ceiling. Therefore, medium sized municipalities end up with less available revenue.

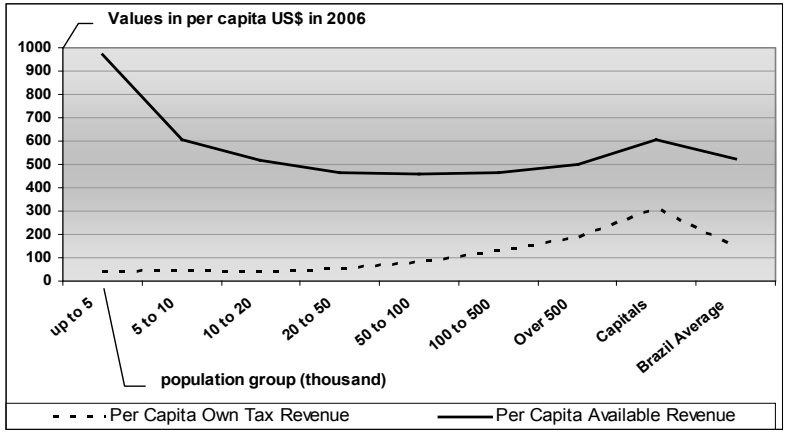
TABLE 9 – FISCAL DISPARITY IN MUNICIPALITIES

EXPRESSED BY THE MAKEUP OF PER CAPITA MUNICIPAL REVENUE IN 2006

Available Municipal Revenue	Brazil	Population Brackets (thousand Inhabitants) and per Capita Values in US$							
	Average	Up to 5	5 to 10	10 to 20	20 to 50	50 to 100	100 to 500	Over 500	Capitals
Available Revenue	523	969	608	516	462	457	463	501	607
Own Tax Revenue	147	44	45	42	54	85	128	190	312
FPM	114	560	262	208	154	109	74	23	48
Other Revenues	263	365	301	265	254	263	261	288	246

Source of data: STB; consolidation source: Araújo, Erika. *Os Recursos Tributários Próprios no Financiamento dos Municípios Brasileiros*. Inter-American Development Bank, 2007.

GRAPH 1 – AVAILABLE REVENUE AND PER CAPITA OWN TAX REVENUE OF MUNICIPALITIES IN 2006



For state governments the data are from 2010. Table 10 and Graph 2 show per capita available (current + capital) revenue of the states ordered according to the Human Development Index or HDI. Graph 3 shows per capita values ordered by tax revenue available for each state and the respective region. The available tax revenue is net of the states' transfers to municipalities and of the values that should be kept in FUNDEB (the Fund for the Development of Basic Education and Appreciation of the Teaching Profession). In the case of capital revenues,

loan transactions, loan amortisations and sales of assets were excluded. The Federal District includes its revenues in a manner equivalent to municipal revenues, although it is not divided in municipalities. Therefore, per capita available revenue (current + capital) reflects the spending capacity of state governments. 2010 data confirm considerable intra and inter-regional disparities among states, in addition to great interstate disparities.

Some of these distortions are the result of the distribution criteria of the FPE (the main instrument for federal transfer payments to the states). For example, in the Northern region, Acre's population corresponds to only 0.4% of Brazilians and has an HDI of 0.697. Its per capita available revenue (current + capital) of R$ 4,701 is 7.4 times higher than its per capita available tax revenue of R$ 639. This shows the importance of central government transfers, particularly from the FPE in the makeup of this state's per capita available income. The state of Pará, also in the Northern region, has 4% of the national population with an HDI of 0.723, with a per capita available revenue of R$ 1,339, only 2.9 times higher than its per capita available tax revenue of R$ 471.

The biggest per capita budget in the Northeast region belongs to the State of Sergipe (R$ 2,623) and is 2.2 times higher than the lowest, belonging to the State of Maranhão (R$ 1,204). There is no great difference in relation to each state's HDI, 0.682 and 0.636 respectively, but they have different spending capacity.

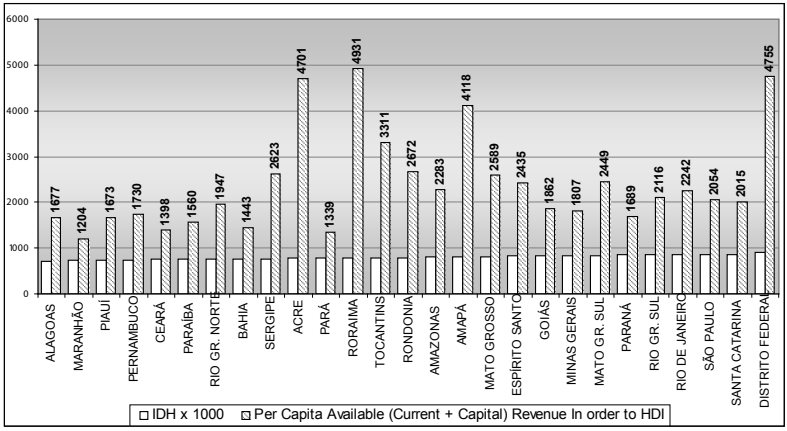
São Paulo, in the Southeastern region, is the state with the biggest population in the country (21.6%) and is considered the richest, with an HDI of 0.820. However, its per capita available revenue (current + capital) of R$ 2,054 places São Paulo in 14th place in relation to the other states. This is a common case of inequality at the state level itself. The states of Rio Grande do Sul, Rio de Janeiro, Amazonas, Espírito Santo, Mato Grosso do Sul, Mato Grosso, Sergipe, Rondônia, Tocantins, Amapá, Acre, the Federal District and Roraima all have more per capita available income than São Paulo.

TABLE 10 – FISCAL DISPARITY BETWEEN STATES, MEASURED BY THE TAX AND TOTAL PER CAPITA REVENUE AVAILABLE IN 2010 – ORDERED BY HDI

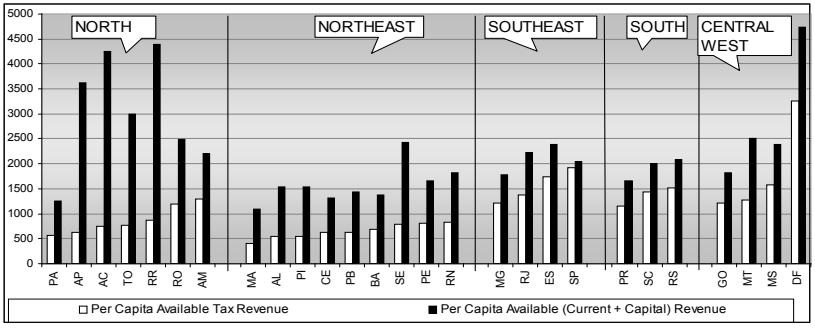
State	Abbre-viation	HDI	Per Capita Available Tax Revenue	Per Capita Available (Current + Capital) Revenue In order to HDI
ALAGOAS	AL	0,722	448	1,677
MARANHÃO	MA	0,724	334	1,204
PIAUÍ	PI	0,740	459	1,673
PERNAMBUCO	PE	0,742	678	1,730
CEARÁ	CE	0,749	516	1,398
PARAÍBA	PB	0,752	525	1,560
RIO GR. NORTE	RN	0,753	695	1,947
BAHIA	BA	0,767	576	1,443
SERGIPE	SE	0,770	660	2,623
ACRE	AC	0,780	639	4,701
PARÁ	PA	0,782	471	1,339
RORAIMA	RR	0,782	739	4,931
TOCANTINS	TO	0,784	661	3,311
RONDONIA	RO	0,784	986	2,672
AMAZONAS	AM	0,796	1,046	2,283
AMAPÁ	AP	0,800	516	4,118
MATO GROSSO	MT	0,808	1,063	2,589
ESPÍRITO SANTO	ES	0,821	1,448	2,435
GOIÁS	GO	0,824	1,037	1,862
MINAS GERAIS	MG	0,825	1,011	1,807
MATO GR. SUL	MS	0,830	1,298	2,449
PARANÁ	PR	0,846	943	1,689
RIO GR. SUL	RS	0,847	1,270	2,116
RIO DE JANEIRO	RJ	0,852	1,151	2,242
SÃO PAULO	SP	0,857	1,492	2,054
SANTA CATARINA	SC	0,860	1,176	2,015
DISTRITO FEDERAL	DF	0,900	2,845	4,755

Source: Secretariat of the National Treasury. Consolidated Budget Execution of States in 2010. Brasilia, 2011.Available at: http://www.tesouro.gov.br/contabilidade_governamental/relatorios_demonstrativos.asp

GRAPH 2 – PER CAPITA AVAILABLE (CURRENT + CAPITAL) REVENUE IN 2010 (R$) STATES ORDERED TO HDI



GRAPH 3 – PER CAPITA TAX AND AVAILABLE (CURRENT + CAPITAL) REVENUE IN 2010 (R$)



In relation to the FPE, as a result of a Supreme Court decision in 2010, states have been made to discuss a review of the sharing criteria, in force since 1992. The states of Goiás, Mato Grosso, Mato Grosso do Sul, Paraná and Rio Grande do Sul challenged the constitutionality of Supplementary Law (SL) 62/89 before the Supreme Court under the argument that tax-sharing indexes set forth since 1992 did indeed breach the Constitution. Article 161, II states that supplementary law shall establish rules for the remittance of the funds seeking to promote social and economic balance among states and among municipalities. In

February 2010 the Supreme Court declared the unconstitutionality of SL 62/89, but maintained the indexes applicable up to 31st December 2012. The states started to discuss new sharing criteria for FPE, but actually it is the National Congress that is in charge of the approval of a new law.

In fact, the states' spending capacity has also been affected by other factors beyond FPE. The increase of transfers from the central government to states and municipalities (FPE and FPM), a consequence of the decentralisation process consolidated by the 1988 Constitution., The new constitution transferred the federal tax on electricity, fuels and minerals to the states, benefiting them and the municipalities, and was followed in the federal sphere by the widening of its tax base, particularly regarding goods and services. In the name of macroeconomic stability (based on a commitment made with the IMF to generate primary surpluses), and in order to compensate for the loss of non-shared revenues, the central government looked towards social contributions to guarantee the necessary revenue to face its duties. [17]

This meant a considerable intrusion on bases of the taxes on circulation of goods and rendering of services of the states. Only between 2002 and 2005 did the federal government's tax collection from contributions, which are non-shared taxes, increase significantly by an average of 63% in nominal terms. In contrast, IR+IPI, the main federal taxes shared with the other state and municipalities had only a 43% nominal increase. The recovery by the states of the tax room taken by the central government requires the analysis of a specific aspect related to the choice made by the Constituent Assembly in 1988 that is also one of the biggest barriers for the approval of a comprehensive fiscal reform in Brazil. That crucial aspect is the duality of the tax system adopted by the 1988 Constitution that distinguishes regular taxes from social contributions. [18]

With the return of the democratic process, taxes met the demands of states and municipalities for financial autonomy by widening of their tax bases and increasing federal transfers and for contributions by meeting the social demands, so that social security had its own and

17 Brazil, *Issues in Fiscal Federalism*, p.V. Report 22253-BR, World Bank, May, 31, 2002.

18 This is very clearly addressed in Rezende, Fernando, Fabrício Oliveira and Érika Araújo, *O Dilema Fiscal: Remendar ou Reformar?* (Rio de Janeiro. FGV publishers, 2007.)

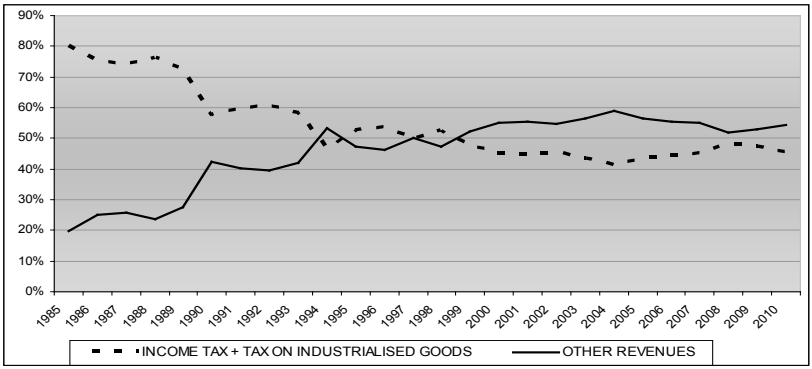
diversified sources of financing. It is not a coincidence that taxes and contributions, which are addressed in different chapters by the 1988 Constitution, are subject to differing principles, with consequences from the fiscal perspective. As contributions are not shared with states and municipalities, they worked as a source of revenue for the generation of primary surpluses aimed at fiscal adjustment in the 90s. Taking into account that contributions are taxes directly bound to funding social security, this was only possible because of a constitutional amendment, which approved a mechanism known as the DRU allowing 20% of these revenues and of other federal taxes not to be restricted and to be spent freely. The federal government started to increase the tax burden on contributions in order to reach primary surpluses. As a result, increasing social security expenditures could fortunately be supported by the simultaneous increase of the remaining 80%. In this way, the DRU, which was initially approved by the National Congress to be in force as a temporary measure, [19] became a permanent need for the federal government. Therefore, it is argued that the federal government faces a Hobbesian dilemma: increase shared taxes or increase the costs to the economy through the charge of cumulative contributions incurred on the payroll and turnover [20] and thus affect Brazilian competitiveness.

The fact is that contributions have become more and more important in the makeup of the federal government's revenue and since 1999 have represented more than has been collected with the personal and corporate income tax (the IR) and the tax on manufactured goods (the IPI) which are shared with the states and municipalities through the participation funds (the FPE and the FPM). Graph 4 shows that IR + IPI represented 76.2% of federal tax collection in 1988, dropping to 45.5% in 2010. The 1988 constitutional arrangement, which conferred more autonomy to states and municipalities, began to progressively fail, particularly in relation to states. To a certain extent, this has lead to conflict within the federal system, even though the problem affected mainly the states that faced losses both in terms of the tax room linked to goods and services and federal transfers, with clear reflections to their available revenue.

19 The DRU has been around since 1994 and has been called Social Emergency Fund or Fiscal Stabilisation Fund.

20 IBGE/ Census, Brazilian Institute of Geography and Statistics, August 2010.

GRAPH 4 – SHARE OF IR + IPI AND OTHER REVENUES (EXCEPT SOCIAL SECURITY) IN THE FEDERAL GOVERNMENT'S TOTAL TAX COLLECTION



Source: own formulation, based on Tax Collection Reports of the Brazilian Federal Revenue.

To balance out the increase in contributions, the federal government grants IPI-related fiscal incentives to taxpayers. As 45% of this tax plus the income tax should be transferred to states (21.5%) and municipalities (22.5% + 1%) in the format of a participation fund (FPE and FPM) and another 10% of IPI is directed to states and municipalities as part of the IPI-Export Fund, benefits awarded by the federal government have a direct effect in the amount shared between subnational governments.

Table 11 show the concentration of federal tax benefits in the IPI and particular in the IR. This table mentions `tax expenditures´ which are defined as indirect governmental expenditures made through the use of the tax system in order to reach targeted economic and social results.

See that CSLL collects 9.4% of the total tax collection of the central government and only 4.9% of that total go to the so called `tax expenditures´. Whereas IR represents 40.7% of the tax collection and 45% is used as "tax expenditure." In relation to the IPI which collects 6.9% of the total, 14.1% is used as "tax expenditure," a proportion much higher than that of Cofins, for example.

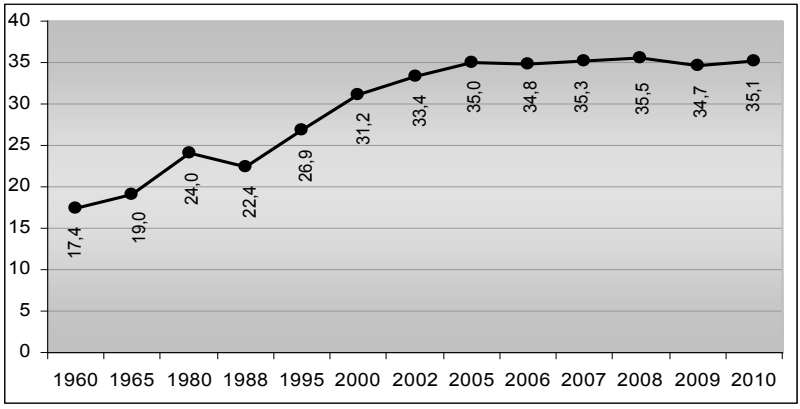
TABLE 11 - SYNTHESIS OF THE TAX EXPENDITURE OF THE FEDERAL GOVERNMENT BY TAX IN 2009

TAX	Tax Expenditure Estimated - R$ Million	Tax Expenditure - % in Total	Total Tax Collected by Central Gov't - R$ Million	% in Total Tax collected
IR – income tax	45,738	45.3%	191,597	40.7%
CSLL – social contribution on net income	4,929	4.9%	44,237	9.4%
IPI – tax on manufactured products	14,204	14.1%	30,753	6.5%
Cofins – contribution for the financing of the social security	27,630	27.4%	117,886	25.0%
PIS and Pasep – social contributions for the Social Integration Programme (PIS) and the Civil Servants´ Equity Programme (Pasep)	5,398	5.3%	31,755	6.7%
Others	3,093	3.1%	14,011	3.0%
Total	100,992	100.0%	470,876	100.0%

Source: Own formulation based on data of the Brazilian federal revenue shown in the report "Gastos Tributários - Estimativas Bases Efetivas 2009" by the Subsecretaria de Tributação e Contencioso; Coordenação-Geral de Estudos Econômico-Tributários e de Previsão e Análise de Arrecadação.

Nevertheless, the overall tax burden has gone up from 19% of GDP in 1965 to 22.4% in 1988 (before the 1988 Constitution); reaching 27% in 1995; 31% in 2000; and 35% in 2010, as Graph 5 shows. More revenue was necessary to fund government spending.

GRAPH 5 – OVERALL GROSS TAX BURDEN – IN % OF GDP



Source: own formulation, based on calculation by José Roberto Afonso. IPEA Seminar 22/09/2010.

An example of how important contributions are for the federal government is when in 2001, despite resistance from states, a small but substantial alteration was made to Article 155 of the Constitution. This change represented an important step towards the advancement of contributions and took place amidst discussions aimed at adapting the tax system to the opening of the oil market started in 1995 when the federal government's oil monopoly was broken. The previous text restrained [21] the central government´s moves towards the taxation of fuels and derivates, minerals, electricity and telecommunication, then under the exclusive authority of states.

From the perspective of states and municipalities, the widening of the base of contributions created to finance social security (health, pension plans and assistance) was probably what stood out the most after 1988. This base began to include profit and turnover of employers (previously it included only payroll). Approximately a quarter of the total of these funds are generated by Conins (Contribution for the Financing of Social Security)

21 Defending that contributions are not taxes, the federal government used to charge PIS and Cofins on the above mentioned products. Taxpayers affirmed that contributions are taxes and in light of Art. 155, X, § 3º argued over the tax feature of contributions, currently acknowledged by the Supreme Court. As a consequence, they are subject to the yearly principle which means that new contributions or the increase of the existing ones can only be charged in the following fiscal year.

and PIS/Pasep, constitutionally bound to FAT (Workers Support Fund) for funding the unemployment benefit programme and the workers' annual allowance. In 2010, the revenue from both these contributions came to a total of R$ 178.6 billion.

For years, taxpayers complained about the cumulative aspects of these two contributions. In 2003, the federal government made changes and they began to have VAT-type features, but cumulative related cases persisted. Also due to cumulative effects another economic contribution on financial transactions, the CPMF, extinguished in 2008, was defended by some and criticised by many. The advantages emphasised its universal characteristic as an efficient overseeing tool and criticism was aimed at its cumulative and regressive aspects.

Despite the focus on the distortions caused by the contributions and the losses suffered by states and municipalities, the biggest criticism in relation to the Brazilian tax system refers to the taxation of production and consumption. There are four VAT-type taxes: IPI, ICMS, Cofins and PIS. Moreover, there is a cumulative municipal tax on service delivery, the ISS. The IPI, mentioned earlier, is a federal tax on national and imported manufactured products. It took that name in 1965, but it is similar to a tax on consumption subject to the system of credit and debit of value added taxes [22] that was created in 1958. ICMS, created by the 1988 Constitution is nothing more than the ICM established in 1965 by Constitutional Amendment 18/65 (EC 18/65), the base of which was widened and the tax replaced the IVC – tax on sales and consignment, which was cumulative. Finally, the ISS was also introduced by EC 18/65 and replaced the old industry and professions tax, and currently it is a tax incurred on services listed in Complementary Bill 56/87, altered by Law 116/2003, which increased the number of taxable services.

IPI and notably ICMS are complex taxes, partly due to the multiple rates resulting from a lot of fiscal incentives and benefits targeted on products, taxpayers or specific operations. An aggravating aspect related to ICMS tax rates is that they may be different in each state. This leads to a lot of difficulty as far as internal and international harmonisation are concerned. Diversity of subnational legislation makes ICMS complex, increasing tax evasion risks, creating unfavourable competitive conditions for good taxpayers

22 According to Aliomar Baleeiro it is consumption tax already anticipated in the 1946 and previous Constitutions, with a new name. See Aliomar Baleeiro, *Direito Tributário Brasileiro*, (Forense: Rio de Janeiro, 1993), pages 199 and 208.

and increasing public and private costs of control. In addition, restrictions to the offsetting credits resulting from acquisitions of capital assets and goods consumed by the companies, and sometimes difficulties in also to the offsetting credits of international sales undoubtedly affect competitiveness.

Therefore, ICMS, which was firstly thought as a consumption tax, applying the principle of destination to allow for the exemption of capital assets and inputs, ended up based on the principle of origin, mitigated as a consequence of different interstate rates. The tax burden of the ICMS collected in interstate operations is still shared between producing and consuming states. In 1988, the idea of making ICMS and ISS into one tax was not successful and ISS remained a municipal tax. Despite this, municipalities had their ICMS transfer increased from 20% to 25%. ISS is cumulative and it subjects taxpayers to the discretion of fiscal authorities, particularly in cases that involve simultaneously the rendering of services and the sales of goods taxed by ICMS. As a result of these comprehensive and at times restrictive distortions, reforms aimed at changing the tax system, particularly targeting the taxation of production and consumption, specifically the ICMS, are a constant item in the national agenda. Section 3 addresses this matter in more detail.

3. CHALLENGES FOR FISCAL FEDERALIM IN BRAZIL 23

3.1. ICMS AND TAXATION OF GOODS AND SERVICES IN BRAZIL

The taxation of goods and services in Brazil is complex because there are many taxes (ICMS, ISS, IPI, Cofins, PIS, Cide, IOF) [24] under federal, state and municipal authority exploring the same tax base in a less than harmonised manner – the consumption base involves three systems: taxes, contributions and the "*simples nacional*" regime - practically a separate tax system for small businesses. However, the ICMS holds the record in terms of collection, with 20.5% of the

23 On this section: the term "operations" includes the delivery of services taxed by the ICMS; reference to states includes the Federal District; and VAT is a general reference to value added taxes.

24 ISS – municipal tax on services; IPI - tax on manufactured goods; Cofins – contribution for the financing of social security; PIS – contribution for the social integration programme; Cide – economic contribution on fuel; IOF – tax on financial transactions.

country's total tax burden and 7.2% of the Gross Domestic Product (GDP) in 2010, [25] and thus is singled out as the greatest problem. The fragmented tax base leads to fragmented legislation with cases of single and multi stage taxation and cumulative and non-cumulative taxes, and even cumulative aspects in non-cumulative taxes. Different calculation methods and regimes can also be applicable to the same tax. In addition, to make things worse, there are several nominal/legal rates and a great variety of effective rates that sometimes happen to be calculated within the tax base itself like in the ICMS. Nevertheless, it is also important to point out that progress has been achieved at the operating level, consequence of a greater availability of new information technology tools that help, e.g., reducing both the compliance burden and tax evasion. However, in practice a considerable degree of duplication of efforts persists amongst the different government spheres whether in auditing, compliance control, recording and information systems, consultations or administrative litigation.

The fragmentation of and the competition for the tax base of goods and services in Brazil and the consequent compression of the ICMS base, first by social contributions under the authority of the federal government and then by ISS were mentioned earlier. Adding to this is the fact that the ICMS may be used as an autonomous non-coordinated state economic policy instrument, referred to by the states as fiscal war. Although it is the main VAT-type tax in Brazil, it is not solely used for tax collection purposes – despite high fiscal productivity. Its complex wording and lack of harmonisation leaves room for tax evasion and avoidance. A great part of that complexity results from state legislation, especially in cases in which it does not comply with the general national rules that have been enacted.

These factors make ICMS lose VAT-type features and compromise tax collection, which is ever more concentrated on the so-called "selective" ICMS. In this case, the levy ends up being concentrated on a few products: oil and its sub-products, electricity and telecommunications, which before 1988 were subject only to federal taxes. There is a concern by the states because they have already reached their limits on these tax bases, made up of products that are part of all stages of the chain of production. In this situation, states may be caught

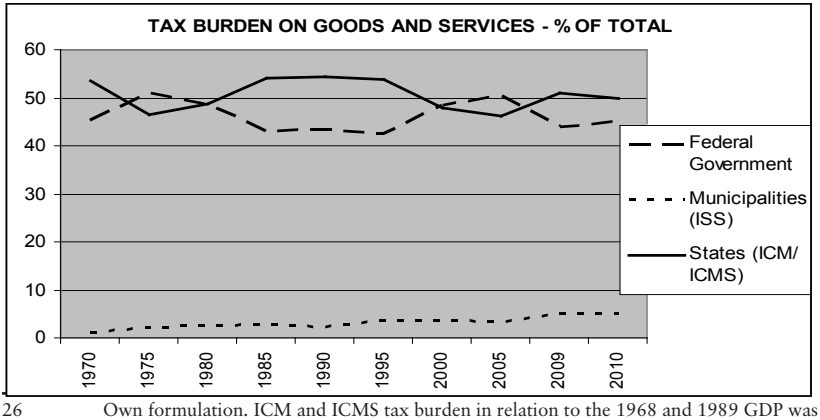
25
José Roberto Afonso, and Kleber Castro, *Carga Tributária Global no Brasil em 2010*, 2011.

off guard in case they have to readapt the levy, aiming at conventional products of the tax base. The wide use of the single-stage ICMS, the so-called "*substituição tributária*" is also a feature of the "selective" ICMS – deferring or anticipating the payment of the tax that is calculated through the use of a pre-fixed value-added margin. The advent of the "*Simples Nacional*" aggravates the current situation of ICMS.

Tables 12, 13 and 14 and Graphs 6 and 7 [26] show indicators that demonstrate the loss of room by states in the taxation of goods and services and the concentration of ICMS collection in some sectors of the economy. In order to confirm the reduction of ICMS, it is important to note that in 2010 it represented practically the same percentage of the GDP that it did in 1968, the year when the old ICM was created. All of this shows that ICMS has stagnated when compared to the systematic increase of the overall tax burden in the country.

TABLE 12 – INTER-TAX COMPETITION FOR THE BASE OF GOODS AND SERVICES IN BRAZIL

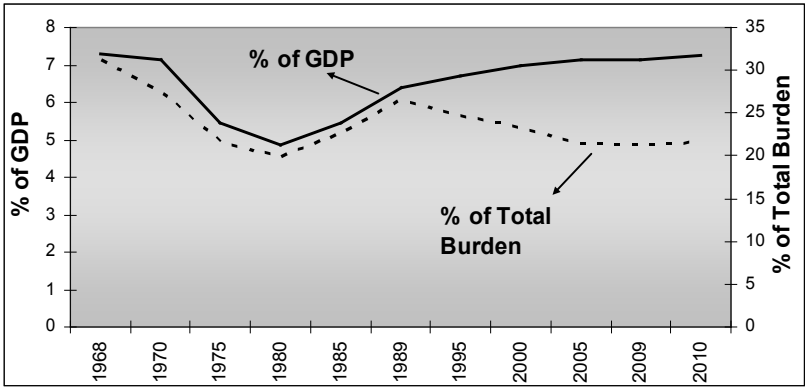
Year	Tax Burden in % of GDP			% ICMS in the tax burden	
	Overall	Goods and Services	ICMS	Overall	Goods and Services



26 Own formulation. ICM and ICMS tax burden in relation to the 1968 and 1989 GDP was calculated considering GDP values prior to the previous 2007 methodological review by IBGE. Taxes on goods and services contemplated in the calculation are: ICMS, ISS, IPI, PIS/Pasep, Finsocial/Confins, IOF, CPMF and the federal Tax on Fuels, Electricity and Minerals (extinguished in 1988).

1968	23.29	...	7.28	31.26	...
1970	25.98	13.38	7.15	27.51	53.39
1975	25.22	11.70	5.45	21.61	46.58
1980	24.52	9.98	4.87	19.86	48.79
1985	24.06	10.06	5.44	22.59	54.05
1989	24.13	11.00	6.41	26.56	58.26
1995	27.00	12.46	6.69	24.78	53.69
2000	29.90	14.57	6.98	23.34	47.91
2005	33.40	15.46	7.15	21.41	46.25
2009	33.60	14.01	7.13	21.22	50.89
2010	33.41	14.52	7.25	21.70	49.93

GRAPH 6 – ICMS SHARE IN BRAZIL'S OVERALL TAX BURDEN



GRAPH 7 - COMPETITION FOR THE TAXATION OF GOODS AND SERVICES:

REDUCTION OF STATES' TAX BASE (ICM

TABLE 13 – CONCENTRATION OF ICMS COLLECTION – % ICMS ON GDP

Year	TOTAL 'SELECTIVE' ICMSTOTAL	ICMS OTHER ACTIVITIES	OVERALL TOTAL ICMS
1997	1.7%	**5.1%**	**6.8%**
1998	**2.0%**	**4.6%**	**6.7%**
1999	**2.4%**	**4.5%**	**7.0%**
2000	**2.8%**	**4.6%**	**7.5%**
2001	**3.1%**	**4.8%**	**7.9%**
2002	**3.1%**	**4.7%**	**7.8%**
2003	**3.2%**	**4.4%**	**7.6%**
2004	**3.2%**	**4.6%**	**7.8%**
2005	3.3%	**4.7%**	**8.0%**
2009	**2.8%**	**4.4%**	**7.1%**
2010	**2.5%**	**4.7%**	**7.3%**

TABLE 14 – CONCENTRATION OF ICMS - % OF TOTAL ICMS

YEAR	FUELS	ENERGY	COMMUNICATION	ALL SELECTIVE	NON SELECTIVE	TOTAL ICMS
1997	12.9	8.3	6.3	27.5	72.5	100
1998	14.0	9.6	8.1	31.6	68.4	100
1999	16.6	9.8	9.7	36.2	63.8	100
2000	18.8	9.7	10.5	39.1	60.9	100
2001	19.0	9.1	12.5	40.6	59.4	100
2002	19.0	9.6	12.2	40.8	59.2	100
2003	**20.3**	10.3	12.3	42.9	57.1	100
2004	19.3	11.0	11.9	42.1	57.9	100
2005	18.8	11.3	12.5	42.5	57.5	100
2006	19.2	**12.2**	**12.8**	**44.2**	55.8	100
2007	18.1	12.0	**12.8**	42.9	57.1	100
2009	15.8	10.1	12.1	38.1	61.9	100
2010	15.1	9.6	11.0	35.7	64.3	100

The bolded values here represent the year that each taxed item reached its highest value as a percentage of the total ICMS.

Note that from 1989 (year when the alterations made to the 1988 Constitution came into force) ICMS also began to be charged on electricity and fuels, as well as on communication services, which

until then were taxed by the federal government. These three economic activities yielded 36% of ICMS total collection in 2010 at the national level, a consequence both of ever higher tax rates and of the fact they are not part of the fiscal war in which states are engaged. The peak of concentration in the collection of these tax bases was in 2006, when the "selective" ICMS reached 44.2%. Significantly, these activities are subject to the principle of destination in interstate transactions. This "principle of destination", proves the argument below that positive interstate tax rates above zero do finance and feed the ICMS-related fiscal war.

The issue of origin-destination lends permanent tension between the principle of destination as a jurisdiction rule (allocation of revenue) and the principle of origin as an integration goal (coordination/ harmonisation). In international trade, the principle that is adopted as a rule is destination. In this case, "border fiscal adjustments" are made on behalf of the jurisdictions involved (customs) to avoid distortions in inter-jurisdictional trade. In cases of advanced regional integration or subnational taxation authority, it is recommended that the principle of origin be adopted to levy the tax in the state of origin and allocate the collected revenue to the jurisdiction of destination. However, this requires mechanisms such as a clearing board to allocate the product of tax collection in part or as a whole to the state of destination. No proposal for a clearing board or other alternative has been politically viable so far in Brazil.

In the case of VAT submitted based on the principle of destination, the tax collection has a direct relation with the consumption of the goods and services in the final destination, in order to provide supply for the demand of public services by citizens, whose income has enabled this consumption. In addition, as consumption tends to be less concentrated than production, the principle of destination is a way of allocating revenues from interstate transactions allows for a more horizontal equal revenue distribution (among states).

Charging ICMS on interstate operations enables the state of origin to grant fiscal benefits related to a part of the tax or all of it. Consequently, this compromises tax collection in the state of origin and imposes on the state of destination the burden of handling the full tax

credit resulting from the tax stated in the invoice, but not paid (as it should have been) in the state of origin. In order to compensate for the amount not charged as a result of benefits granted, it is possible that the state looks for other ICMS revenue sources. Possible solutions are to increase even more the tax rates on electricity, fuels and communication services. However, this solution, besides being unpopular, affects the chain of production rather heavily. Taking these conditions into account, it is fair to say that with the current format, ICMS/VAT sometimes looks like a selective tax and sometimes like a single stage tax; and when it is charged using its normal regime, it may turn into a weapon at the service of fiscal war.

3.2. FISCAL COMPETITION BETWEEN STATES (FISCAL WAR)

With the establishment of ICM in 1967, Brazil became the first country to allocate VAT-type tax authority to a subnational government level. The 1988 Constitution created the ICMS, whose tax base was increased compared to the ICM, as mentioned earlier. As ICMS' general rules apply to all states, it is a national tax and the definition of its base is described in the 1988 Constitution, which also details sets the main applicable rules. During the centralised political regime in force until the mid-80s, an elevated degree of tax harmonisation prevailed and there was no need for intergovernmental cooperation. With the democratisation process triggered by the 1988 Constitution, subnational entities achieved a significant level of autonomy and the need for building effective cooperation emerged. The success of this cooperation is questionable in terms of ICMS, particularly in relation to interstate transactions, which offer a source of ammunition for fiscal war.

ICMS is levied on the circulation of goods and the supply of communication and intermunicipal and interstate transportation services[27]. It is also levied on some interstate transactions and on imports from abroad. In addition to the 1988 Constitution, Complementary Bill No 87/96 defines its base and general rules; Complementary Bill No 24/75 sets rules concerned with the granting of fiscal benefits. Both laws should be

27 The other services are taxed by the ISS, the tax on services levied by the municipalities.

applied by all states. Interstate and minimum internal rates are determined by the Senate, which can also define maximum internal rates in order to resolve conflict among states. However, the power given to the state by the 1988 Constitution and Complementary Bill 24/75 to award fiscal benefits, ends up by interfering in the effective rates. Not to mention illegal benefits that the states grant unilaterally, as will be explained in the next section. The states are left with the power of defining and drafting the rules of the ICMS tax in their own territory, including the internal rate, as long as the limits established by the Senate are respected. Therefore, it is possible to affirm that generally speaking, the ICMS is ruled by the principle of legislative homogeneity, despite being regulated by different laws in all twenty-six states and the Federal District (Brasilia).

Table 15 shows the historical background of interstate ICM and ICMS rates. When the old ICM began in 1967, it started as a uniform and harmonised tax, with a rate of 15% on all transactions totally subject to the principle of origin, even in international transactions. Soon after, the competition between consuming and producing states started: so already in the 70s it was noticed that an interstate rate lower than the internal rate could provide for a desirable sharing of revenue between the state of origin and destination. Then, the Senate edited Resolution 65/70 and interstate and export rates became gradually smaller than the internal ones.

In 1980, Confaz [28] decided that in calculating the ICM charged on interstate transactions between taxpayers, the states could apply percentages of reduction to the price in cases approved by all of the states. [29] In the same year, Resolution 07/80 from the Senate approved different interstate rates according to the country's regions of origin and destination, reducing them once more to 10% (1980), 9.5% (1981) and 9% (1982) for goods leaving the richer South and Southeast regions (except Espírito Santo state) bound for the poorer Northern, Northeast and Central West regions [30].

After the 1988 Constitution, Senate Resolution No 22/89 kept that structure of rates. The rate drops to 7% in transactions from states of the South and Southeast to states of the North, Northeast and Central West. The state of origin keeps a part (12% or 7%) of the tax and the state of destination

28 National Finance Policy Council.
29 ICM Agreement 01/80.
30 For interstate rate purposes, Espírito Santo was classified as a Northeastern state. The Federal District is in the Central West region and in tax matters enjoys the same prerogatives as states, although it is not divided in municipalities, it charges state and municipal taxes.

the difference. For example, if the internal rate is 17%, the difference in favour of the state of destination could be 5 or 10 percentage points, according to the applicable interstate rate of 12% or 7%. In these terms, the lower the interstate rate, the lower the amount taxed by the origin state and the ICMS credit to be offset by the taxpayers in the state of destination. This means that in ICMS terms, Brazil does not adopt the principle of origin nor of destination, but a mixed principle, where interstate rates work as a tax sharing mechanism between origin and destination states. This mechanism works as a horizontal revenue transfer for less developed regions and since it adoption has led to a certain level of conflict in the federal system. However, for communication services, and for electricity and oil, including lubricants and other by-products of oil, only the destination principle is applied.

TABLE 15 – HISTORICAL BACKGROUNG OF INTERSTATE ICM AND ICMS RATES IN TRANSACTIONS BETWEEN TAXPAYERS

	From the North / Northeast /	From the South/ Southeast - ES (1)	
PERIODS	Central West + ES	To N / NE / CO/ +ES	To SU / SE -ES
1967 (1)	15.0%	15.0%	15.0%
1968 and 1969 (1)	18.0%	15.0%	15.0%
1970 (2)	15.0%	15.0%	15.0%
1971 (2)	14.5%	14.5%	14.5%
1972 (2)	14.0%	14.0%	14.0%
1973 (2)	13.5%	13.5%	13.5%
1974 (2)	13.0%	13.0%	13.0%
1975 (3)	12.0%	12.0%	12.0%
1976 to 1979 (3)	11.0%	11.0%	11.0%
1980 (3)	11.73%	10.0%	11.78%
1981 (3)	11.0%	9.5%	11.0%
1982 and 1983 (3)	11.0%	9.0%	11.0%
1984 (4) to 1988	12.0%	9.0%	12.0%
1989 (5)	12.0%	8.0%	12.0%
1990 onwards (5)	12.0%	7.0%	12.0%

Source of data until 1977: Ministry of Finance/Secretariat of Economy and Finances/ *Revista de Finanças Públicas* No 85. From 1978:

(1) Complementary Act No 31/66 established a uniform national rate of 15% for all operations.

(2) Senate Resolution 65/70.

(3) Senate Resolutions 58/73, 98/76 and 07/80; Agreement ICMS 44/76.

(4) Constitutional Amendment No 23/83.

(5) Senate Resolution 22/89.

The ICMS was set up in the 1988 Constitution [31] as a non-cumulative tax. But its rates in interstate transactions lead to states interfering with one another, as ICMS paid in the state of origin should be fully acknowledged as an ICMS credit by the buyer in the state of destination. This practice requires

31 Art. 155, § 2º, I.

a reasonable level of harmonisation amongst states. In the absence of such harmonisation, states implement practices that effectively foster a fiscal war and make up mechanisms and strategies with no economic reasoning. One of these practices, the awarding of ICMS credits, widely used in the last few years, will be analysed in the following section.

3.3. FISCAL WAR: CAUSES, CONSEQUENCES AND ALTERNATIVES

During the 80s, ICM fiscal benefits were practically restricted to the extension of the tax payment deadline, which according to Complementary Bill 24/75 could be up to 180 days from the day of the transaction. During that time, it cannot be said that the states that granted a 180-day payment period were engaged in fiscal war. However, with the financial crisis of the public sector in the 80s and the increasing scale of inflation, this payment-related elasticity became a factor for concern by the states. In their turn, enterprises resisted the reduction of the payment periods, only truly implemented after the introduction of the ICMS, in the period after the 1988 Constitution as decided by Confaz.

The financial difficulties faced by states during the economic crisis in the 80s kept the fiscal war at a low level until the mid 90s, as a result of the lack of investments. The competition only took on more aggressive features in the second half of the 90s, driven by the return of foreign investment in Latin America from the end of the 80s, and of internal investment – a consequence of monetary stabilisation in 1994. Some states began to use several tax incentives to attract companies from the automotive sector. State governments also began to create new programmes or funds for supplying the demands of companies interested in doing business, a circumstance referred to by Cavalcanti and Prado (p. 89) 32 as "fiscal-financial operations aimed at specific projects." Cardozo, 2010 33 analyses the amount of ICMS applied in

32 Carlos Eduardo G. Cavalcanti and Sérgio Prado, *Aspectos da Guerra Fiscal no Brasil* (São Paulo: IPEA/FUNDAP, 1998).

33 Soraia Aparecida Cardozo, *Guerra Fiscal no Brasil e alterações das estruturas produtivas estaduais desde os anos 1990*. (Unicamp: Dissertação de Mestrado, Campinas, 2010).

policies for the attraction of investment in a number of states, among them the state of Paraná. Table 16, for example, shows the percentage of total ICMS deferred in Paraná from 1992 to 2007, whose peak coincides with the settlement and first years of production of Nissan, Renault and Volkswagen/Audi in that state. Besides being granted a considerable period of time to pay the ICMS without fines, late charges or indexation, these companies were favoured with arrangements that ranged from special infrastructure of services and real estate donations for plants to the exemption of local taxes and stock ownership by the state itself.

TABLE 16 – ICMS DESIGNED FOR PROGRAMS OF INCENTIVES WITH SPECIAL ICMS CREDIT PAYMENT CONDITIONS IN THE STATE OF PARANÁ

ANOS	R$ Mil (standard cost)	R$ Mil (average cost in 2010 (inflator: IPCA)*	Percentage in total ICMS of the state
1992	2,0	4,076	0.1%
1993	571,4	56,334	1.3%
1994	12,161	55,098	0.9%
1995	24,992	68,210	1.0%
1996	30,226	71,265	1.0%
1997	97,312	214,571	3.4%
1998	245,657	524,899	8.3%
1999	293,756	598,590	8.5%
2000	482,196	917,917	11.1%
2001	657,282	1,171,105	13.3%
2002	634,823	1,042,958	11.2%
2003	642,503	920,172	9.5%
2004	559,673	751,940	7.1%
2005	523,268	657,837	5.9%
2006	547,016	660,078	5.9%
2007	572,182	666,188	5.7%

Source: Own formulation based on data of the Secretary of Finance of the State of Parana and Cardozo, 2010.

*IPCA = Broad Consumer Price Index.

Then, states also intensified competition to attract commercial

ventures offering ICMS credits not actually corresponding to previous acquisitions of inputs, so-called awarded or presumed credits. The use of the presumed credit method in its origin is a technique aimed at the replacement of credits to facilitate the calculation of a tax in specific situations such as inputs bought from farmers and other rural producers. In such cases it is difficult to find out the actual amount, so presumed credit allows for a fixed amount in the offsetting the tax credits.

Its function was to make the principle of non-cumulativity operational, but it began to be used as a weapon in the fiscal war. In this context, the taxpayer is conferred the right to a credit of ICMS - a determined amount – as well as, in general, to the regular ICMS credit from inputs. Some distinguish the ICMS awarded credit from the ICMS presumed credit on the basis that the first does not result from agreement among the states.

Awarded credit implies the effective reduction of the ICMS tax burden and is clearly part of a subsidy, a donation given to the company, which may or may not transfer this benefit in the prices it charges. The practice of granting ICMS award credits affects the credit and debit chain and destroys any attempt towards ICMS harmonisation. It enables the granting state to affect market conditions in opposite to all good practices related to VAT-type taxes.

An important strategy of any war is that chances of winning always increase when the weapons used are unknown by the enemy. Therefore, "secrecy is the recipe for success." Thus, states have preferred to "war" over ICMS award credits. This modality makes it more difficult for the fiscal benefit to be identified in the invoice and even impedes it from being audited, making it harder for the state of destination to adopt safeguarding measures. A competitive "advantage" of ICMS award credit for a company in the state of origin is that the company in the state of destination may appropriate the full credit. Invoices issued to send goods and services to other states highlight ICMS, be it at a rate of 12% or 7% (depending on the state of destination). The state of destination takes on the ICMS's full credit highlighted in the invoice, even if the charge has been totally or partially cancelled in the state of origin through an ICMS award credit.

This practice was intensified in 1997. Before then, there was no clear perception of how fiscal war hindered the tax collection of another state, and that was the reason why reform proposals did not address the issue much. In order to reduce losses, some states tried to make the Supreme Court aware of the fact that the state of destination may or may not allow the offsetting of such ICMS award credits when the state of origin has partially or totally cancelled the charge. In such cases, this provided the company in the state of origin with a fiscal benefit, with no support or agreement amongst the states. In view of that, it is reasonable to consider ICMS award credit as a benefit to a private company. For, once granted, this credit should be given the treatment of public expenditure with a requirement of due transparency.

States grant indirect fiscal benefits through tax expenditures (the opposite of tax collections) through offsets such as ICMS award credits, renouncing revenue basically for two reasons: firstly, because the bill is paid by other states; secondly, because granting benefits through the state budget may not be possible in view of budget inflexibility at the state level[34]. The grant of fiscal benefits through the renouncing of revenue works as a means of avoiding statutory budgetary restrictions. So, in addition to being illegal, this practice may also be harmful to the municipalities which do not receive the 25% from ICMS that they would have had if the benefit had not been granted - as the revenue is not even accounted for in the state budget. In the same way, other budgetary binding obligations are not provided for, such as the 25% that should go to education and 12% for health. The missing ICMS is also not accounted for when the net current revenue is verified – it is the parameter for calculating the amount that the state should pay monthly to the federal government because of the (intralimit) debt.

Therefore, a number of fiscal benefits given through the revenue-renouncing channel do not have to compete in the budget for scarce public funds, nor do they have to face financial restrictions that need to be followed by states. Public budgets are instruments aimed at organising, listing, prioritising and publicising government spending. Fiscal benefits that use the illegal revenue-renouncing channel actually do the opposite,

34 States have always wanted their revenues not to be designated for specific programs, but the National Congress never approved such a practice, despite the fact that the federal government uses a mechanism known as the DRU to leave some federal revenues out that rule.

as they imply a "bartering" feature in their implementation, a type of "offsetting procedure" between potential ICMS taxpayers and the state. Such offsetting procedures avoid the intermediary stages related to public policies that encompass tax collection and spending, in this order. According to the Fiscal Responsibility Law (LRF), "tax expenditure" (revenue renouncement) should be detailed in state public budgets, but few states mention this expenditure transparently in the annual state expenditures statement.

Article 14 of the LRF sets limits to the granting of fiscal benefits affecting the financial-budgetary conditions of the federal government, states or municipalities. Some think that this article may restrict the "fiscal war," but this does not occur because the LRF fits into the field of financial law and thus, may not interfere in tax rules related to the granting of fiscal benefits and incentives. Article 14's role is to ensure balanced budgets. As at the level of renegotiation of debts, states commit to making monthly payments in terms of percentage of their real net revenue, thus, instruments that effectively impede fiscal benefits that compromise revenue performance from being granted need to be developed. Article 14 also establishes that the renouncing of revenue should be followed by a balance sheet that proves that the fiscal targets will not be affected by the renouncing of revenue; or that the state will implement compensation measures to increase revenue through the increase of tax rates, widening the tax base, the exceptional increase or creation of a tax or contribution.

The 1988 Constitution (Art. 165, §6º) already rules that the budgetary draft bill be followed by a detailed balance sheet on the effect on revenues and spending, resulting from exemptions, amnesties, remissions, subsidies and financial, tax credits and benefits. It is up to the LRF, which states and municipalities must comply with, to establish cases where benefits that lead to revenues being renounced are allowed. Currently, for the benefit to be authorised it is enough to show that it will not affect fiscal targets. Evidently, it is desirable that all benefits granted be shown in the budgets – as determined by the 1988 Constitution. However, only when it is possible that fiscal targets established in the budget may be compromised, are states required to show the impact and point to funding sources to compensate the renouncing of revenue.

The LRF was only approved in 2000. Therefore, significant benefits that have driven the fiscal war, granted in the peak of this conflict in the 90s, are not considered by this instrument as (new) renouncement of revenue.

ICMS award credit has been sowed in the fertile ground of Brazilian imports. If the highly valued national currency favouring imports was not enough, the states decided to make things worse intensifying the fiscal war in this modality, which brings together imports and wholesale and distribution centres.

ICMS is charged on imported goods [35]. The tax is owed the moment the goods go through customs, but it is due to the state of the purchaser, be that a company or a consumer. Faced with the difficulty in identifying the real buyer, states fight for the right to tax imports, particularly when the buyer that placed the import order was in different state from the one where customs were cleared.

Complementary Bill 87/96 says that ICMS from imports belongs to states where the actual purchaser of the imported good or service is located. Nevertheless, the prevailing understanding of courts has been divergent: the importer is the company that is the legal recipient, even if the good follows on directly after customs clearance or is sent to another state after being internalised in the state where the importing agent is located. Nonetheless, there are cases where the legal recipient is not the real purchaser, but may be a mere agent serving the actual purchasing company in the capacity of proxy, as in the import modalities "for account and by order of" or "by order."

Cases in which states attract businesses like trading companies, distribution centres or mere import service deliverers have been multiplying. When customs are cleared in a state other than the purchaser's, the state grants total or partial suspension of ICMS

35 1988 Constitution, Art. 155, II.

payment. Then the imported merchandise is forwarded to other states with the normal ICMS interstate charge of 12 or 7% (according to state of destination) with ICMS credit being awarded to the state of destination. The ICMS suspended during clearance at customs is not charged from the importer in the state of origin, which grants totally or partially the ICMS award credit. The result: it is not the state that grants the benefit that loses with tax collection, but the state of the destination of the goods, which has to offset the ICMS award credit.

The main instrument for reducing the ICMS burden on imports has been the ICMS award credit. From the point of view of the state that awards the benefit, the motivation resides in the fact it will not lose revenue, as this is what happens to the state that has to provide for the full ICMS credit. The awarding state, together with the company located in its territory share the difference in the tax rate at a cost to the state of destination. The perception of the awarding state is that they have lost nothing, because if the legal importer was located in another state, the awarding state would collect no revenue at all. Though, in aggregate terms, there is tax collection loss at the national level and economic distortions. The ICMS credit needs to be fully acknowledged in the state of destination, but the debit was neutralised in the state of origin with the ICMS award credit, as shows item 2 on Table 17. Item 3 on that table shows that State B wins R$ 108.00 at the cost of State A, which loses R$ 720.00. Considered the country as a whole, there remains a revenue loss of R$ 612.00 that may reflect in the offering of public services, particularly in State A.

TABLE 17 – TAX WAR USING ICMS ON IMPORTED GOODS: example of the effect of ICMS award credits not corresponding to the ICMS levied in the previous transactions.

NOTE: Company 1 is in state A

Company 2 (trading) is in state B

Consumer resides in state A

ICMS rate in intrastate transactions and imports: 18%

ICMS rate in interstate transactions: 12%

Premise: price is unchangeable

1. TRANSACTION WITHOUT ICMS BENEFITS: Company 1 in state A imports through that same state	**State A**	**State B**	**Total ICMS**
1.1. Import (from abroad) by Company 1			
1.1.1. Tax base (ICMS)	6,000.00		
1.1.2. ICMS rate on imports	18%		
1.1.3. ICMS incurred (on customs) = 1.1.1 x 1.1.2	1,080.00		
1.1.4. ICMS credit	-		
1.1.5. ICMS paid = 1.1.3 - 1.1.4	1,080.00	0	1,080.00
1.2. Resale of the imported good by Company 1 to Consumer in the same state A			
1.2.1. Tax base (ICMS)	10,000.00		
1.2.2. ICMS rate (intrastate)	18%		
1.2.3. ICMS incurred = 1.2.1 x 1.2.2	1,800.00		
1.2.4. ICMS on inputs = 1.1.5	1,080.00		
1.2.5. ICMS paid = 1.2.3 - 1.2.4	720.00	0	720.00
1.3. Total ICMS = 1.1.5 + 1.2.5	**1,800.00**	**0**	**1,800.00**

2. TRANSACTION WITH ICMS BENEFIT: Company 1 (state A) hires Trading Company 2 (state B) to operate the import for its account and order.	**State A**	**State B**	**Total ICMS**
2.1. Import (from abroad) by Company 2			

2.1.1. Tax base (ICMS)		6,000.00	
2.1.2. ICMS rate on imports		18%	
2.1.3. ICMS suspended or deferred		-	
2.1.4. ICMS credit		-	
2.1.5. ICMS paid = 2.1.3 - 2.1.4		0	0
2.2. Resale from Company 2 to Company 1			
2.2.1. Tax base (ICMS)		6,000.00	
2.2.2. ICMS rate (interstate transactions)		12%	
2.2.3. ICMS incurred = 2.2.1 x 2.2.2		720.00	
2.2.4. ICMS credit (fiscal benefit) = 2.2.3 x 85%		612.00	
2.2.5. ICMS paid = 2.2.3 - 2.2.4		108.00	108.00
2.3. Resale from Company 1 to Consumer in the same state A			
2.3.1. Tax base (ICMS)	10,000.00		
2.3.2. ICMS rate	18%		
2.3.3. ICMS incurred = 2.3.1 x 2.3.2	1,800.00		
2.3.4. ICMS credit = 2.2.3	720.00		
2.3.5. ICMS paid = 2.3.3 - 2.3.4	1,080.00		1,080.00
2.4. Total ICMS = 2.1.5 + 2.2.5 + 2.3.5	**1,080.00**	**108.00**	**1,188.00**

RESULTS ON ICMS REVENUE	State A	State B	Total ICMS
3. NET ICMS LOSS			
3.1. Loss for state A = 1.3 - 2.4	720.00		
3.2. Gain for state B = 1.3 - 2.4		108.00	
3.3. Net loss of ICMS revenue for Brazil = 3.1 - 3.2			612.00
4. IMPACT ON COMPANIES 1 AND 2			
4.1. Company 1			
4.1.1. Gain on ICMS incurred = 1.3 - 2.4	720.00		
4.1.2. Costs paid to Company 2 = 10% of 2.2.1 (estimated)	600.00		
4.1.3. Net profit = 4.1.1 - 4.1.2	120.00		

4.2. Company 2			
4.2.1. Payment from Company 1		600.00	
4.2.2. ICMS incurred = 2.2.5		108.00	
4.2.3. Net profit = 4.2.1 - 4.2.2		492.00	
5. Net profit of Companies 1 and 2 (4.1.3 + 4.2.3) = Net loss of State A + State B (3.3)			612.00

Source: Own formulation.

In a chain succession, most states saw themselves made to reduce ICMS tax burden on imports from abroad. As a reactive or defensive measure, this practice works as an inside-out customs barrier36, as it favours artificially imports from abroad to the detriment of national production.

Table 18 and Graph 8 show the evolution of imports in the selected states, taking 2003 as the reference year, which is equal to 1. In that year the governors that intensified the granting of fiscal benefits of ICMS to imported goods took office

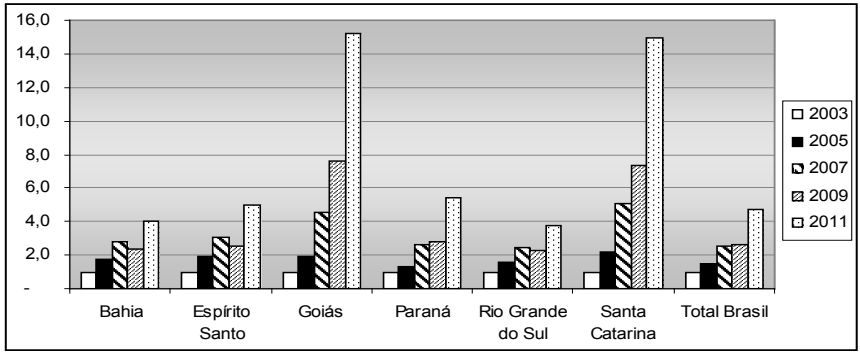
In the state of Espírito Santo, fiscal benefits of ICMS on imports have occurred every year since the 1970s. As that state started to face competition of the other states, the evolution of its imports became similar to the national average in the period analysed. The states of Bahia, Paraná and Rio Grande do Sul also faced an evolution of imports similar to the national average. There is evidence that those states have not entered a regular practice of granting ICMS benefits to imports. On the other hand, in Goiás and Santa Catarina the increase of imports is quite above the national average due to their heavy adoption of ICMS benefits on imported goods after 2003.

36 Expression used in the 1980s by Clóvis Panzarini, then tax coordinator of the Secretariat of Finance of the State of São Paulo.

TABLE 18 – EVOLUTION OF IMPORTS IN SELECTED STATES (reference: 2003=1)

STATE	2003	2004	2005	2006	2007	2008	2009	2010	2011
Bahia	1,0	1,6	1,7	2,3	2,8	3,2	2,4	3,4	4,0
Espírito Santo	1,0	1,4	1,9	2,3	3,1	4,0	2,5	3,5	5,0
Goiás	1,0	1,7	1,9	2,6	4,5	8,1	7,6	11,1	15,2
Paraná	1,0	1,2	1,3	1,7	2,6	4,2	2,8	4,0	5,4
Rio Grande do Sul	1,0	1,3	1,6	1,9	2,4	3,5	2,3	3,2	3,7
Santa Catarina	1,0	1,5	2,2	3,5	5,0	8,0	7,3	12,1	14,9
TOTAL BRASIL	1,0	1,3	1,5	1,9	2,5	3,6	2,6	3,8	4,7

GRAPH 8 – EVOLUTION OF IMPORTS IN SELECTED STATES (reference: 2003=1)



In the case of the state of Espírito Santo, the tax is being financed by the Fund for the Development of Port Activities (FUNDAP). The state was a pioneer in the granting of the import benefit in the 1980s, a time when ICMS award credit was not used yet. In relation to the practice of returning the tax to the beneficiary company, author Luciano Miguel (p. 63), [37] says that after detailed study states that "...it is not a financial benefit, benefit granted in such a way as to reduce the ICMS that incurs in determined transactions and services. In this case, we are faced with a fiscal benefit disguised as a financial benefit and as such, it has to be submitted to an approval process, as defined by Complementary Bill No 24/75."

37 Luciano Miguel, *O ICMS e os Benefícios Fiscais nas Operações de Importação* (Catholic University of São Paulo - PUC/SP : Dissertation for a Master's Degree in Law, 2011).

The phenomenon was relatively restricted to Espírito Santo in the 80s. However, it started to spread when in the 1990s the Federal District granted benefits to the wholesale sector. In Santa Catarina, importing products through its ports means that the importer or person who places the order, incurs only 3% of ICMS, which is the result of suspension during clearance, added to the ICMS award credit in the next stage of the interstate transaction. Paraná, a neighbouring state, in a defensive measure adopted the same measure.

Fiscal war, which began as a consequence of states competing for new manufacturing plants, can significantly hinder the national productive sector in the case of imports. An imported product generates employment and income in another country and when imported in more beneficial conditions than those found in the internal market, contributes to reducing employment levels and the generation of wealth in Brazil.

It is possible that the severity of the fiscal war in what refers to imports has not reached even higher levels as a result of the increase in Cofins imposed by the federal government from 2004, which coincided with the increase of ICMS import fiscal benefits. This means that the part that states gave up of their ICMS tax base in imports, could be taken by the central government.

Since 2011, the federal government opted for "*slicing*" how they would address the problems that affect ICMS, among those of benefits granted to imports. At the time of this writing, a proposal for a Resolution (PRS 72/2010) is under debate in the Senate to reduce ICMS tax rates in interstate transactions with imported goods. Identifying a resistance on the part of states, the federal government has suggested a three year transition until a 2% interstate ICMS on imports is reached. The decreases proposed were from 12% to 8% and from 7% to 4% in 2012. They would fall from 8% to 4% in 2013. Finally, they would drop from 4% to 2% in 2014. Alternatively, there was also a proposal for changing the ICMS interstate tax rates in all transactions from 12% to 10% in 2012 (the current 7% rate would remain); and for 8% in 2013 (the current 7% rate would remain); to 6%, 4% and 2% in 2014, 2015 and 2016 respectively.

Therefore, on the one hand the adoption of the principle of destination is being discussed. On the other hand, keeping an interstate

rate between 2% and 4% has been argued as a means of keeping interstate transactions under control. However, a very low or even 0% interstate rate has negative implications such as the accumulation of ICMS credits requiring additional mechanisms of control. In its turn, the alternative envisaged consisting in the pre-payment of the ICMS levied has been considered extraterritorial intrusion and distortive to the ICMS as a VAT-type tax. Another aspect is that even the allocation of the proceeds of a minimum interstate ICMS rate to the state of origin distorts the principle of destination and seems unfair from the point of view of the consuming states.

The interstate rate finances the fiscal war, caused according to the less developed [38] states mainly by the lack of an effective regional development policy by the central government. Hence, altering interstate rates brings with it two other issues: the first refers to how states will deal with already awarded fiscal benefits – acknowledgment or validation; validity period; period for the adoption of new rates and not granting new benefits. The second issue involves new transfers from the federal government so that states may be able to fund their own development policies.

The cost of the fiscal war cannot be precisely quantified. The states do their sums, but there is not a converging calculation method, as each state's data on the matter are not published. Much to the contrary, agreements with companies tend to be almost "secret." This makes it difficult to understand the transition to new interstate rates, as well as to set a possible desired compensation in way of federal government funding. The lack of agreement in both cases seems to be an insurmountable obstacle in approving the ICMS reform.

The states want the deadline for extinguishing already granted benefits to be at least compatible with the transition period for the interstate rate floor. A longer deadline for benefits requires more funds from the federal government to compensate losses. In turn, a slower reduction of the interstate rate gives states more breathing space so that they are able to finance their stock of benefits. Nevertheless, keeping already awarded benefits requires a secure financing source: the interstate rate. Consequently, the vicious cycle tends to prevail.

38 Albérico Mascarenhas, Presentation at the 2nd International Seminar of the Fiscal Forum of Brazilian States on Fiscal Competition and Regional Inequalities (Belém / Pará / Brasil: August 31, 2005).

Harmful effects as a result of the fiscal war have been systematically pointed out since 1995, when Constitutional Amendment Proposal No 175/95 was forwarded to the National Congress. The definition and implementation of a regional development policy able to detect potential comparative advantages in underprivileged regions, as well as creating adequate growth fostering instruments for these regions seems essential to an agreement that involves the ICMS reform. The creation of a Regional Development Fund (FNDR) financed by the federal government that the states consider sufficient to replace the ICMS as an instrument of economic policy is being discussed.

Clélio Campolina Diniz et al (2007) admit that "The effort of states as well as inter-regional competition led to different fiscal war mechanisms aimed at attracting investments" and that these mechanisms worked [more] in the industrial decentralisation process, to whose logic "dictated by the market were added different regional state efforts through its own mechanisms and promotion." .[39] However, the authors also point out the expressive shift in the relative position of states and regions between 1970 and 2004. Diniz et al also draw attention to the increase "of the Northern region share in the national manufacturing activity from 0.7% to 4.9%, the Northeastern region from 5.7% to 8.5%, the South from 12% to 20.1% and the Central West from 0.8% to 3.6%." They also point out the "reduction in the Southeast region position, from 80.8% to 62.8%, led by the reduction in São Paulo from 58.1% to 43.2% and Rio de Janeiro from 15.7% to 8.1%. However, Minas Gerais and Espírito Santo increased their shares."

They still stress that regions should not be treated homogeneously, as they are heterogeneous and thus, incentives should be offered differently, according to a new regionalisation process. Instead of diluted development, new central locations would work as new producing centres, which, in order to achieve higher inter-regional efficiency and complementarity "should have different sectoral priorities as a result of its potential or specialisation." By drawing attention to the need to avoid a "predatory logic (as in fiscal wars) between same level territorial scales and conflict over several policies," they highlight the role of the central government as coordinating agent in liaising industrial and regional

39 Clélio Campolina Diniz et al., *A Regionalização da Política Industrial* (Federal University of Minas Gerais: Second Brazilian Congress of Innovation in Industry, April, 2007).

policies. [40] The relevant issue is in effect the development model Brazil wishes to adopt, the formulation of respective policies and the definition of secure and dynamic financing sources. A new regionalisation process of the industrial policy, according to Campolina, does not necessarily imply the creation of new financing funds, such as the proposed FNDR, as existing funds may be used, adapting their use and reviewing value and sharing criteria.

The ICMS fiscal war phenomenon is a result of gaps in the legislation regarding more effective sanctions aimed at the non-compliance. In that sense, the Constitution, Complementary Bill 24/75 and the LFR lack the necessary changes. Effective sanctions may imply reciprocal interference, affecting states' autonomy because they require efficient mechanisms and instruments to be enforced. Late experience in Brazil has shown that sanctions aimed at making public managers accountable can work.

The Constitution determines that legislation shall define how states and the Federal District grant ICMS fiscal exemptions, incentives and benefits. [41] In its turn, Complementary Bill 24/75 establishes that fiscal benefits may only be approved by unanimous decision on behalf of states. These decisions are under the authority of Confaz, the previously mentioned body made up by representatives from the states and the Federal District, and on which the federal government has a seat, albeit without the right to vote. In addition, Confaz assesses acts that aim at integrating states with respect to the management of ICMS. In these terms, fiscal war may be seen as a unilateral granting of fiscal incentives and benefits, violating the Constitution and legislation.

Indeed, the Brazilian Supreme Court has been considering unilateral benefits as unconstitutional in one hundred percent of cases. On the 1st of June 2011 it adjudicated several suits that had been started over ten years before. In fourteen cases, the Court found unconstitutional behaviour, reaching seven states and twenty-three pieces of legislation and reiterated the fact that Complementary Bill 24/75 is in compliance with the 1988 Constitution. In practice, these decisions have yet to bring changes in the behaviour of state governments, which in theory could be made accountable for unduly renouncing of ICMS revenue

40 According to Campolina 'part of the service sector growth is associated to activities of the manufacturing sector itself'. Therefore, care should be taken when affirming that as the biggest employer sector the sevice sector determines 'the dynamics of the economy'.

41 1988 Constitution, Art. 155, § 2º, XII, g.

through penal and civil responsibilisation of its governors or trough the application of sanctions such as the reduction of federal transfers. However, according to Luciano Garcia Miguel (p. 162)[42] "... federative units are extremely agile in granting, altering and revoking benefits awarded. Often, the benefit object of the lawsuit is changed or replaced by another similar benefit." As the Supreme Court has understood that by revoking a benefit, the object of the unconstitutionality suit is lost, mainly as a result of delay, Supreme Court decisions have been harmless to states and useless in improving public policy, as the granting state revokes the questioned act and re-establishes that with a new feature. It has been argued that the Supreme Court should issue a binding precedent to speed up and universalise the defendants applicable to all cases involving the illegal granting of fiscal benefits. In this way, case the precedent would fill in the gap of Complementary Bill 24/75 in relation to sanctions.

Despite all this, Supreme Court decisions seem to have had some effect. States have taken action to solve the issue of (illegal) unilateral benefits and even if not within a context of a wider reaching reform have discussed a possible agreement aimed at validating granted benefits and limiting the grant of new ones. The problem is that an agreement of this nature requires unanimity of the states. But as a result of diverging interests *vis-à-vis* the category of granted benefits, it will be difficult for such a consensus to be reached. For example, there are cases where benefits were granted to manufacturing companies and other where benefits were awarded to mere "distribution centres," linked to the importing and wholesale market, which are considered to compromise competitiveness.

On the 5th of September 2011, journalist Marta Watanabe wrote in the *Valor Econômico* newspaper that amongst the six states that had ICMS incentives judged to be unconstitutional by the Supreme Court in June 2011, four gave fiscal incentives again without Confaz's approval. Espírito Santo and Pará gave fiscal incentives again, without approval by Confaz. Rio de Janeiro and Mato Grosso do Sul (MS) re-established at least part of the contested benefits. MS published legislation setting up the MS *Forte Indústria* Programme, establishing a reduction of up to 67% of ICMS for a period of 15 years. The MS *Forte Indústria* Programme is very similar to the MS Entrepreneur Programme, judged

42 Miguel, op. cit.

to be uncontitutional by the Supreme Court in an unconstitutionality suit filed by the governor of Paraná. The old program allowed for the reduction of the outstanding tax at the same rate of 67%, also applicable to industrial investments mainly. The only difference was that the 5-year period was shorter, it went up with the MS *Forte Indústria* Program.

Everardo Maciel[43] proposed the review of Complementary Bill 24/75 in order to do the following:

- establish a better concept of fiscal benefit
- allow for the reduction of the base for calculating effective rates lower than the interstate rate
- correct problems in sanctions applicable in case of non-compliance
- restructure Confaz giving it overseeing roles, setting up a system to follow-up fiscal renouncement,
- make ICMS interstate rates uniform at 9%, and
- establish general parameters for legal fiscal competition.

However, Maciel is pessimistic in relation to a legal fiscal competition option, as it has not been possible in the past. The negotiation channel among states, under the coordination of the federal government is far from being used.

On the one hand, scholars, businesses and governments seem to agree in relation to the need to fix distortions and harmonise the tax system, particularly the ICMS. On the other, the reform process does not advance as a result of the sacrifice that harmonisation represents to the autonomy of subnational governments. The efforts made by technical commissions with the aim of pointing out efficient and viable solutions to improve the tax system have been lost during cyclic discussions about a multiple proposals.

If an agreement is reached and indeed some level of legislative harmonisation does come into effect, new obstacles, disparities and unilateral initiatives tend to lead to new levels of disorganisation. Therefore, harmonising goes beyond constitutional and legal alterations. Amongst other things, it requires the creation of supra-state

43 At the Seminar on *Federation and Fiscal War* (Brasilia Institute of Public Law (IDP) and the Getúlio Vargas Foundation (FGV). September 2011). The professors participating were José Roberto:Afonso, "Intergovernmental Relations in Brazil: Slice or Renegotiate?"; Clélio Campolina Diniz, "Territorial Dynamics, Regional Policy and the Tax Issue in Brazil"; Everardo Maciel, "ICMS Fiscal War"; Sérgio Prado, "Fiscal Equalisation and Participation Funds: An Alternative View"; Fernando Rezende, "New Challenges for Regionalism and Fiscal Federalism"; and Luiz Vilela, "FPE and Federative Renegotiation."

administrative levels that work ensuring that legislation, litigation and procedures are aligned. In addition, it requires the intensification and enhancement of an information exchange system and, in view of the disparities among states, a reasonable degree of levelling of state tax administrations, especially in what refers to the training of civil servants and use of information technology. The success of this structure will without a doubt have to take into consideration the level of autonomy that the federated units are ready to renounce in the name of harmonisation, as well as the central government's coordination capacity.

CONCLUSION

The key issues summarized here made up the Brazilian federal agenda in 2010 and 2011. In the opinion of some experts [44], these issues are the main problems faced by fiscal federalism recently at the state level and are the challenges considered priority in the agenda, which states need to face. They agree that Brazil needs a wide reaching federal renegotiation that reaches both the tax sharing system and the natural resources sharing system.

Since the 1988 constitutional reform, governments have faced a dilemma between comprehensive or partial reforms of the tax system. In the first case, there has been no success because broad changes involve complex conflicts within the federal system and require political liaison that has yet to be established. In the latter case, partial reforms proposed involving the interests of states and municipalities have not moved forward, probably because they fail to take into consideration matters that are co-related and need to be discussed in parallel such as the ICMS and the transfer system. Furthermore, industry and civil society have marginally taken part in these processes. According to José Roberto Afonso, isolated changes do not solve structural and inter-related problems and end up fostering local reactions and additional conflicts within the federal system.

Part of this problem is due to the fact that Brazil waited too long to make the necessary changes and currently, problems have accumulated – more severe and interrelated. A comprehensive reform has not been advanced because it requires very complex negotiations; in its turn, partial reform also has not been advanced because it ignores the problems that have increased and are interconnected. Indeed, Josér Roberto Afonso raises the issue of an approach that should be used in the discussion of intergovernmental relations in Brazil: slice or renegotiate? The terminology “slice” is being used by the federal government since 2011 to express the strategy to propose that each matter be assessed separately.

In the context of the **taxation of goods and services,** , the following should be addressed together:

- ICMS and the other value added taxes

44 Ibid.

- the damaging fiscal competition process amongst states (fiscal war)
- the gradual reduction of interstate rates
- the rules applied to unilateral fiscal benefits granted in the past
- whether to create a development fund to replace policies of attraction of investment using ICMS or to use the existing funds

In the context of the **reform of the arrangements** involving these issues should be addressed together:

- sharing of revenue*
- ICMS
- compensation of possible losses resulting from the reforms

*Revenue sharing should be addressed with the other two issues – and its discussion should be not only about the sharing criteria for the State Participation Fund (FPE) whose freezing was considered unconstitutional by the Supreme Court but also with the distribution of royalties from the Pre-Salt layer of offshore oil deposits. [45]

The index of the states' debt in relation to the federal government and a renewed discussion of the taxes/contributions shared by the federal government with states and municipalities including the Participation Funds (FPE and FPM) would complement this fiscal-federative agreement. These correlated issues are only the most urgent from the state governments' perspective. The comprehensive reform, discussed since the 90s, would also have to assess the model adopted by the 1988 Constitution, which distinguish taxes and contributions. [46]

Luiz Vilela [47] states that the need for a tax reform in Brazil is being discussed for at least 20 years, but all attempts have failed. One-off adjustments have been made to supply for the need of additional revenues, which led to an increase in the fiscal burden, with no coordination of the system and without meeting neutrality (efficiency), equity and manageability requirements. In contrast, the principle of convenience was abused.

45 The pre-salt layer is located off-shore, below the ocean salt layer, 3 to 4 thousand metres deep. Due to the expertise of Petrobras, Brazil has found oil there and estimates that reserves in the pre-salt layer of the Brazilian coast are of 80 to 100 billion barrels. The discussion about the sharing of royalties of the oil in that layer among the Union, states and municipalities is being held by the Chamber of Deputies and Senators of the National Congess.

46 Rezende et al, *O Dilema Fiscal…*

47 Seminar on *Federation and Fiscal War* (Brasilia Institute of Public Law (IDP) and the Getúlio Vargas Foundation (FGV). September 2011), cited in footnote 44.

For José Roberto Afonso, [48] intergovernmental relations in the Brazilian federation are complex and diverse, which inevitably lead to growing tensions within the federal system. It is no longer possible to address federative fiscal and tax issues in Brazil in a simple manner as idealised by the 1965/67 tax system, which, although patched up, remains the backbone of the current system. A strategic view is necessary to bring the federation together again. The process may be gradual, but the diagnosis needs to be updated and broadened. First, it is important to agree on the principles that would organise the new tax and federal system in a coordinated way.

Clélio Campolina Diniz [49] sees a need to coordinate the discussion agenda, interconnecting territorial related dynamics to regional policy and the taxation issue. A new institutional quality is necessary in regional policy so as to achieve an effective national policy for regional development, without using ICMS as a fiscal war instrument for the states. Establishing new criteria for the allocation of resources is necessary, as well as new national regionalisation process, adopting different and specific typology for each policy.

Fernando Rezende [50] points out the new challenges for fiscal federalism and regionalism in Brazil. According to him, changes in the regional disparities were not followed by a reform of Brazilian fiscal federalism and as a result, the fiscal geography unattached itself from the political and socioeconomic geography, leading to new challenges towards appropriate balance and federal cohesion.

In February 2010, the Supreme Court in a decision related to an unconstitutionality case (ADI) No 875/DF and others declared provisions in Complementary Bill No 62, from 1989, unconstitutional. These legal provisions established fixed sharing coefficients for the FPE. The Court judged that static/frozen coefficients do not promote socioeconomic balance between states, as required by the Constitution. They gave the National Congress until December 2012 to pass new legislation. As pointed out by Sérgio Prado, the core issue is recovering dynamic/flexible distribution criteria, able to produce variable distribution coefficients.

A draft bill under debate in the National Congress defines the share of royalties from the new oil reserves, the so-called royalties

48 Ibid.
49 Ibid.
50 Ibid.

from the pre-salt oil layer, another reason for controversy amongst oil-producing and non-producing states, and between them and the federal government. Rio de Janeiro and Espírito Santo, main oil producers receive 85% of royalties and refuse to support a proposal that will lead to a lower share. [51]

Sérgio Prado [52] defends the position that FPE transfers be linked to an equalising system, because among other factors, this allows for changes that may take place in the states' fiscal capacity to be noticed quickly, which in addition to not being static may be significantly altered with the regulation and distribution of royalties and with the ICMS reform. Automatic adjusting FPE transfers to the impact of the economic cycle of the states' own tax bases would contribute to reducing conflicts within the federal system.

Therefore, the debate underway about the changes to the FPE and oil royalties, as well as the need for stopping fiscal war between states, leads Brazil to having to face fiscal federalism challenges in a coordinated manner. For Mendes and Rocha[53], negotiation between twenty-seven states, with conflicting interests, will probably not reach a consensus. It cannot be expected that municipal and states governors arrive at an economically efficient reform with quality public spending. This should be coordinated by the federal government. But possibly fearing for having to foot the bill of the negotiation, the federal government has watched as the National Congress leads the discussion on royalties and the states fall out over ICMS and FPE related issues.

51 Sharing arrangements of the natural resources in Brazil apply to resources in the continental shelf of the so-called exclusive economic zone of the ocean and the territorial sea, to minerals in the subsoil and to hydraulic energy, resources that constitutionally belong to the central government.The participation in the result of explotation of these resources or other finantial compensation (incuding for oil and gas) are assured to the state, the Federal District and the municipalities, as well as to agencies directly administered by the central government (1988 Constitution Art. 20) according to the law.

52 Ibid footnote 44.

53 Marcos Mendes and Alexandre Rocha, "Oportunidade de ouro para melhorar o federalismo fiscal," *Jornal Valor Econômico,* 07/10/2011.

ANNEX

BRAZIL	
Area (Km2)	8,514,877
Population 2010 (thousand)	190,756
GDP 2010 (R$ billion)	3,675
GDP per Capita 2010 (R$)	19,265

REGION	Abbre-viation	% Area	% Popu-lation 2010	% GDP 2008	GDP Per Capita 2008	HDI 2005 (UNDP)	Life Expec-tancy 2009 (age)	Child Mortality 2009 (deaths per thousand)	illiteracy rate 5 to 14 years of age
NORTH	N	45.3%	8.3%	5.1%	10.216	0.7634	72.2	23.5	23.6%
NORTHEAST	NE	18.3%	27.8%	13.1%	7.488	0.7196	70.4	33.2	25.9%
CENTERWEST	CO	18.9%	7.4%	9.3%	20.372	0.8130	74.3	17.8	15.8%
SOUTHEAST	SE	10.9%	42.1%	56.0%	21.183	0.8234	74.6	16.6	14.4%
SOUTH	S	6.8%	14.4%	16.5%	18.258	0.8293	75.2	15.1	15.0%
TOTAL BRASIL	BR	100%	100%	100%	15.990	0.7940	73.1	22.5	19.1%

Source: own formulation based on data provided by the Brazilian Institute of Geography and Statistics – IBGE and the United Nations Development Program – UNDP.

REGIONS / STATES	Abrev.	% of Area	% Population 2010	% of GDP 2008	GDP Per Capita 2008	HDI 2005 (UNDP)	Life Expectancy 2009 (age)	Child Mortality 2009 (deaths/ thousand)	Illiteracy rate 5 to14 years old
TOTAL BRAZIL	**BR**	**100%**	**100%**	**100%**	**15.990**	**0.7940**	**73.1**	**22.5**	**19.1%**
NORTH	**N**	**45.3%**	**8.3%**	**5.1%**	**10.216**	**0.7634**	**72.2**	**23.5**	**23.6%**
Acre	AC	1.8%	0.4%	0.2%	9.896	0.7510	72.0	28.9	25.3%
Amazonas	AM	18.4%	1.8%	1.5%	14.014	0.7800	72.2	24.3	20.2%
Pará	PA	14.7%	4.0%	1.9%	7.993	0.7550	72.5	23.0	27.4%
Rondônia	RO	2.8%	0.8%	0.6%	11.977	0.7760	71.8	22.4	16.6%
Amapá	AP	1.7%	0.4%	0.2%	11.033	0.7800	71.0	22.5	21.1%
Roraima	RR	2.6%	0.2%	0.2%	11.844	0.7500	70.6	18.1	20.0%
Tocantins	TO	3.3%	0.7%	0.4%	10.223	0.7560	71.9	25.6	20.8%
NORTHEAST	**NE**	**18.3%**	**27.8%**	**13.1%**	**7.488**	**0.7196**	**70.4**	**33.2**	**25.9%**
Maranhão	MA	3.9%	3.4%	1.3%	6.104	0.6830	68.4	36.5	34.1%
Piauí	PI	3.0%	1.6%	0.6%	5.373	0.7030	69.7	26.2	28.4%
Ceará	CE	1.7%	4.4%	2.0%	7.112	0.7230	71.0	27.6	24.0%
Rio G. do Norte	RN	0.6%	1.7%	0.8%	8.203	0.7380	71.1	32.2	26.2%
Paraíba	PB	0.7%	2.0%	0.8%	6.866	0.7180	69.8	35.2	26.5%
Pernambuco	PE	1.2%	4.6%	2.3%	8.065	0.7180	69.1	35.7	23.8%
Alagoas	AL	0.3%	1.6%	0.6%	6.228	0.6770	67.6	46.4	26.7%
Sergipe	SE	0.3%	1.1%	0.6%	9.779	0.7420	71.6	31.4	18.2%
Bahia	BA	6.6%	7.3%	4.0%	8.378	0.7420	72.6	31.4	24.3%
CENTRE WEST	**CO**	**18.9%**	**7.4%**	**9.3%**	**20.372**	**0.8130**	**74.3**	**17.8**	**15.8%**
Mato Grosso	MT	10.6%	1.6%	1.8%	17.927	0.7960	73.7	19.2	15.0%
Mato G. do Sul	MS	4.2%	1.3%	1.1%	14.188	0.8020	74.3	16.9	18.0%
Goiás	GO	4.0%	3.1%	2.5%	12.879	0.8000	73.9	18.3	15.8%
Fed. District	DF	0.1%	1.3%	3.9%	45.978	0.8740	75.8	15.8	14.5%
SOUTHEAST	**SE**	**10.9%**	**42.1%**	**56.0%**	**21.183**	**0.8234**	**74.6**	**16.6**	**14.4%**
Minas Gerais	MG	6.9%	10.3%	9.3%	14.233	0.8000	75.1	19.1	14.3%
Espírito Santo	ES	0.5%	1.8%	2.3%	20.231	0.8020	74.3	17.7	16.9%
Rio de Janeiro	RJ	0.5%	8.4%	11.3%	21.621	0.8320	73.7	18.3	13.8%
São Paulo	SP	2.9%	21.6%	33.1%	24.457	0.8330	74.8	14.5	14.3%
SUL	**S**	**6.8%**	**14.4%**	**16.5%**	**18.258**	**0.8293**	**75.2**	**15.1**	**15.0%**
Paraná	PR	2.3%	5.5%	5.9%	16.928	0.8200	74.7	17.3	14.1%
Stª Catarina	SC	1.1%	3.3%	4.1%	20.370	0.8400	75.8	15.0	13.5%
Rio G. do Sul	RS	3.3%	5.6%	6.6%	18.378	0.8320	75.5	12.7	16.8%

Source: own formulation based on data of IBGE and UNDP.

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