TEXTO PARA DISCUSSÃO

No. 558

# Tax reform in Brazil: an evaluation at the crossroads

Rogério L. F. Werneck

DEPARTAMENTO DE ECONOMIA
www.econ.puc-rio.br

Departamento de Economia
PUC-Rio

TEXTO PARA DISCUSSÃO
Nº 558

# TAX REFORM IN BRAZIL: AN EVALUATION AT THE CROSSROADS

Rogério L. F. Werneck
*rwerneck@econ.puc-rio.br*

Janeiro 2008

A. BACKGROUND

B. TOWARDS A MORE SENSIBLE INDIRECT TAXATION SYSTEM

C. DIMENSIONS OF THE TAXATION TO BE REFORMED

D. CHALLENGES BEYOND FEDERALISM: LIMITS OF THE POSSIBLE

E. POLITICAL ECONOMY AND DIFFICULTIES

F. CONCLUDING REMARKS

REFERENCES

Tax reform has been a central issue of the Brazilian economic debate for at least a decade. But despite the supposedly reformist resolution of several governments, very little was in fact achieved. The idea of reforming the country's indirect taxation system is, once again, in the forefront of the government's agenda. The complexity of Brazil's fiscal federalism has been often and rightly mentioned as a major difficulty to the advancement of the tax reform. This paper tries to look beyond fiscal federalism and focus on difficulties of a different kind, that have to do with the sheer magnitude of the reform and the uneven sectoral distribution of the indirect-tax burden in the country. After an initial section providing a brief historical and institutional background, section B discusses the various tax-reform attempts that took place since 1997, and draws useful insights for the analysis of the political economy of the tax-reform deadlock. Sections C and D look into indirect taxation in Brazil, calling attention to challenges entailed by the scale of the intended reform and the uneven sectoral distribution of the tax burden. The political economy of the involved difficulties is discussed in section E. Concluding remarks are presented in section F.

## A. BACKGROUND

### *A.1 Fiscal federalism and the evolution of the Brazilian tax system*[1]

Much of what happened to the Brazilian tax system over the last decades stems from the peculiar way the country faced the challenge of keeping the aggregate tax revenue growing as fast as the rapidly expanding public expenditures, given the increasingly binding constraints imposed by it's highly complex fiscal federalism arrangement.[2] Almost 40 years ago, a very commendable tax reform, including a pioneering value-added taxation scheme, was successfully implemented in Brazil.[3] But since the mid-sixties much of what was achieved by that refurbishment was lost, as the quality of the Brazilian tax system went through a clear and worrisome deterioration process, at least in what concerns the taxation of goods and services.

A good part of the deterioration can be attributed to changes that were entailed by the Constitution of 1988, in the aftermath of the country's redemocratization, after 20 years of

[1] This section draws heavily from Werneck (2006).
[2] For an analysis of the rapid expansion of public expenditures in Brazil since the early nineties, see Werneck (2005b)
[3] See Guérard (1973).

military regime. Unfortunately, the long and delicate political negotiations which brought about the new Constitution took place exactly when the central government had become notably feeble. Drafted without minimum consistency guidelines, that the politically crippled executive branch was unable to press for at that moment, the new constitution failed to endow the state with a coherent mechanism to protect the interests of the majority of the population against the multiple pressures of an emerging mass democracy. Instead, it amplified the scope for the historical widespread rent-seeking behavior of many segments of the Brazilian society, imposing upon the federal budget a considerable additional burden, exactly when the Union's fiscal resources were being reduced in favor of state and local governments, in the wake of a newly introduced but basically inconsistent fiscal federalism arrangement.

As the new tax system designed in 1988 was phased in during the early nineties, the central government faced growing financial difficulties. But soon, as could be expected, it started an unrelenting reaction to evade the pincer movement of shrinking revenues and swelling expenditures that had been imposed on the Union by the new Constitution. And, as often happens, increasing revenues proved to be much easier than cutting back expenditures, especially when a large part of the federal spending could not be reduced unless politically costly constitutional amendments were duly approved by Congress.

Actually, the Union's consistent effort to increase its tax revenue over the period – in order both to recover what had been lost to state and local governments and to be able to properly finance its much enlarged spending responsibilities – would prove to be a tremendous success, were it not for a big problem. As the central government devised every kind of exotic taxation scheme that could raise revenues that would not be shared with lower-level governments, most of the substantial increase in the federal tax burden achieved over the last twenty years stemmed from very low-quality taxes. Most often that meant various forms of cascading turnover taxes, that back in the mid-sixties seemed to have been definitely eliminated from the Brazilian tax system.

At the state level, distortions of a different kind accumulated over the last three decades. Part of the difficulties also stemmed from the 1988 Constitution, that granted the states a much freer hand to introduce changes in the tax-rate structure of their value-added tax (VAT), the

ICMS[4]. And as most of the uncoordinated changes were in fact for the worst, they slowly transformed the pioneering, reasonably well designed, value-added taxation scheme that had been introduced by the 1967 reform, into a confusing, disharmonic collection of 27 highly complex state-tax codes, forming an unmanageable crazy quilt of VAT arrangements. Tax-exclusive state-VAT rates imposed on some sectors, as telecommunications, have been as high as 40 percent.

Though most states are still facing severe fiscal stringency, they have been fighting for long a fierce fiscal war. With some bending of the legislation, they have been competing among themselves to see which one offers the most generous tax breaks and succeeds in attracting the flashier big industrial investment projects. The collective irrationality of that fiscal war has been a source of increasing resentment among state-governors and come to be perceived by a growing number of them as the swan song of the present state-VAT arrangement.

It is easy to understand therefore why, over the last ten years, at least, there has been a growing outcry in favor of a deep change in the way goods and services are being taxed in the country. Of course, that discontent has been greatly amplified with the very steep increase in the country's tax burden observed in the period. From around 25 percent of the GDP in the early nineties to an estimated 35 percent of GDP in 2007.

### *A.2 The indirect taxation system*

The Brazilian tax system has become extraordinarily complex. Taken together, the three levels of government impose dozens of different taxes. Table 1 presents the structure of the country's aggregate tax revenue in 2005, showing the relative importance of direct and indirect taxation. The gross tax burden reached 33.7 percent of GDP in 2005. Exceedingly high for a developing country.[5] Direct taxes generated roughly 54 percent of the country's total tax revenue. A large part of that share stemmed from payroll taxes and most of the rest from personal income tax and profit taxes. Property taxes and financial transactions taxes raised approximately one seventh of the total revenue that came from direct taxation.

---

[4] *Imposto sobre a Circulação de Mercadorias e Serviços*.

[5] The official statistics computed by *Secretaria da Receita Federal* initially estimated the gross tax burden in 2005 to be even higher: 37.4 percent of GDP. But as the newly-published (March 2007) and substantially revised national accounts showed an upward 11 percent correction in the 2005 GDP value, the gross tax burden estimate was downsized to 33.7 percent of GDP.

*Table 1*
*Brazil, General Government, 2005*
*Structure of the Tax Revenue*

| | *R$ million* | *As percent of the total tax revenue* | *As percent of GDP* |
|---|---|---|---|
| *Revenue fom indirect taxes* | *318772* | *44,02* | *14,84* |
| *Federal level* | *151083* | *20,86* | *7,03* |
| *IPI* | *26096* | *3,60* | *1,21* |
| *COFINS* | *86794* | *11,99* | *4,04* |
| *PIS* | *18570* | *2,56* | *0,86* |
| *PASEP* | *2880* | *0,40* | *0,13* |
| *CIDE* | *7681* | *1,06* | *0,36* |
| *Imports* | *9062* | *1,25* | *0,42* |
| *State level - ICMS* | *154810* | *21,38* | *7,21* |
| *Municipal level - ISS* | *12879* | *1,78* | *0,60* |
| *Revenue from direct taxes* | *390741* | *53,96* | *18,19* |
| *Payroll taxes* | *176194* | *24,33* | *8,20* |
| *Personal income tax and profit taxes* | *156476* | *21,61* | *7,28* |
| *Property taxes* | *22863* | *3,16* | *1,06* |
| *Financial-transactions taxes* | *35208* | *4,86* | *1,64* |
| *Revenue from other taxes* | *14600* | *2,02* | *0,68* |
| *Total tax revenue* | *724113* | *100,00* | *33,71* |

As much as 44 percent of the aggregate tax revenue stemmed from indirect taxation. What deserves special attention is the disharmonious way goods and services are taxed in the country. The taxation involves not less than seven different taxes collected by three government levels. The most important tax is the ICMS, the peculiar and problematic state-level VAT that constitutes the core of value added taxation in the country. But federal-level indirect taxes have become increasingly important. Their combined revenue in 2005 was only slightly below the total ICMS revenue collected by the country's 27 states. Among federal indirect taxes, the most important is COFINS, which was initially created as a turnover tax, but since the 2003 reform was converted into a sort of value added tax, as will be seen below.

There is also the ISS, the badly exploited municipal tax that is supposed to be imposed on the huge tax base formed the service sector, but generates less than 2 percent of the country's aggregate revenue. This inefficient and somewhat chaotic multi-level value-added taxation system is by far the weakest part of Brazil's tax system, that has been calling for an urgent reform.

## B. TOWARDS A MORE SENSIBLE INDIRECT TAXATION SYSTEM

### *B.1 Assessing tax reform proposals that have been discussed in the period 1997-2005*[6]

In spite of all the outcry over the tax system in the mid-nineties, the Cardoso government, that took office in early 1995, in the wake of the successful launching of the stabilization plan in 1994, remained too busy to be able to have a clear stance about the tax reform at least till late 1997. Of course, lip service continued to be paid to the importance of carrying on a bold tax reform, as had been defended since the President's electoral campaign. But the new government had at first to deal with the difficulties imposed by the Mexican crisis. And, in fact, during its first months, it was deeply divided on how to react to the crisis. When it pulled itself together, as the effects of the external turmoil on Brazil proved to be less strong than anticipated, the Executive was able to extract from Congress important constitutional reforms that would open the way to the privatization of state-owned enterprises in mining, telecommunications and electricity-supply industries. But that was the relatively easy part of what proved to be a very challenging constitutional reform program. Typically, those reforms involved changing or deleting a few of words in the Constitution. However, there were many other much more complex reforms ahead, as the tax reform, the social-security reform and the public administration reform, which required a detailed and complex redesign of the existing arrangements. And the fact is that, in 1995, the new government had no articulate detailed projects for those far more complicated reforms. It simply did not know what it really wanted from Congress.

1996 should be the year to go ahead with the pending reforms, especially when it became clear that 1995 had been marked by a very serious deterioration of the public accounts. But the government would be completely mobilized with something else. The vast political

[6] This section draws heavily from Werneck (2003a).

capital, amassed in the wake of the success of the inflation-fighting program, would be mainly allocated to extracting from Congress a Constitutional amendment that would allow the reelection of the president. The Executive played a tough game and finally got the amendment approved in early 1997. But very precious time was lost, as the economy was becoming increasingly vulnerable to a less favorable external environment.[7]

The more optimistic analysts believed that, having assured the possibility of being reelected, and having therefore reinforced its political capital, the President would be finally ready to press Congress to move forward the required constitutional reform program. But nothing of the sort happened. Quite to the contrary, in the second quarter of 1997, the government started to publicly discuss whether the pending reforms were in fact needed. But soon the government would be shaken back to reality, with the sudden change in the international environment caused by the Asian crisis.

In late 1997, hastily preparing an emergency fiscal-adjustment package that had to be announced in the wake of the external crisis, the federal government decided that it was about time to show a more active role in the mostly nonsensical debate on tax reform that was taking place in Congress and within the business community. At an already troubled moment, the uproar over taxes was bringing much unneeded additional bad press. Though far from prepared to present something that could resemble a detailed tax-reform proposal, the government was able to announce a sensible outline of what it considered to be the required reform.

According to that outline, the envisaged reform would concentrate on straightening out the way goods and services were taxed in country. The idea was to eliminate all forms of turnover and cascading taxes, to discard the existing federal tax on manufactured goods, to dismantle the inconsistent and distorting set of state VATs and to scrap the service tax, so poorly exploited by local governments. Those taxes would be replaced by three new ones: a consistent broad-based nationally-managed value-added tax, a new federal excise tax on a small number of goods and services and a local retail sales tax. A new set of revenue-sharing

[7] It should be mentioned that, in what concerns the tax-reform effort, the government managed to introduce an isolated important change in 1996, with the approval of the Kandir Law (Lei Complementar No 87), that exempted exports and capital goods from the ICMS, the state-level VAT.

and compensation rules would be designed in such way as to preserve federal, state and local governments from revenue losses.

The announcement that, based on such outline, the government was preparing a detailed tax reform proposal to be eventually submitted to Congress produced a clear turnaround in the ongoing debate. The government had established a new focal point. During the next few months the federal tax authorities seemed in fact mobilized by the challenge of transforming that simple sketch of so far-reaching changes in the tax system into a minutely consistent and implementable reform project. But such mobilization would soon lose momentum.

The fiscal-adjustment package that had been announced in late 1997 had given the economy some leeway to face the shock waves of the worst part of the Asian crisis. But, in the second quarter of 1998, as soon as the external environment became less unfavorable again, the government proved to be confident enough to suspend a sizable part of the fiscal-adjustment measures it had so hastily announced some months before. In the wake of that fallback, the urgency that seemed to have been assigned to the tax reform disappeared. Top priority was attributed to assuring victory in the coming presidential election.

It was not a very wise move. A few months after, in August 1998, but still two months before the election, the Brazilian economy would be caught in a very vulnerable position by the shock wave of the Russian crisis. This time it was a major shock wave, but the adoption of all relevant reacting measures had to wait for the election. When the measures were finally adopted, tough as they were, given the circumstances, they proved to be far from enough to prevent the economy from plunging in the serious foreign-exchange crisis of early 1999.

Short as it was, that scaring experience seems to have inoculated a surprising degree of conviction on the re-elected government about the need to maintain and consolidate the fiscal-adjustment measures adopted since the Russian crisis. However, in what concerns the tax reform, the government emerged from the crisis extremely skeptical about the possibility of going ahead with the proposal outlined in late 1997. In a landmark interview to a major newspaper in mid-March 1999, President Cardoso was particularly candid on the matter, leaving no doubts whatsoever about how he was assessing the odds. He simply said that the tax reform was too complex and that he thought the country still "lacked the required

consciousness" of the involved issues and interests. Pushing the reform forward would simply paralyze the parliament, so heavy were the required political negotiations.[8]

Crystal-clear as that position may have seem, it would soon prove be politically untenable. Having put off the tax reform for his whole first term in office, the President suddenly found out that there was no political room left for *explicitly* putting off the reform for still another term. After all, if the tax reform was considered to be too complex to be negotiated in Congress when the President was just beginning its second term, it was hard to believe that it would be seen as an easier task in 2000, when the local elections campaign would naturally lead to a much hotter discussion of the involved issues. And, of course, it was even harder to believe that the reform would be perceived as a simpler challenge during the second half of the presidential term, when congressmen and governors would be involved in a complex redeployment of political forces, in preparation for the general elections of 2002. Postponing the reform to a more convenient moment would therefore almost certainly mean to leave the whole issue for the following presidential term.

In Congress, it was immediately perceived that the President's position was in fact untenable. Given the unyielding public outcry over the inadequacy of the tax system, it would be very difficult to continue to evade the whole issue, particularly in such an overt manner. Almost simultaneously, the presiding officers of both the Senate and the Chamber of Deputies made incisive declarations to the media, disagreeing with the President's stance and strongly stressing how urgent they thought a tax reform really was. Given the impending possibility of losing initiative in such an important matter to Congress, the Executive was forced to back off and to declare that the reform was in fact a top priority issue. Having been obviously dragged to a battle it would rather evade, and worse, in the uncomfortable position of follower of the Congress, the Executive seemed in late March 1999 not only unprepared for the coming action in this area but also dangerously tempted to resort to improvisation.

But, with the benefit of hindsight, one may say that, from then on, the government would deal with the tax reform as if it had decided to follow a very clear course of action. More precisely, perhaps one should say, a course of inaction. That does not mean at all that nothing happened. In fact, over the following eighteen months the tax-reform issue would involve a convoluted

---

[8] See "Reforma política é a prioridade, anuncia FHC", *O Estado de S. Paulo*, 14 de março de 1999.

and far from uneventful game between Congress and the Executive. However, at the end of that game, the latter's strategy proved to have simply focused on a firm adherence to the stance the President had so clearly expressed before having been forced, back in March 1999, to unwillingly play such a game with Congress. The end of the that meandering story is somewhat melancholic. But its thread was elaborate enough to involve as much as five different tax-reform proposals.

Table 2 allows a comparison of the main features of those tax-reform proposals, all made over the period 1997-2000.[9] Except for the last proposal, which seems to have been somewhat designed to bring down the curtain, all the other four have important common elements. They seem to share the same basic diagnosis on what is wrong with indirect taxation in the country. They are strikingly similar in what concerns taxes to be eliminated. And are not so dissimilar in what concerns taxes to be created. Considering that two of those proposals stemmed from the Executive and two from Congress, that seems to point out to a surprising degree of agreement on the main line of the required reform.

The guiding idea is the reconstruction of value-added taxation on broader and more rational grounds, in such a way as to allow the elimination of the turnover and cascading taxes that gained so much importance over the last decade. The big question was how that switching of tax base should be brought about. The involved difficulties are certainly amplified by the complexity of the Brazilian fiscal federalism, especially because value-added taxation has traditionally been the mainstay of revenue at the state level.

It is against that background of a long and unsuccessful tax-reform campaign that one should analyze the first tax-reform efforts of the new Administration that took office in January 2003, that basically tried to follow the broad lines that had been discussed since 1997.[10] In early 2003, the newly-elected Lula government launched what at first seemed to be a resolute tax-reform effort. Having decided to simultaneously push forward two politically challenging reforms – the tax reform and the social-security reform – the new Administration thought it was advisable to make sure that the newly-elected governors would support the proposed changes in both fronts. In mid-February 2003, the federal government held a two-day meeting with all governors in Brasília in order to build consensus on the main lines of the two reforms.

[9] For a more detailed analysis, see Werneck (2003a)

[10] For a more extensive discussion on what comprised the tax-reform agenda in late 2002, see Werneck (2002).

*Table 2*
*Tax-Reform Proposals, 1997-2000*
*Comparison of the Main Features*

| *Proposal* | *Taxes to be eliminated* | *Taxes to be created* |
|---|---|---|
| *Executive's Late 1997 Proposal October 1997* | *All turnover and cascading taxes (Cofins, PIS-Pasep), except tax on financial transactions*<br><br>*Federal tax on manufactured products (IPI)*<br><br>*State VAT (ICMS)*<br><br>*Service tax charged by local governments (ISS)* | *Nationally-managed VAT*<br><br>*Federal excise tax on goods and services*<br><br>*Retail sales tax (IVV)* |
| *Executive's Late 1999 Proposal October 1999* | *All turnover and cascading taxes (Cofins, PIS-Pasep), except tax on financial transactions*<br><br>*Federal tax on manufactured products (IPI)*<br><br>*State VAT (ICMS)*<br><br>*Service tax charged by local governments (ISS)* | *Federal VAT*<br><br>*State excise tax on goods and services*<br><br>*Municipal retail sales tax (IVV)* |
| *Special Committee's Proposal March 2000* | *All turnover and cascading taxes (Cofins, PIS-Pasep, CPMF)*<br><br>*Federal tax on manufactured products (IPI)*<br><br>*State VAT (ICMS)*<br><br>*Service tax charged by local governments (ISS)* | *Dual VAT (coexisting federal and state VATs)*<br><br>*Municipal retail sales tax (IVV)* |
| *Non-voted Rapporteurs's Proposal March 2000* | *All turnover and cascading taxes (Cofins, PIS-Pasep, CPMF)*<br><br>*Federal tax on manufactured products (IPI)*<br><br>*State VAT (ICMS)*<br><br>*Service tax charged by local governments (ISS)* | *Dual VAT (coexisting federal and state VATs)*<br><br>*Non-cumulative excise tax* |
| *Executive's Proposal August 2000* | *Federal tax on manufactured products (IPI)*<br><br>*State VAT (ICMS)*<br><br>*Service tax charged by local governments (ISS)* | *Federal tax on goods and services (IBS)*<br><br>*Nationally uniformed state VAT*<br><br>*Municipal retail sales tax (IVV)* |

In what concerned the tax reform several decisions were taken. The changes to be introduced in the tax system were to be neutral, in the sense of implying neither gains nor losses to the three government levels. The main state tax, the ICMS, would be unified, the number of tax-rates drastically reduced and the 27 coexisting state codes put under a single national value-added tax legislation. Payroll taxes would be gradually reduced as the burden of social-security financing would be partly shifted to a new turnover tax. Following changes that had already been introduced in the PIS[11], the Cofins[12] would also be converted into a non-cumulative tax. It was also decided that the progressivity of the tax burden was to be enhanced.

But the proposed reform met strong political resistance and had to be substantially changed.[13] The idea of developing a consensual proposal, fully supported by state governors, proved to be much more difficult than was apparently anticipated. The reform had to be changed and scaled down as much of the resistance turned out to be insurmountable.

The government decided to concentrate on important measures that had a real chance of being approved, and to either postpone or simply shelve the most controversial ones. It did not seem to mind when hard-to-defend measures that could be grouped under the "taxing-the-rich" label were not approved by the Senate (giving force to the interpretation that their inclusion in the initial reform proposal had been only a question of paying lip-service). The retreating movement also involved splitting the reform proposal in two. The less controversial part was approved by the Senate and promulgated in mid-December 2003. More difficult measures, involving the complex renovation of the ICMS, were left to a second part. Given the envisioned difficulties, that part was divided in different modules, to be phased in over a period of up to four years, opening room for putting off delicate definitions of dissent-inducing details. The unification of the ICMS would only take place in 2005. The number of allowed tax rates would be reduced to five. The Senate would fix the rates and then sanction a consensual view of the states on how the rates should be applied to different goods and services. In 2007, the first year of the next presidential term, the ICMS would be replaced by a national broad-based value-added tax to be defined in the future. This second part of the reform, that basically outlines the renovation of the ICMS and its eventual transformation into

[11] *Contribuição ao Programa de Integração Social.*
[12] *Contribuição para o Financiamento da Previdência Social.*
[13] For a detailed analysis of the 2003 tax-reform effort, see Werneck (2006).

a broad-base value-added tax, was also approved by the Senate in December, but has not been ratified by the Chamber of Deputies.

What was effectively approved after all? Not much. Curiously enough, after much excitement over constitutional amendments, it was a measure that only required an ordinary law -- the conversion of the Cofins into a non-cumulative tax -- that turned to be the most remarkable result of more than 12 months of intense mobilization with the tax-reform. Other approved measures involved tax relief for exports and capital goods, the CIDE revenue-sharing arrangement, further simplification of the taxation of small businesses, the eventual partial replacement of payroll taxes with turnover taxes and, of course, the extensions of the DRU, the CPMF and the Manaus Free Zone.

The single most important outcome of the 2003 tax-reform effort has been the transformation of the Cofins into a non-cumulative tax. Having shied away from a bolder indirect-taxation reform, that would simply eliminate the Cofins and create a consistent broad-based nationally managed value-added taxation system, the government decided to apply what was deemed an easier pragmatic fix to the problem. The main idea was to extend to the Cofins the same solution that had already been adopted by the Cardoso Administration, at the very end of its second term, to turn another cascading tax, the PIS, into a non-cumulative one. Taken together, the new PIS and the new Cofins represented a hefty supplemental value-added tax surcharge of 9.25 percent.

Looking back to what has happened between 1997 and the end of the first term of the Lula government, one may be tempted to explain the tax-reform deadlock resorting to the usual handy argument: lack of required political will in Brasília. But doing so would mean to evade a deeper understanding of the difficulties and uncertainties which turned the idea of implementing a sound tax reform in Brazil into a challenge of extreme complexity.

### *B.2 Political economy of the tax reform deadlock*

The measures that were in fact approved in the 2003 tax-reform drive are having important collateral effects that deserve close attention. The transformation of the Cofins into a non-cumulative tax, in particular, has contributed to make the real proportions of the economy's

tax burden much more explicit and visible. And that, in turn, seems to be fueling an unprecedented widespread outcry in Brazil about both the irrationality of the country's tax system and the tax burden it entails.[14] It is too early perhaps to say whether such outcry will prove to be strong enough to affect the political calculus involved in the mobilization of Brasilia with tax-reform issues. But it has surely become an important factor to be monitored in the assessment of the possible evolution of the tax-reform effort in the near future.

Concern with the irrationality of the tax system and the size of the tax burden is also bound to be enhanced as growth-inducing policies started to receive more attention in the country, in the wake of successful stabilization policies. That could certainly make the formation of the political coalition required to push the tax reform forward less problematic than so far it has proved to be. It is also important to have in mind that the positive effects of the economic growth on the fiscal accounts of subnational governments may open room, in tax-reform negotiations, for a less disruptive dispute on the distribution of fiscal resources within the Federation.

But there is a widespread feeling in Brazil that, once again, a good opportunity to carry on a thorough and much needed tax reform has been lost. This time, by the Lula government. After a decade of supposedly reformist resolution in that area, very little was in fact achieved. In hindsight, there seems to be important common facts that cut across the various unsuccessful tax-reform attempts observed over the period. The conjunction of those facts appears to be hampering the required collective action that could turn the reform feasible and to be giving way to what at first sight seems to be simply a deplorable conformism. From a careful analysis of how little was really accomplished by the convoluted tax-reform efforts observed in the country since the mid-nineties, five crucial facts seem to stand out.

*Abstract objective*

Since 1997, at least, the debate on tax reform in the country has been dominated by the concern with the irrationality of the tax system. The consensual view has been that the required reform should be able to make the tax system less complex, less inefficient and less obstructive of economic growth, without altering either the tax burden or the shares of three government levels in the aggregate tax revenue. There are certainly good arguments to defend

[14] For a fuller discussion on this point, see Werneck (2003b).

an efficiency-enhancing tax reform in Brazil along these lines, but one has to recognize that such reform has an extremely abstract objective. It is not something that can galvanize the electorate. In fact, there are good reasons to believe that this objective has not even been well understood by a large part of the country's political elite.

*Remote benefits*

Even among those that are perfectly able to grasp the importance of rationalizing the tax system, the dominant view is that benefits of a reform focused on such objective, substantial as they may be, will only be strongly felt after a number of years. Especially, of course, if the reform contemplates a slow phasing in of the involved changes.

*Virtues of old taxes*

Part of the most influential opinions about tax reform come from the elite of the tax collecting bureaucracy (at the three government levels), tax lawyers and members of the Judiciary, who are all prone to defend the idea that the good tax is the old tax. Collecting an old tax would always be far less problematic than trying to collect a new one. In its unabated defense of the *status quo*, that segment of the public opinion is invariably ready to try to sink any reform proposal with a barrage of worrying presages of endless judicial litigations.

*The reform is only feasible in the first year of the presidential term*

Tax reform is seen as a complex challenge that can only be successfully faced in the first of the four years of the presidential term. In the second year, there are municipal elections. In the last, it is unthinkable. In the third, amid the political mobilization for the general elections of the fourth year, it is definitely too late.

*Revenue-loss risk*

Last but not least, there has been much uneasiness about the possible fiscal costs of a reform. With all government levels facing a hard-budget constraint, there is a great fear of revenue loss. A fear that affects not only mayors and governors but the central government itself. Only sizable changes in the tax system would be able to assure substantial efficiency gains. But bolder changes entail higher risk of considerable revenue loss. Of course, the reform could include an agreement on compensation rules within the federation. Yet the fear persists. Who can assure those rules will not be changed in the future?

Those facts seem to establish very unfavorable conditions for the approval of the kind of tax reform the country needs. An important reform that can really make a difference in terms of efficiency gains requires some degree of boldness. But the bolder the reform, the higher the risk of revenue losses. Apprehensions with possible losses tend to be exacerbated by prophecies of overwhelming waves of judicial injunctions brandished by defenders of the virtues of old taxes. Having in mind their hard-budget constraints, governors and mayors tend to oppose bolder changes, unless they can be assured of full compensation of any losses by the Union. The federal government, having to face its own risk of revenue loss, has to decide whether such compensation can be really assured. It may also fear that if the Pandora box of a bold tax reform is opened, subnational governments may size the opportunity to extract from Congress a more generous piece of the aggregate tax revenue pie. For one reason or the other, the federal government has to decide whether it can stand the costs of having to keep a more precarious fiscal stance. Given the public-sector`s over-indebtedness, the generation of sizable primary surpluses on a steady basis has become a crucial condition to bring down real interest rates and put the economy on a sustainable expansion path. With the government strongly pressed to deliver economic growth, the idea of abandoning a sound fiscal position to bet on a risky tax reform may not sound very attractive. Economic benefits seem remote and there is no possibility of getting strong popular support out of a reform with such abstract objectives. Particularly when the next election seems so near.

The combination of those facts creates very unfavorable conditions for the approval of the kind of tax reform the country needs. A high public-debt environment may make perfectly reasonable fiscal-reform initiatives seem extremely risky. Without any room to absorb revenue losses, in a complex fiscal-federalism arrangement, the government is bound to recurrently see badly needed tax reform, which could lead to a much less distorting tax system, as an unaffordable adventure.[15]

[15] Werneck (2005a) develops a simple political economy model to analyze how adverse such conditions may prove to be for the advancement of the tax reform.

## C. Dimensions of the Taxation to be Reformed

The debate on tax reform in Brazil has been largely dominated by the involved fiscal-federalism issues. Of course, those complex issues are undeniably crucial. But concern with them should not be a reason for disregarding other fundamental dimensions of the challenges entailed by the reform. The sheer magnitude of the proposed operation and the country's peculiar sectoral pattern of indirect taxation are two aspects that deserve close attention.

As may be seen in Table 1, a really thorough reform of the country`s indirect taxation system would impose changes to taxes that have generated fiscal resources that correspond to almost 15 percent of GDP, or 43 percent of the combined revenues of the three government levels. As the fiscal base of indirect taxation also includes imports, a more accurate measure of the implied aggregate burden would be given by the ratio of total revenue generated by indirect taxes to GDP *plus* imports, a sum that amounts to the economy`s final demand for goods and services. Assuming $VA$ is the aggregate value added of the economy, $T$ is the indirect-taxes revenue (net of subsidies), $Y$ is the GDP at market prices, $D$ is the final demand and $M$ represents imports of goods and services, the aggregate indirect-tax rate[16] would be given by

$$t = T/(VA+M+T) = T/(Y+M)= T/D \qquad [1]$$

In order put in the right perspective the peculiar sectoral pattern of indirect taxation in the country, it may be useful to disaggregate $t$ into tax rates on different products produced by the economy. As the final demand may be broken down in consumption, investment, government expenditures with goods and services and exports of goods and services,

$$D = C + I + G + X \qquad [2]$$

one may write, for each product $j$ produced by the economy,

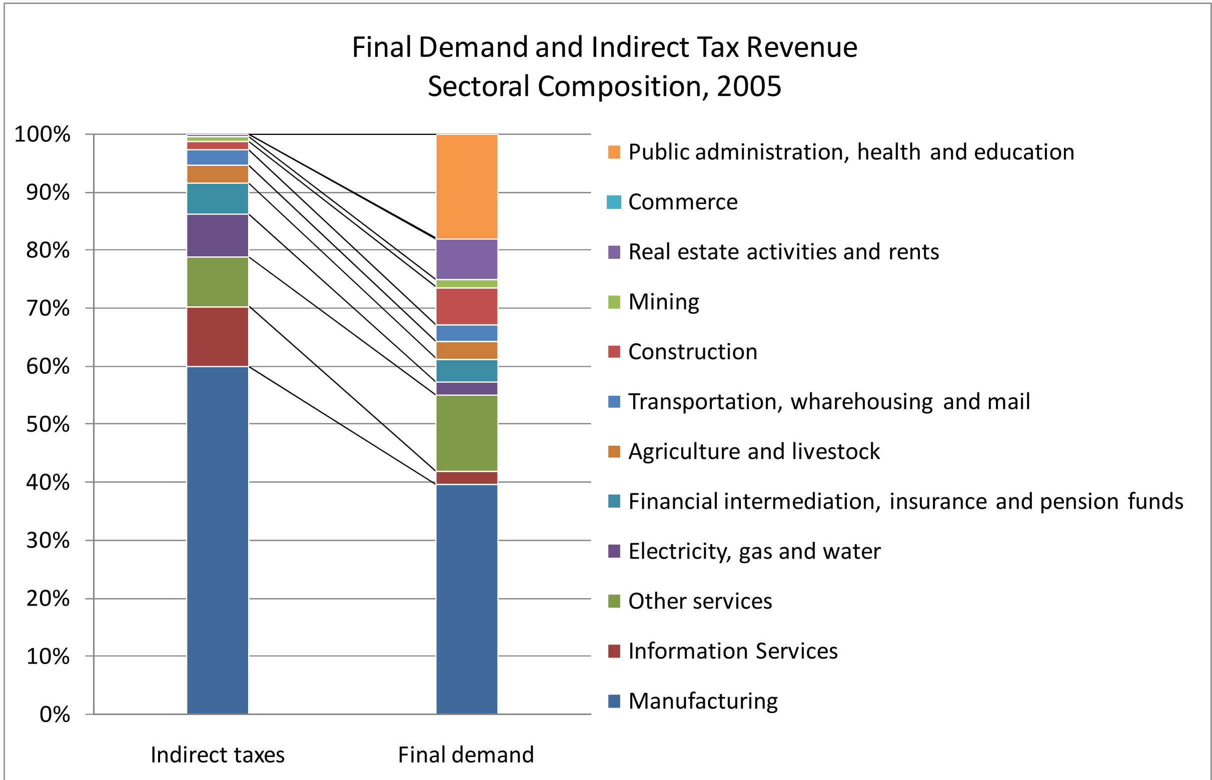
$$D_j = C_j + I_j + G_j + X_j \qquad [3]$$

and say that indirect taxes imposed on the fiscal base $D_j$ generate a tax revenue $T_j$ .

[16] It should be noted that, as defined in equation [1], $t$ is in fact the *tax-inclusive* rate.

National accounts data provide a disaggregation of final demand into different sectoral "products" and an allocation of indirect taxes to those "products". As shown in Figure 1, indirect taxation in Brazil is highly concentrated on few sectors. Almost 80 percent of the total revenue generated by indirect taxes comes from three "products": manufacturing, information services (mainly telecommunications) and electricity, gas & water. But those three "products" correspond to only 45 percent of the total final demand.

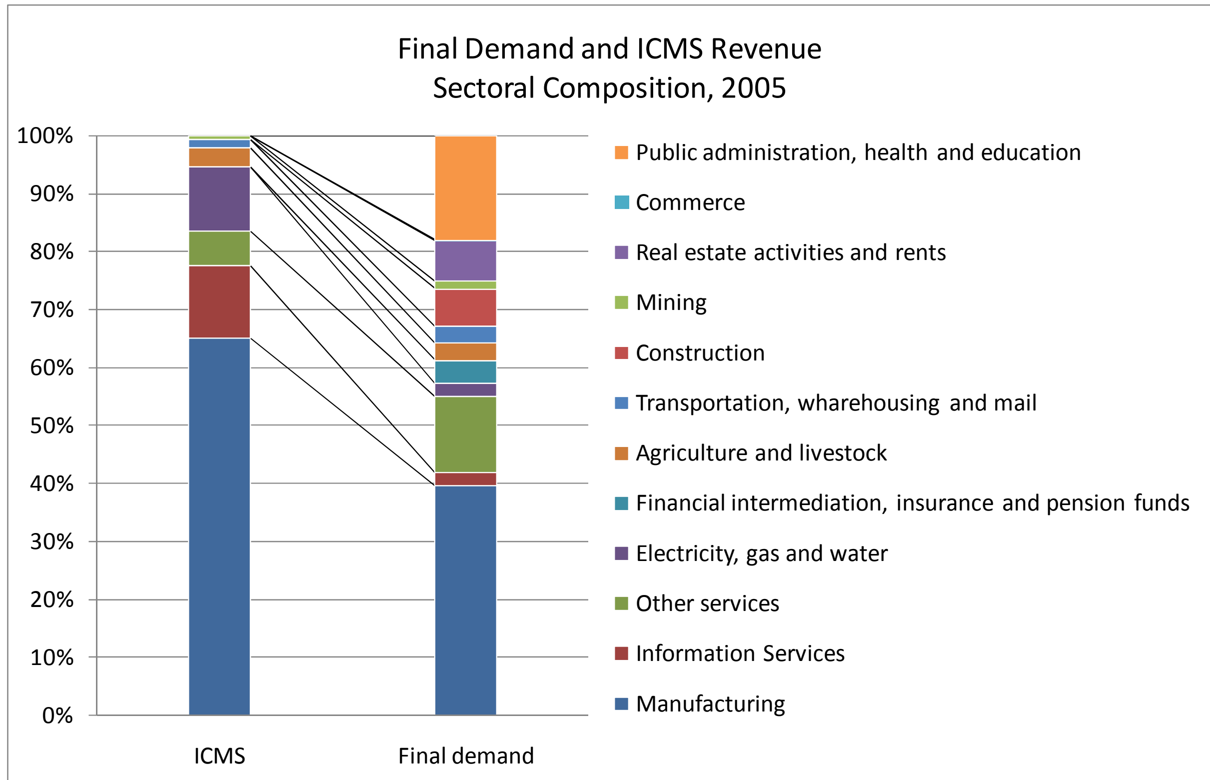
Figure 1




As may be seen in Figure 2, the degree of concentration is even higher in the case of the state-level VAT tax (ICMS), the most important indirect tax in the country. Almost 90 percent of the total revenue of the ICMS stems from the taxation of the three mentioned "products".

In order to have an idea of the magnitude of the involved tax rates, a "product" level disaggregation of equation [1] may be used. But it is important to take into account that some components of final demand are exempt from taxation. That is the case not only of government expenditures with goods and services, but also, to very large extent, of exports. This means no more than acknowledging that the burden of indirect taxation falls on consumption and investment.

Figure 2




Assuming $T_j$ is the revenue collected from the taxation of "product" $j$ , and supposing that neither $X_j$ nor $G_j$ are taxed, one may use equations [1] and [3] to define the product-level tax-inclusive rate as

$$t_j = T_j / (C_j + I_j) \qquad [4]$$

Indirect taxes imposed on $C_j$ and $I_j$ – the consumption and investment demands for product $j$ – could be written as

$$T_{Cj} = t_j \, C_j \qquad [5]$$

$$T_{Ij} = t_j \, I_j \qquad [6]$$

Aggregating those two equations across "products", one may estimate how the burden of the indirect taxation is distributed between consumption and investment in the economy. Figure 3 presents the composition of final demand, showing the importance of indirect-taxes on consumption and investment.

Figure 3

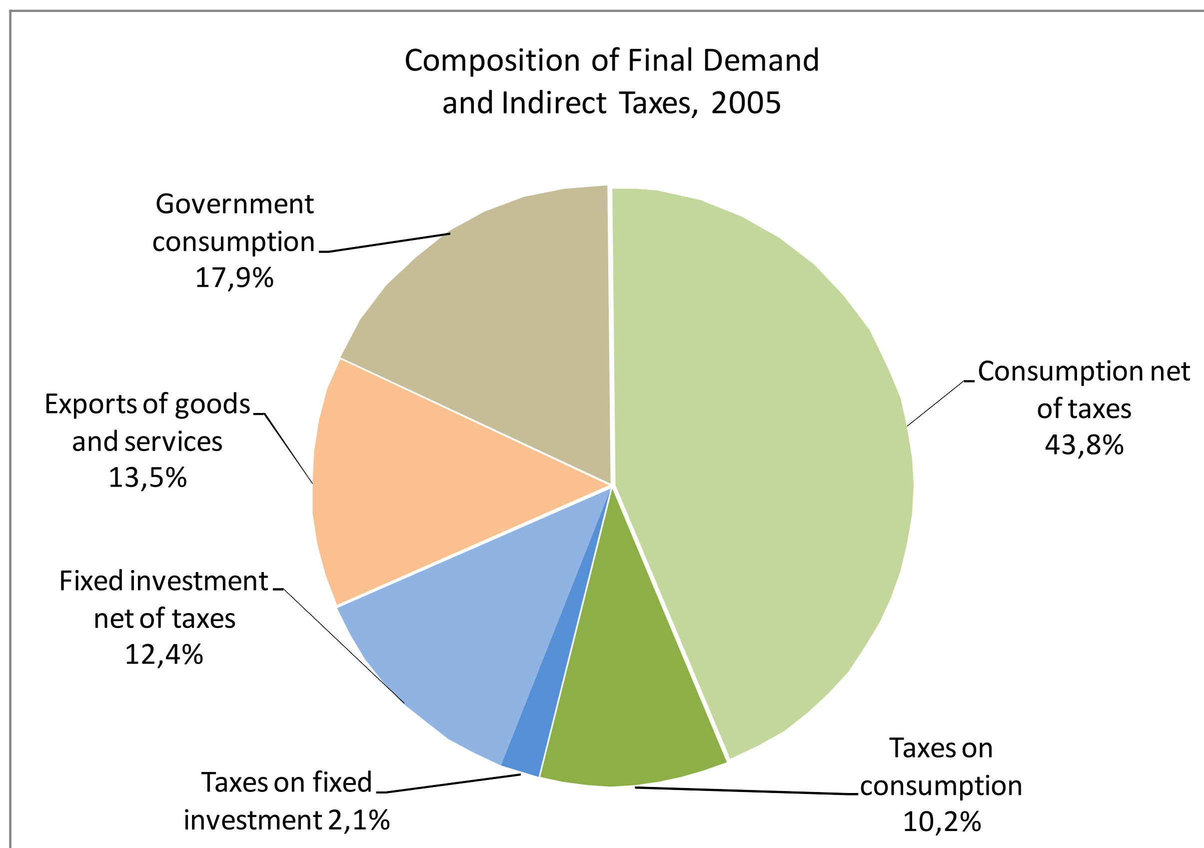
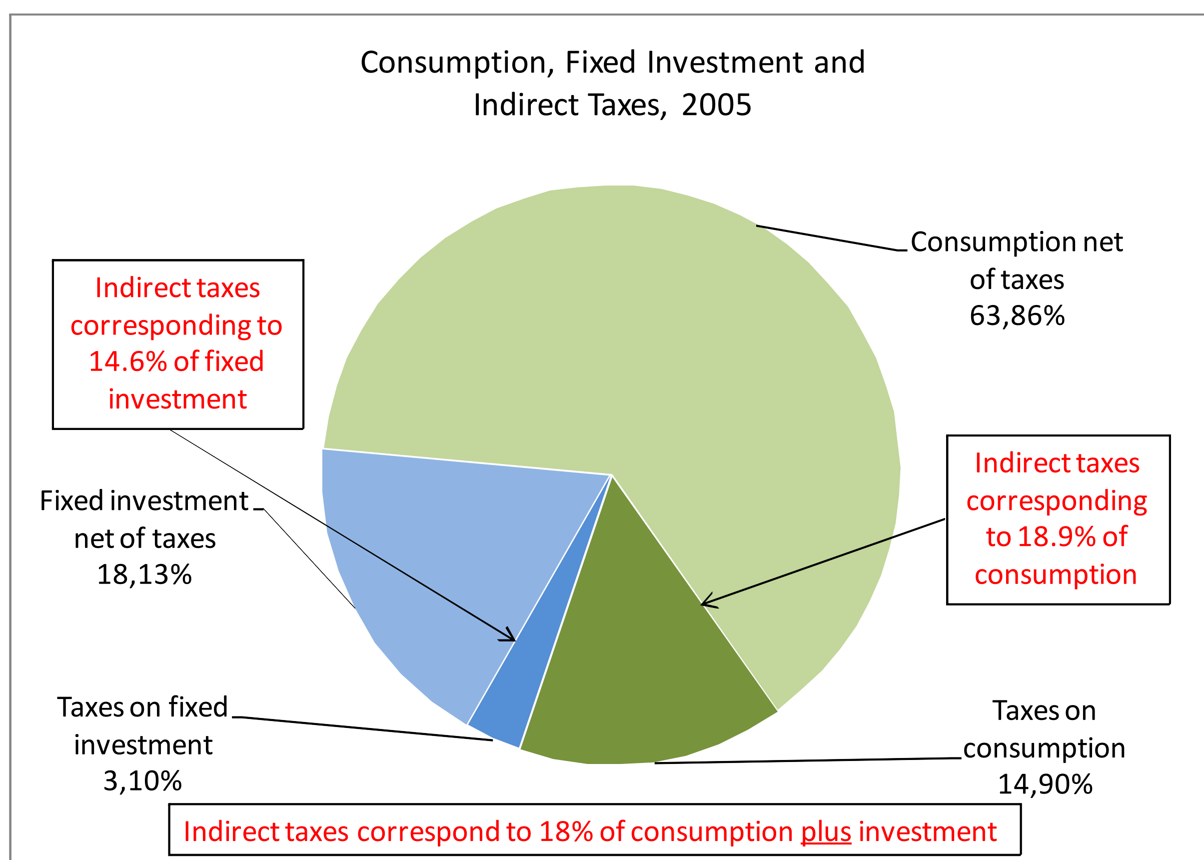


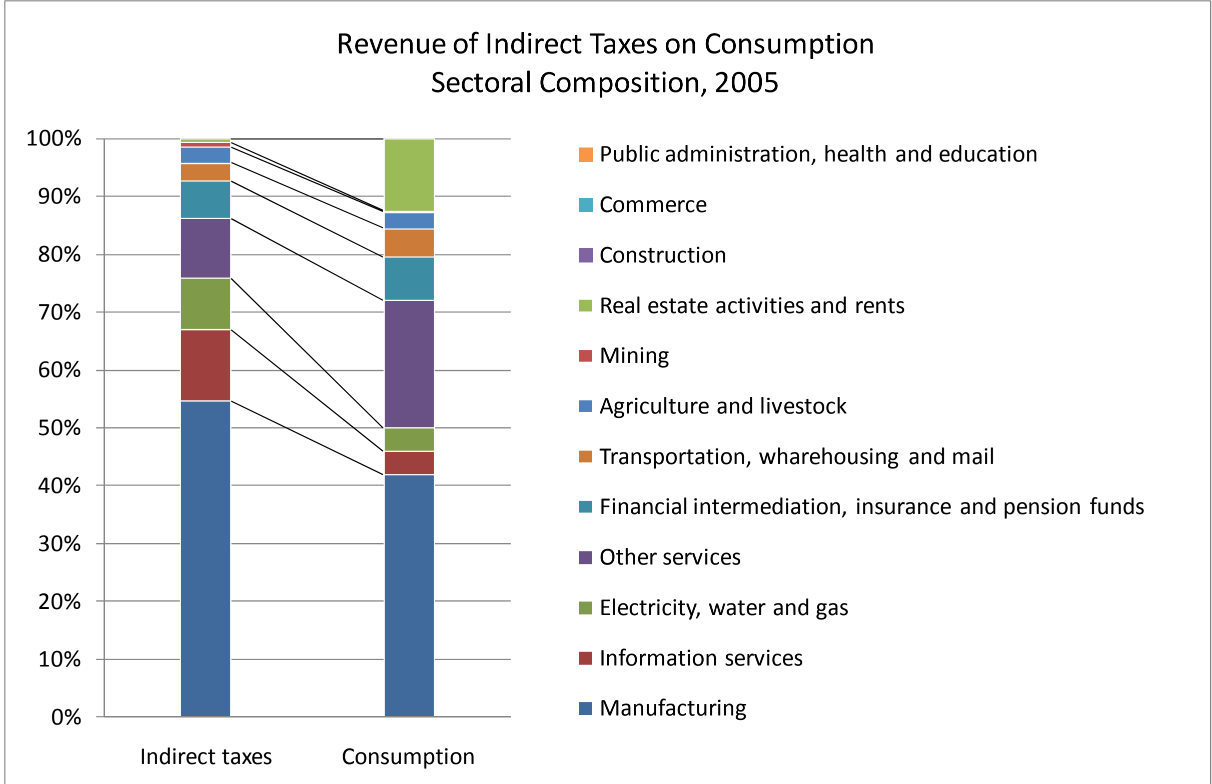

Figure 4



An even clearer picture is shown in Figure 4, that focus on the two taxed components of final demand. Indirect taxes amount to roughly 18 percent of the total aggregate value of consumption and investment. The burden on consumption (18.9 percent) is somewhat heavier than on investment (14.6 percent). Around 83 percent of the indirect taxation fall on consumption, but the taxation of investment still accounts for 17 percent of the total revenue of indirect taxes.

Looking into the taxation of consumption, the sources of the sectoral concentration of indirect taxes become more evident. As may be seen in Figure 5, more than 76 percent of the total revenue of indirect taxes on consumption stems from the taxation of the three above mentioned "products" – manufacturing, information services and electricity, gas & water – that, together, correspond to only 50 percent of aggregate consumption. The last two, that account for 21.3 indirect taxes on consumption, represent no more than 8 percent of aggregate consumption.

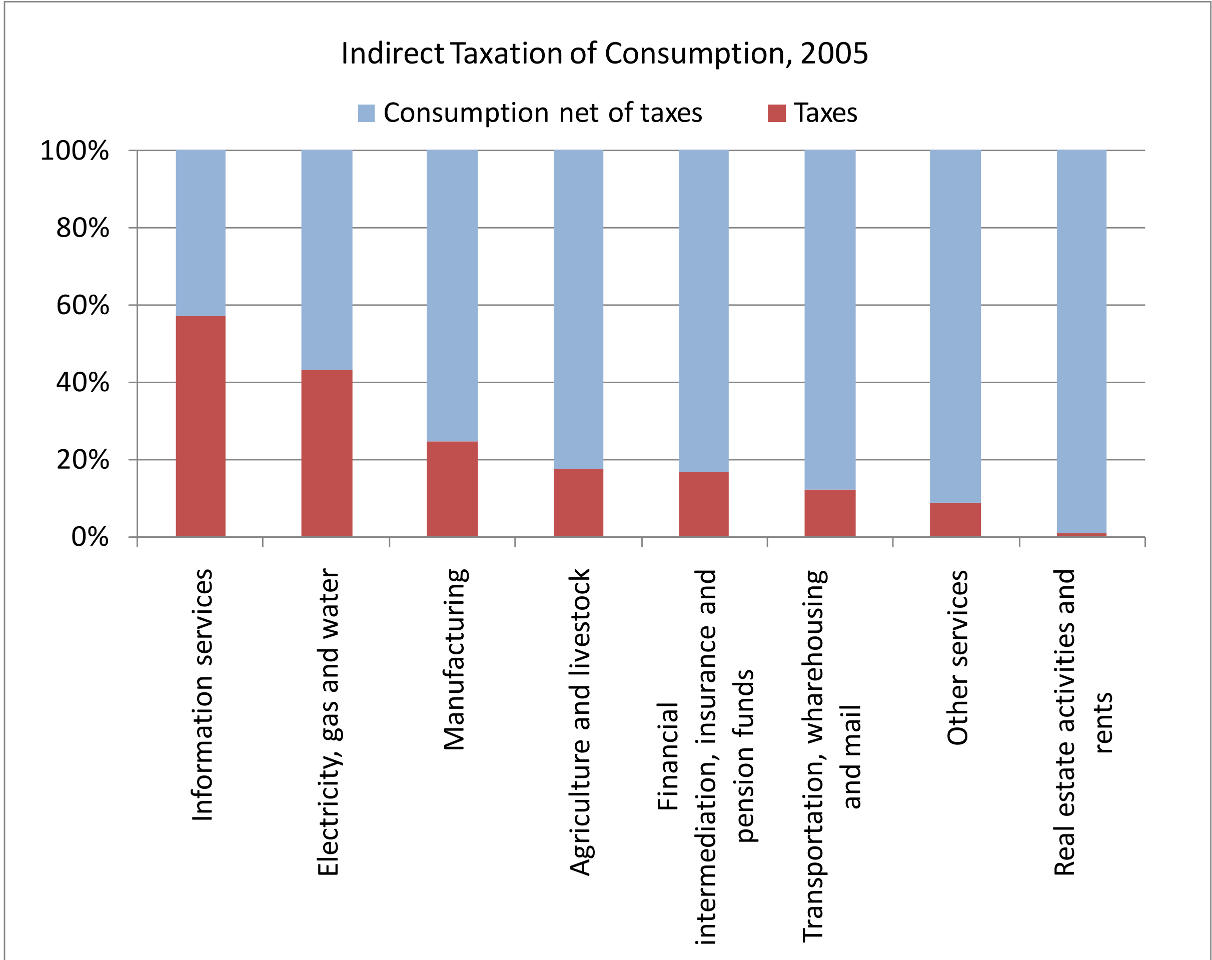
Figure 5




Such concentration means, of course, that the various "products" that comprise aggregate consumption are taxed at widely different rates, as shown on Figure 6. The tax-inclusive rate

reaches 57.2 percent in the case information services, 42.8 percent in the case electricity, gas & water and 24.7 percent in the case of manufacturing. But is much lower for most services.

Figure 6



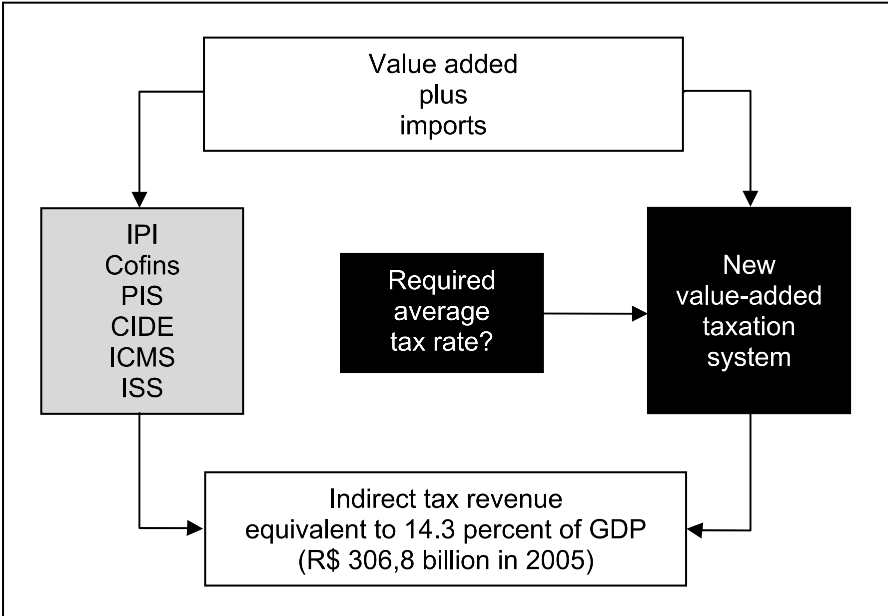

D. Challenges Beyond Federalism: Limits of the Possible

After a decade-long national debate, there is a reasonably widespread consensus in the country on the main lines that an ambitious tax-reform effort should follow. The general idea is to advance towards a broad-based harmonic value-added taxation system, that could allow the phasing out of the present chaotic and distorting multi-level indirect-taxation arrangement. In order to assure that exports and investment would be fully exempted, the value-added tax base would have to be restricted to aggregate consumption. The required broadening of the base should allow a more homogeneous taxation of the various sectors of the economy, increasing fiscal extraction in under-taxed areas and reducing the unreasonable high tax rates that have been imposed on others. These guidelines have been often presented in the debate

combined with the firm expectation that it will be possible to introduce all those changes, without any significant loss of aggregate tax revenue and any major redistribution of that revenue, either among the three government levels or within each of those levels. The idea is that the reform would have to include some sort of elaborate compensation mechanism that would be able to assure that kind of neutrality.

Of course, one should not underestimate the technical and political intricacies of the fiscal-federalism issues that would have to be properly dealt with to make such a complex reform feasible. Important as those issues certainly are, it may be useful to leave them aside, for a moment, in order to have a clearer perspective of other crucial difficulties that would be involved in the reform, even if there were no fiscal federalism problems to be addressed. Apart from the complications of fiscal federalism there is a key simple question to be answered. If the reform is going to introduce a well designed broad-based value-added taxation system, how high would have to be the average tax rate in order to avoid an aggregate revenue loss? Simple as the question may be, it has no simple answer, but calls attention for a number of important difficulties the reform would entail. The diagram in Figure 7 helps to pose the same question in a more precise and specific manner.

Figure 7

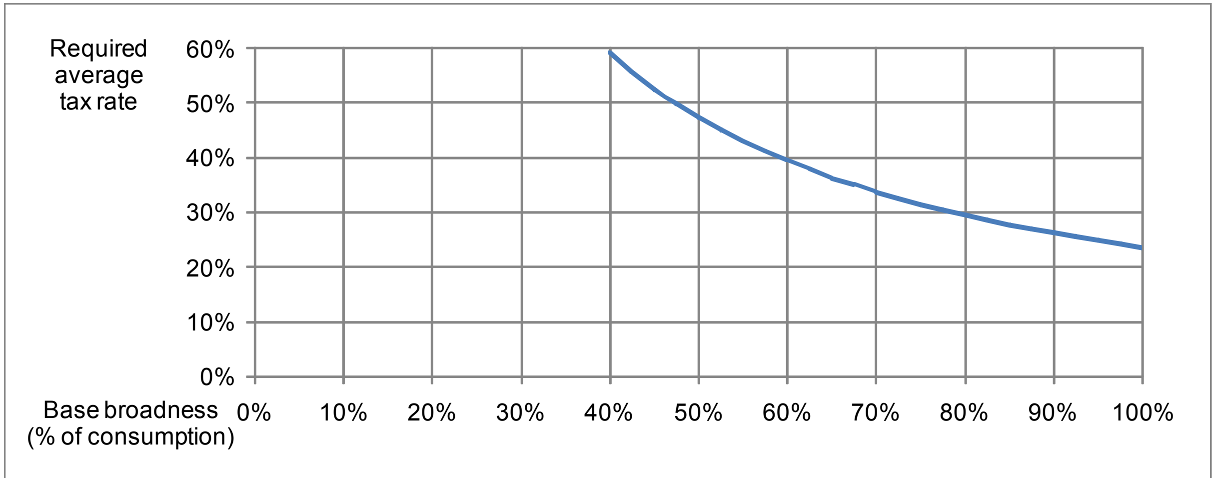



What is being ultimately conceived is the possibility of orderly replacing the present problematic indirect taxation system, involving six different taxes, with a brand new value-

added tax system able to generate the same aggregate tax revenue. Assuming for simplicity that the new system could involve a single tax, what average value-added tax rate would be required to assure that the aggregate indirect-tax revenue would remain at 14.3 percent of GDP?

The first step to answer that question is to note that much will depend of how broad the tax base of the new value-added tax will be. Of course, the broader the base the lower could be the required average tax rate. If exports and investment are to be fully exempted[17], the tax base will be restricted to aggregate family consumption. Under the very extreme assumption that the totality of aggregate consumption will be subject to taxation, the required average rate would be roughly 24 percent. But it is highly improbable that the tax base could be so broad. Under more realistic assumptions on the base broadness, the rate would have to be considerably higher. The smaller the proportion of aggregate consumption that could be taxed the higher will have to be the required average tax rate, as shown in Figure 8.

Figure 8
Required Average Tax Rate



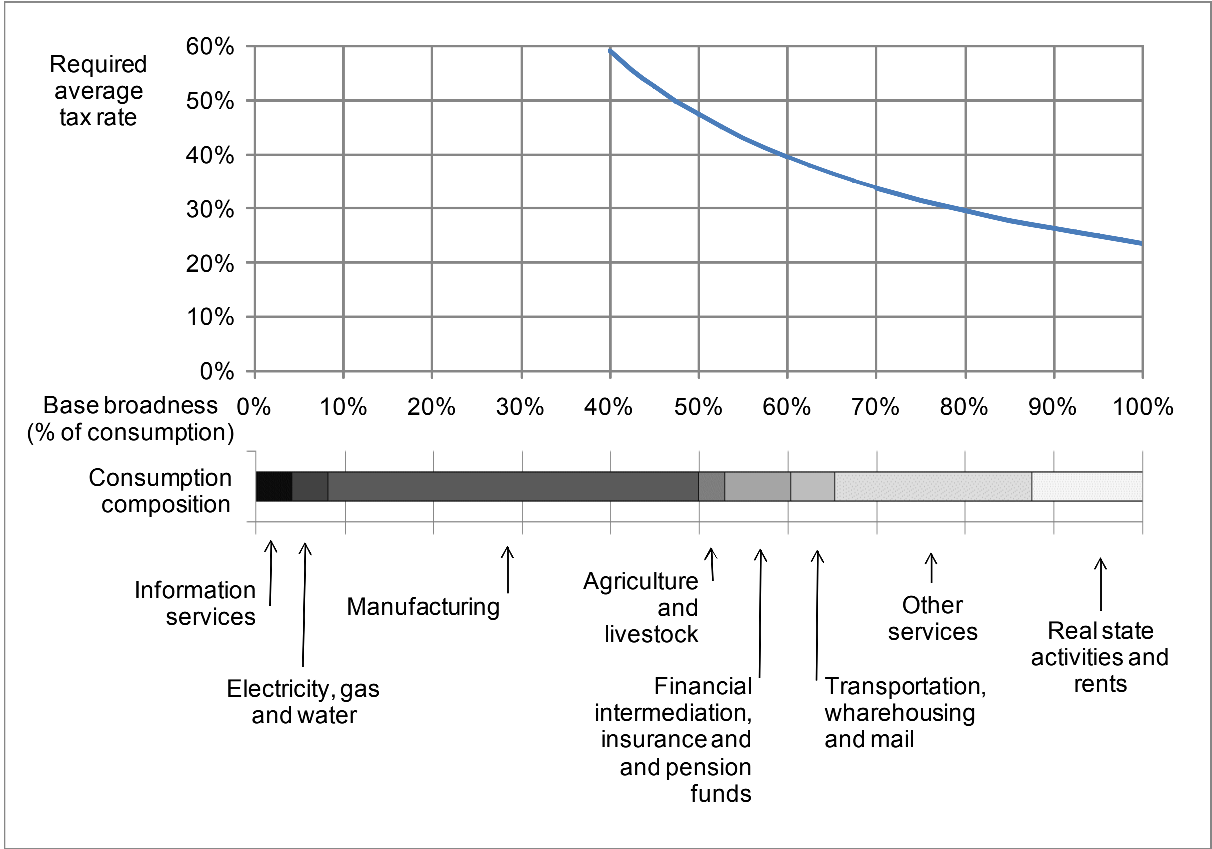

It may be seen that as the tax base narrows the required average rate quickly becomes prohibitive. Actually there is here a well known two-way relationship to be taken into account. On one hand the tax base has to be broad enough in order to allow the required tax rate to be reasonably low. On the other, if a high tax rate is imposed, it will be unwise to count on an effective broad tax base, even if, legally, the base seems to be broadly defined.

[17] Though there have been important progress in the effort to exempt exports from indirect taxes, exports continue to be residually exposed to indirect taxation.

## F. Political Economy and Difficulties

The difficulties that could be involved in assuring a sufficiently broad tax base may be perceived more clearly when aggregate consumption is broken down into demand for goods and services produced by the various sectors, since different sectors are currently being exposed in widely distinct degrees to indirect taxation, as analyzed above in section D. The disaggregation of consumption into the various "products" it comprises is presented in the lower part of Figure 9.

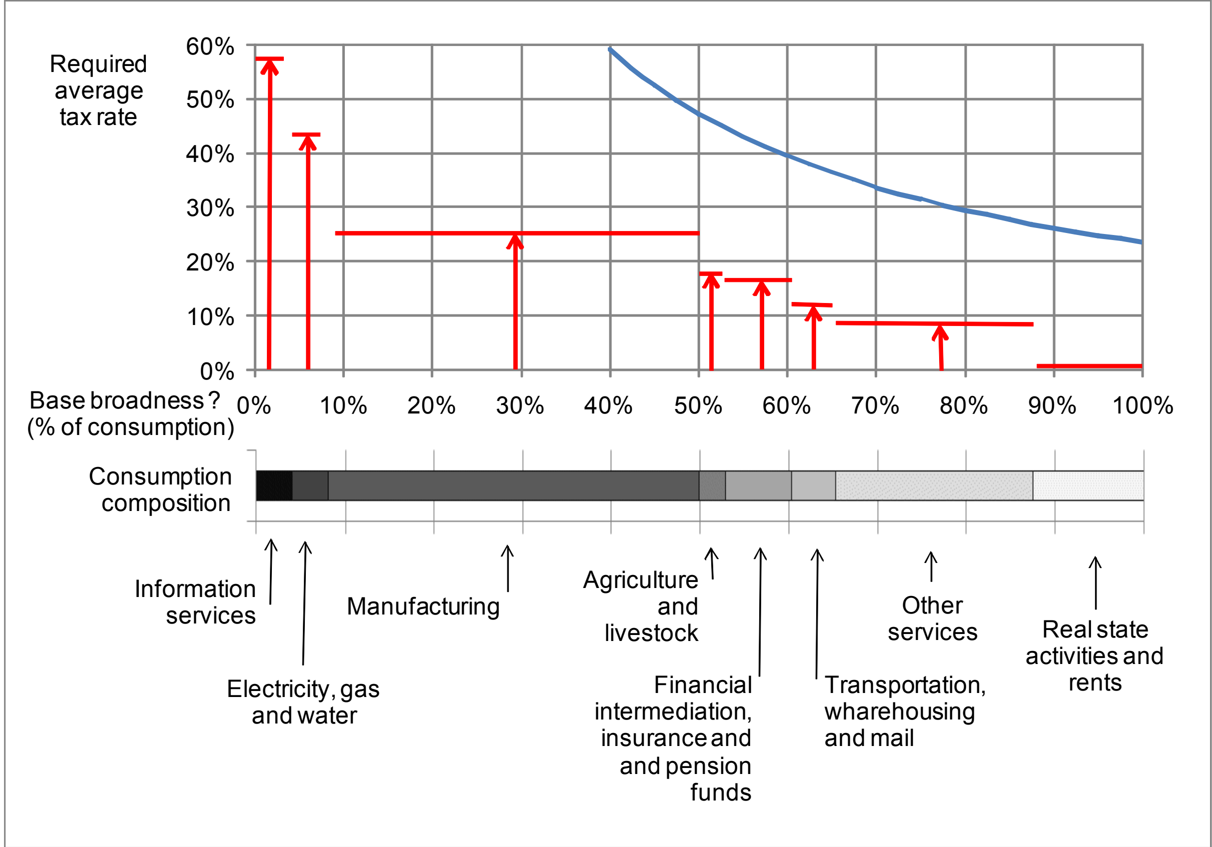
Figure 9
Required Average Tax Rate and Composition of the Aggregate Consumption




"Products" have been ordered according to their present exposure to indirect taxation. The most heavily taxed are on the extreme left, the less taxed ones on the extreme right. In order to visualize more clearly the difficulties involved in the transition of the present indirect-tax system to a new broad-based value-added tax system, Figure 10 adds to the chart of Figure 9 the current implicit tax rates imposed on the various "products".

Figure 10 calls attention to a crucial point. There is a double challenge to be faced. The basic idea of fully exempting investment and exports in the new tax system envisaged by the reform already entails a considerably heavier tax burden on aggregate consumption. But base broadening will also require a sizeable redistribution of the tax burden that already falls on consumption, in such a way as to assure a heavier taxation on the less exposed half of aggregate consumption and a lighter burden on the obviously overtaxed components of aggregate consumption. That may prove to be a very difficult task. An effort to redistribute the tax burden along these lines is bound to face serious political resistance in Congress.

Figure 10
Required Average Tax Rate, Composition of the Aggregate Consumption
And Current Implicit Tax Rates




Imposing considerably heavier taxation on sectors that have been so far well sheltered from indirect taxes entails complex political economy problems. Political support that could come from those that would be benefited by the full exemption of both investment and exports, on one hand, and by the lighter taxation of the currently overtaxed sectors, on the other, will

probably be not enough to offset the enormous resistance that would certainly come from the vast sectors that would have to more heavily taxed.

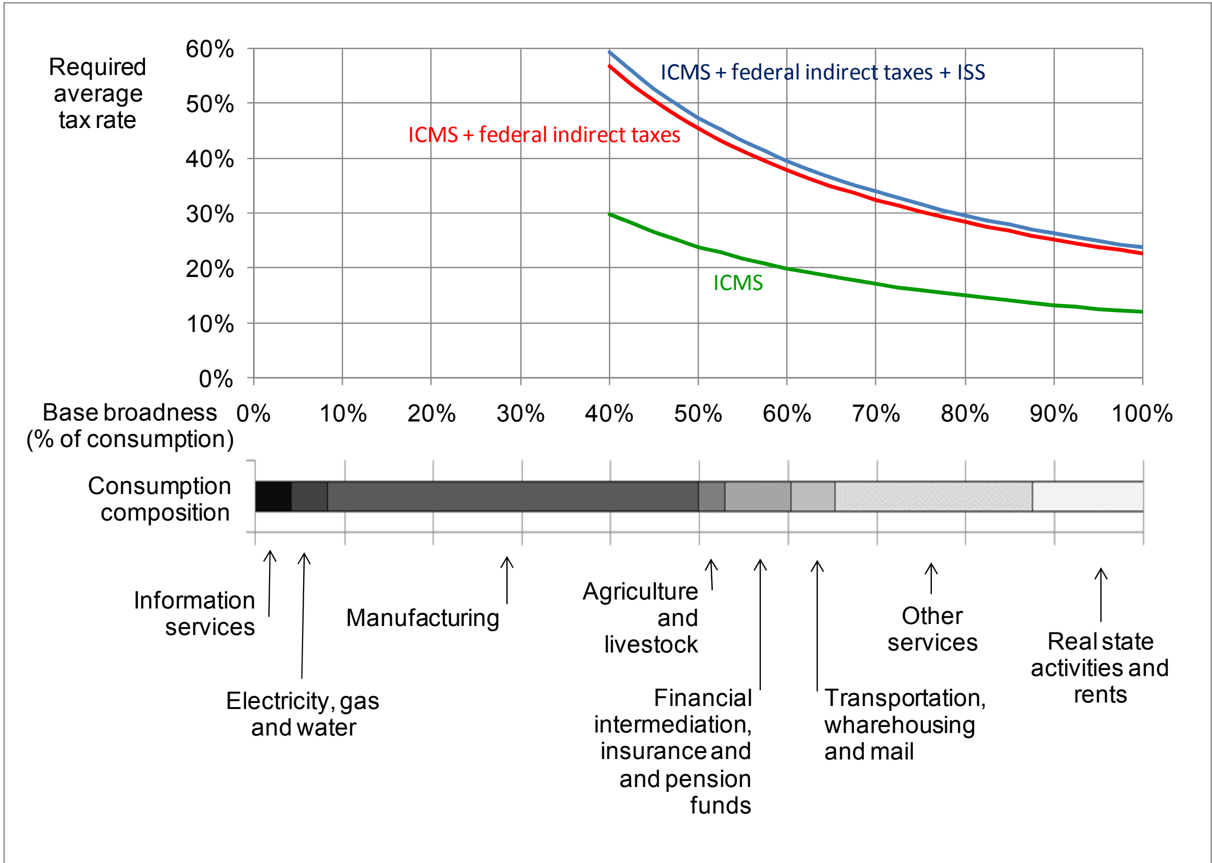
A large part of the services would have to be taxed in a much more effective way. Heavier taxation would also have to fall on many important consumption items that, either implicitly or explicitly, have been treated by the tax system as part of the rather imprecise categories of “merit goods” and “essential goods”. It is easy to imagine the intricate and powerful coalitions that could be formed in Congress to protect strongly-established privileged positions and to fiercely resist efforts to broaden the tax base. A perfectly consistent tax-reform project, counting on a really broad base, may easily become completely inconsistent if the required tax base suffers fatal erosion in Congress.

Having made the point that broadening the base represents an enormous challenge, quite apart from other challenges that fiscal-federalism intricacies may bring to the reform, it is important to acknowledge that efforts to broaden the base will have to deal with complex fiscal-federalism issues. For analytical purposes, it is certainly useful to treat those challenges separately. But that does not mean that they could or should be faced independently. Quite on the contrary. The taxation of services is a good example. The effort to broaden the base will have to be, to a large extent, an effort to impose a more effective taxation on services. But in the present fiscal-federalism arrangement the power to tax services has been largely attributed to local governments. Even though most municipal governments end up taxing services very lightly, the idea of bringing services to the broad base of a new comprehensive value-added taxation system is bound to face strong resistance from local governments and to entail a very complex negotiation of the reform in Congress.

Such resistance has already become very clear among mayors of state capitals and other large cities that have been exploiting more intensely the municipal tax on services (ISS). But aggregate data shows that, when compared to its huge potential tax base, the ISS continues to be very poorly exploited by local governments as a whole. It is, therefore, hard to see how a broad-based value-added taxation system can be created without the elimination of the ISS. There is no other way to bring most of the services to the base of the new system.

Figure 11 helps to stress the importance of including the ISS in the reform. The upper curve in the chart has been already presented in Figure 8 above. It shows the required average value-added tax rate for different assumptions about the broadness of the value-added tax base, when it is supposed, as was made clear in Figure 7, that the new tax would replace the combined revenues from one state level tax (ICMS), four taxes charged at the federal level (IPI, COFINS, PIS and CIDE) and one municipal-level tax (ISS).

Figure 11
Required Average Tax Rates for Different Scopes of the Reform
and Composition of the Aggregate Consumption

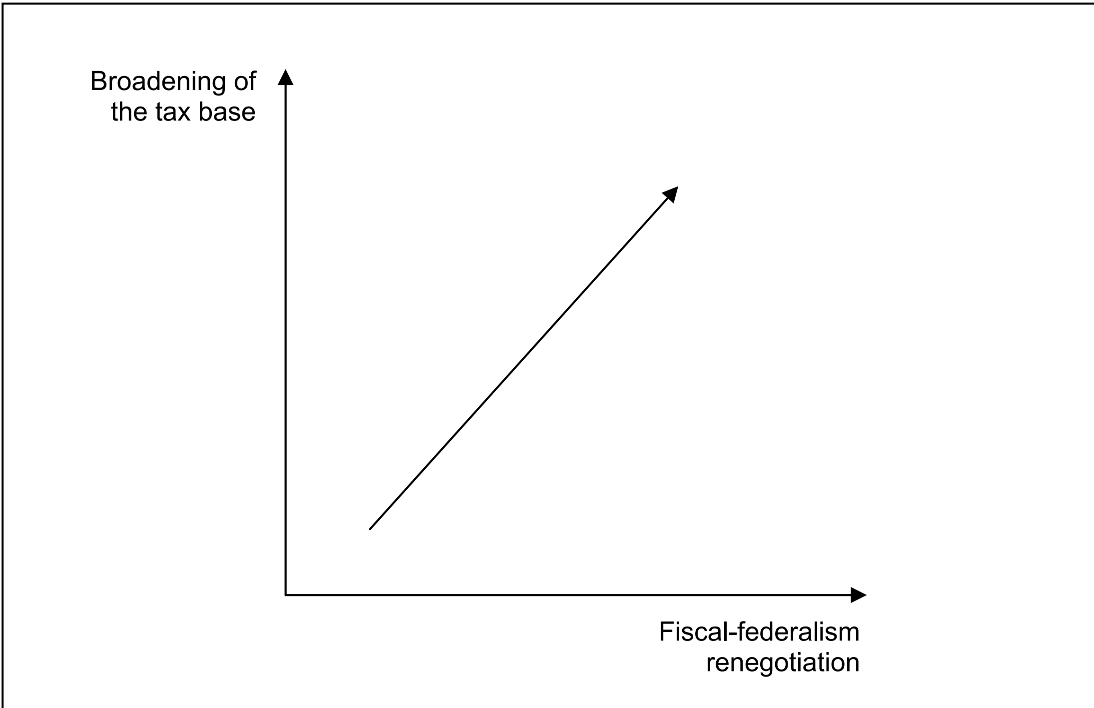



The other two curves in Figure 11 show required tax rates when reforms with a narrower scope are considered. If only the revenue from the state-level ICMS had to be replaced, the required tax rates could be much lower, as shown by the lowest curve in the Figure 11. But, as the intermediate curve shows, when the combined revenues to be replaced also include the four federal-level taxes (but not the municipal ISS), the required rates become quite similar to the rates that would be required if the revenue from the ISS were also included. That means that to exclude the ISS from the reform would entail, on the one hand, a very small reduction in the required tax rate of the new system and, on the other, a huge narrowing of the potential

tax base, as most services would have been left out. So huge as to put the feasibility of the reform at risk. That does not mean all that it will be easy to break resistances to the inclusion of the ISS in the reform. It only means that the involved challenges will become much more difficult if the ISS is not included.

The general point to have in mind here is another important two-way relationship. The required base-broadening effort will have to involve an intricate renegotiation of the present fiscal-federalism arrangement. But, on the other hand, that renegotiation will seem much less promising and, therefore, less bound to be successful, if, for reasons beyond fiscal federalism, the required base broadening becomes hard to be realistically envisaged. That points to the need of a coordinated mutually reinforcing advancement on the two reform fronts, as shown in Figure 12.

Figure 12




## G. Concluding Remarks

The resistances analyzed above may be compounded by difficulties of a different kind. The tax reform that has been considered contemplates the possibility of converting the current

largely origin-based value-added taxation system into a destination-based one. The well known resistances such a conversion would have to face, given the country`s peculiar state-level VAT system, may be substantially strengthened if the conversion has to be combined with firm efforts to broaden the tax base. As such efforts would have to involve a well less benevolent taxation of the consumption of goods and services that have been treated as essential and meritorious, they would probably face stronger opposition from states with lower per capita income, where the relative importance of those goods tend to be greater. This calls attention to a crucial point. Dealing with the complex political economy of the reform will prove to be a poor-visibility flight till the impact of the proposed changes on the tax base of each state can be mapped with reasonable detail, taking into account differences in the composition of consumption at the state-level.

## REFERENCES


Guérard, M. (1973). "The Brazilian Value-Added Tax", *Staff Papers*, International Monetary Fund, Vol. 20.

Werneck, R. L. F. (2002). "Reforma Tributária: Urgência, Desafios e Descaminhos", in A. C. Castro (ed.), *Desenvolvimento em Debate: Paineis do Desenvolvimento Brasileiro*, Rio de Janeiro: Maud/BNDES.

Werneck, R. L. F. (2003a). "Tax Reform in Brazil: Small Achievements and Great Challenges", in J. A. González, V. Corbo, A. O, Krueger and A. Tornell (eds.), *Latin American Macroeconomic Reforms: The Second Stage* Chicago: The University of Chicago Press.

Werneck, R. L. F. (2003b) "Exacerbando as Contradições", *O Estrado de S.Paulo*, December 19th, 2003.

Werneck, R. L. F. (2005a). "Tax reform on the brink of fiscal dominance: a political economy model" ,Texto para Discussão n. 505, Departamento de Economia da Pontifícia Universidade Católica do Rio de Janeiro, agosto 2005.

Werneck, R. L. F. (2005b). "Além da Estabilização: Desafios da Agenda Fiscal". *Economia*, v. 6, p. 1-15.

Werneck, R. L. F. (2006). "An Evaluation of the 2003 Tax Reform Effort in Brazil", *Brazilian Journal of Political Economy*, Vol. 26, N.1, January-March, pp. 75-94.

Departamento de Economia PUC-Rio
Pontifícia Universidade Católica do Rio de Janeiro
Rua Marques de Sâo Vicente 225 - Rio de Janeiro 22453-900, RJ
Tel.(21) 35271078 Fax (21) 35271084
www.econ.puc-rio.br
flavia@econ.puc-rio.br