



Ministry of Finance

TAX REFORM

Brasília - DF
February 28, 2008

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1. IMPORTANCE OF TAX REFORM

Driven by a new cycle of vigorous and balanced economic expansion, Brazil has achieved an ongoing process of sustained growth. The foundations of this growth cycle can be described as increasingly greater consolidation of macroeconomic stability, coupled with a fiscal policy that guarantees consistent reductions in the overall public debt, low and stable inflation and solid current accounts, powered by a burgeoning export sector and record international reserves.

1. Macroeconomic Indicators - Brazil

	2003	2007
GDP Growth (%)*	1.1	5.2
Inflation (IPCA) – (%)	9.3	4.5
Exports (US\$ billion)	73.2	160.7
Trade Surplus (US\$ billion)	24.9	40.0
International Reserves (US\$ billion)	49.3	180.3
Primary Surplus (% of GDP)	3.9	4.0
Nominal Deficit (% of GDP)	(4.7)	(2.3)
Net Public Sector Debt (% of GDP)	52.4	42.8

*/In 2007, projection

The most significant characteristic of the current economic moment is a policy targeted to accelerated growth, coupled with social inclusion and reduction of inequalities, considered the driving force underlying all measures taken by the current administration.

The challenge before us at this time is to avoid a spirit of complacency in the face of the results achieved, while creating the conditions required to consolidate the progress attained and generate even more rapid growth, with attenuation of social and regional inequalities.

It is in this framework that one should view the Tax Reform bill recently sent to the National Congress, following wide-ranging debate with states, municipalities, workers and the business community over the course of the last year. The major objectives of this bill are to restructure our tax system and broaden the nation's growth potential.

All segments of society are keenly aware of the need for a general review of our very complex tax system. The Tax Reform is designed to eliminate obstacles to more efficient and less costly production, reduce the fiscal burden imposed on both producers and consumers, stimulate formalization of economic activity, making it possible to achieve more balanced development of states and municipalities.

Various reasons can be listed showing why the Tax Reform will contribute significantly to accelerating the nation's growth potential:

- simplification and administrative streamlining of the tax system will sharply reduce the number of taxes and the costs incurred by businesses in their efforts to comply with accessory tax liabilities;
- increased economic formality will result in more equitable distribution of the tax burden: those who pay taxes will pay less, while those who do not comply with their tax obligations will begin contributing;

- elimination of distortions in the tax structure will reduce the cost of investments and exports;
- the end of fiscal war among the states will result in increased investments and enhanced economic efficiency;
- significant progress in the policy of reducing taxation will result in lesser tax costs for legally established businesses and consumers, while improving the nation's competitiveness;
- improvements in regional development policy, introducing more efficient development mechanisms that will benefit the poorer regions of the country.

Past failures in attempts to implement a national tax system reform generated a certain degree of skepticism in some segments of society regarding the possibility of approving the bill. Nonetheless, the current moment is significantly more favorable to its passage.

The most important difference is that the country is now immersed in a period of vibrant economic growth that has clearly impacted tax inflows. Such an environment tends to attenuate resistance to the Reform, allowing the federal government to reduce the tax burden and offset possible losses at the state and municipal levels without throwing public accounts out of kilter.

On the other hand, exhaustion of fiscal war as a policy aimed at attracting investments, while generating intense deterioration of the business climate and of relations among the states, has created a considerably more favorable climate for purging this distortion from our system.

Finally, implementation of the Electronic Invoice (NF-E), coupled with integration of the activities of fiscal authorities at the different levels of government, will not only sharply reduce tax evasion, but will make it possible to introduce technical alterations unfeasible in the past, including:

- levying of the ICMS predominately in the state of destination, without increasing tax evasion;
- implementation of a system of compensation among businesses designed to resolve the problem of cumulative tax credits;
- precise calibration of gains and losses at the state level generated by alterations introduced by the Reform, making it possible to rationally debate the offsetting of possible losses.

2. Major problems of the Tax System

2.1 Complexity

Brazil has an extremely complex tax structure, in which many different taxes are levied on the same base. This problem is particularly acute in the case of indirect taxes on goods and services. While most countries have just one or two indirect taxes, Brazil has six, with highly diverse and constantly changing legislation.

At the federal level alone there are four taxes and three tax systems. The ICMS, which is a state tax, has 27 different bodies of legislation and an enormous variety of rates and calculation criteria. There are two distinct taxes on business profits: the income tax (IR) and the social contribution on net income (CSLL).

2. Indirect Taxes on Goods and Services

Tax	Jurisdiction	System	Base
IPI	Federal	Noncumulative	Imports and production of industrialized goods
COFINS	Federal	Mixed	Imports, production and marketing of goods and services
PIS	Federal	Mixed	Imports, production and marketing of goods and services
CIDE – Fuels	Federal	Cumulative ¹	Imports and marketing of oil and natural gas and derivatives
ICMS	State	Noncumulative	Circulation of merchandise and rendering of interstate and inter- municipal transportation services and communications
ISS	Municipal	Cumulative	Rendering of services of any nature, not covered by the ICMS base, and defined in complementary legislation

¹/The CIDE generates credits in the fuel production chain, but does not generate credits for companies that consume fuels. It is for this reason that levying of this tax is considered cumulative.

Application of this model subjects businesses to high bureaucratic costs in their efforts to calculate and pay their taxes, together with an enormous number of disputes with tax authorities. This is just one of the reasons why a World Bank study named Brazil as holder of the world record in terms of the time spent by businesses in complying with their tax obligations.

2.2. Cumulativity

Cumulative levying of a tax, in which the tax paid at one stage of the productive chain does not generate a credit in the following stages, results in a series of economic distortions: inefficient organization of the productive structure; increased investment and export costs; favoring of imports.

Notwithstanding recent advances, the Brazilian tax system still has a series of cumulative taxes, including the Cide-Fuels and the ISS. Even in the case of noncumulative taxes (ICMS, PIS/Cofins), part of the goods and services used by companies do not generate credits, thus creating an added burden on investments and exports.

Table 3 presents an estimate of the cumulative levying of taxes that still exist in the Brazilian economy, with an overall level of almost 2% of GDP. The truth is that the problem is even greater, since, in some business sectors and categories, the PIS/Cofins is still levied according to the cumulative system, though it is impossible to calculate the impact of this distortion.

3. Cumulative Levying	R\$ billion/2006		
	Collection	Impact*	% of GDP
Cumulative Taxes			
ISS	15.3	9.9	0.4%
CIDE-Fuels	7.8	3.9	0.2%
Noncompensated Credits			
ICMS		17.0	0.7%
PIS/COFINS		13.0	0.6%
Total		43.8	1.9%

*/ Part of the levying of the ISS and CIDE affects only final consumers and is not therefore considered as cumulative.

2.3. Increased Investment Costs

Aside from the question of cumulativity, the cost of investments is high because of the long period involved in recovering credits for taxes paid on capital goods. A company takes 48 months

to offset the ICMS paid in the purchase of a machine (at the rate of 1/48 per month) and 24 months to offset the PIS/Cofins.

The effective cost of this deferral depends on the financial situation of the company. For a liquid company, it corresponds to what it does not receive since it is unable to invest the resources in the financial market. For an illiquid company, it corresponds to the interest paid on the loan it is forced to take out in order to finance recovery of the tax over the long-term.

Table 4 shows estimates of how this financial cost can result in a higher price for a machine in the case of one liquid company and two illiquid companies. In general, the problem tends to be greater for smaller scale companies since they are less liquid and pay higher financial market rates.

3. Financial cost of deferral (percentage of the price of the equipment)

Capital Cost	PIS/ COFINS	ICMS	Total
Selic (11.25%)	1.0	1.7	2.6
Working Capital (27.9%)	2.0	3.3	5.3
Overdraft Account (58.8%)	3.3	4.9	8.2
Memo:			
Tax Rate	9.25%	8.80%	

2.4. Problems with the ICMS

Many of the ICMS-related problems have to do with the system of charging this tax in interstate operations. In these transactions, part of the ICMS is due to the state in which the merchandise originated (corresponding normally to a rate of 12%) and part to the state of destination. In sales made to other states by Southern and Southeastern states (except Espírito Santo), the rate belonging to the state of origin is 7%.

One of the problems that this structure generates is that, based on the argument that they would have to refund a tax debt paid in a different state, many states resist refunding cumulative ICMS credits to exporter companies. Accumulation of credits is one of the major concerns of Brazilian exporters and, on several occasions, has resulted in losses of investments to other countries.

An even more serious problem, however, is fiscal war, through which one state reduces the ICMS in order to attract investments to its territory.

Initially, the fiscal war was viewed as an option taken by poorer states to attract investments and offset the lack of a more effective regional development policy. With time, however, the wealthier states also adopted this practice. As a result, the so-called fiscal war lost its character as a regional development instrument and began generating a series of distortions that were highly detrimental to the nation's growth.

2.5. Fiscal War

In a situation in which states have granted fiscal benefits on a case-by-case basis, without any coordination whatsoever, the situation of fiscal war has generated a chaotic tax environment, with enormous investor uncertainty.

The truth is that, on making an investment, a company does not know whether its competitors will receive benefits that could jeopardize the investor's capacity to compete and survive on the market. This uncertainty has led businesspersons to invest less or to demand higher returns on their investments, in detriment to consumer interests.

Today, this uncertainty even impacts companies that have received incentives but do not know whether they will manage to maintain them:

- as a result of judicial decisions that recognize the unconstitutional nature of the benefits granted, even requiring retroactive charging of unpaid taxes; or
- because various states do not accept ICMS credits on products that received incentives in other states.

There are still other problems that result from the fiscal war, including granting of benefits that favor imports in detriment to national production. When a country imports a product, the entire value of the ICMS is due to the state in which the company is located and the benefit can reach 100% of the tax. However when the same product is purchased from a different state, a share of the ICMS remains in the state of origin and the benefit only reduces part of the tax.

Finally, the fiscal war results in economic inefficiency and unproductive shifting of merchandise from one state to another. In many cases – mainly in such predatory modalities as fiscal war in the wholesale trade – the benefit depends only on transiting of the merchandise through the state that grants the incentive, thus generating congestion on our highway network.

2.6. Excessive Payroll Taxation

One of the characteristics of the Brazilian tax system is a very high level of payroll taxes, resulting not only from the Social Security and FGTS contributions, but also the financing of programs that have no relationship whatsoever to worker wages, such as the “S” System and basic education (financed through a contribution known as the “education wage”).

High payroll taxes generate a series of negative impacts on the Brazilian economy:
 loss of competitiveness by national companies;
 incentive to economic informality;
 lower level of Social Security coverage (today 51% of employed persons in Brazil do not contribute to the Social Security system).

This situation results in a vicious circle in which high levels of taxation provoke increased informality and high levels of informality require that those operating in the formal sector of the economy pay higher tax rates.

5. Payroll Taxes (percentage of salaries)

	Minimum	Maximum
Employer		
Social Security contribution		20.0%
Work accident insurance ¹	0.5%	6.0%
“S” SEBRAE System		3.1%
“Education wage”		2.5%
Others		0.2%
Total without FGTS	26.3%	31.8%
FGTS		8.0%
Total with FGTS	34.3%	39.8%
Employee (Social Security contribution)	8.0%	11.0%
Total	42.3%	50.8%

Note. Situation corresponding to the system in effect for a commercial or industrial company that does not pay taxes according to the National SIMPLES system.

1/ Amounts in effect as of January 2009.

3. The Tax Reform Bill – Major Proposed Measures

The constitutional amendment bill sent to the National Congress has six major objectives:

- simplify the tax system in terms of both federal taxes and the ICMS, eliminating taxes and reducing and streamlining tax legislation;
- end the fiscal war among the states, with positive impacts on investments and economic efficiency;
- implement measures aimed at reducing taxes, principally in those cases in which they are prejudicial to development;
- correct distortions in taxes on goods and services that hamper investments, the competitiveness of national companies and economic growth;
- improve regional development policy, a measure that is important in itself, but that becomes even more significant when viewed in the framework of the tax reform as a condition for ending fiscal war;
- improve the quality of federative relations, enhancing fiscal equity between the Federal Government and the states and municipalities, correcting distortions and initiating a process targeted at improving fiscal federalism in Brazil.

3.1. Simplification of Federal Taxes

The major alteration proposed in the federal tax framework is extinction of five taxes in the second year following approval of the Reform and creation of a new value added tax (IVA-F), with a neutral impact on tax collection. The Cofins, Contribution to PIS, CIDE-Fuels and the “Education Wage” payroll contribution would be eliminated and replaced by the IVA-F. Aside from this, extinction of the CSLL is also proposed and would be incorporated into the corporate income tax.

During discussions that preceded elaboration of the bill, the possibility of incorporating the IPI into the IVA-F was also considered. However, it was decided that the IPI would be maintained, since it makes it possible to simplify and reduce the number of IVA-F brackets. Despite this, expectations are that the IPI will be greatly simplified and will be maintained only in light of its regulatory functions:

- as a selective tax, with higher rates on tobacco and beverages;
- as an industrial policy instrument, as in the case of the Informatics Law;
- as an instrument of regional policy, through maintenance of benefits that already exist in the Manaus Free Port.

3.2. Simplification of the ICMS

The principal simplification measure proposed in the Tax Reform bill is unification of the 27 state ICMS laws into a single law. The change will be made with extinction of the current ICMS and creation of a “New ICMS”, with the same scope as current legislation in terms of goods and services.

The new tax will continue being charged by the states and the rates will be uniform throughout the country. These rates will be determined in the following sequence:

- the Senate defines the applicable rates (probably 4 or 5 brackets);
- Confaz proposes classification of the goods and services within the various brackets;
- the Senate approves or rejects the Confaz proposal.

The proposed model establishes a system of checks and balances between Confaz’s concerns with preserving revenues and the Senate’s worries regarding not increasing the overall tax load.

Parallel to this, in order to avoid leveling the rates at the highest level – with a consequent increase in the tax load – the proposal determines that states will be able to set differentiated rates for a limited array of goods and services – to be defined in complementary legislation, making the necessary upward or downward adjustments in their revenue totals. This mechanism will make it possible to resolve the problem of products with high levels of participation in state revenues and sharply differentiated rates from one state to another, such as in the case of diesel oil which has a rate that varies from 12% to 25%.

3.3. End of the Fiscal War

One of the main objectives of the Tax Reform bill is to end the fiscal war among states, since this has a very negative impact on growth.

The surest way of putting an end to the fiscal war is to modify charging of the ICMS in interstate transactions, in such a way that the tax would be due in the state of destination. However, an immediate alteration in the system of interstate transactions is not feasible, for at least two reasons:

- adoption of the system of charging the tax at destination would have a powerful impact on the distribution of revenues among the states and a brusque transition would make it very difficult to put together a reliable system of compensation;
- immediate cancellation of benefits already granted in the fiscal war environment would be practically impossible, due to the difficulties that would exist in any attempt to eliminate commitments already assumed by various states with a variety of corporations.

In this framework, the proposal calls for gradual transition to levying of the ICMS at destination, progressively reducing the rates charged at origin. The process would be completed in the eighth year after passage of the Reform, with creation of the New ICMS. The reason for transitioning the current ICMS to the New ICMS and for unifying legislation only at the end of the process is that, were the New ICMS to be created immediately, the proposal would have to foresee how already granted benefits would be incorporated into the new tax and this would open the doors to an enormous dispute among states and could even result in a total impasse regarding implementation of the Reform.

Based on discussions with state governments and concern with preserving a certain degree of charging in the state of origin as an instrument for stimulating inspection activities, the proposal determines that the New ICMS would maintain a rate of 2% on interstate transactions, levied in the state of origin. Charging of a low rate in the state of origin is not sufficient to generate fiscal war and is considered fully compatible with the objective of eliminating predatory competition among states.

6. ICMS Rate in the State of Origin

Current Rate	2010	2011	2012	2013	2014	2015	2016
12%	11%	10%	8%	6%	4%	2%	2%
7%	6.5%	6%	5%	4%	3%	2%	2%

In order to avoid a very common current form of tax evasion - issuing of an invoice indicating an interstate operation (with a lower rate), while the merchandise remains in the state of origin – the bill makes it possible to charge the ICMS fully in the state of origin, with transfer of the amount collected to the state of destination through a clearinghouse.

3.4. Revenue Guarantee – Revenue Equalization Fund

The proposal calls for creation of a Revenue Equalization Fund (FER), with the task of compensating states for possible revenue losses caused by the Tax Reform. The FER, which

would be created through enabling legislation, would be the guarantee that no state would suffer losses as a result of the Reform.

According to the terms of the bill, FER resources would be utilized with decreasing intensity, in order to compensate states for losses of export taxes, and with increasingly intensity for purposes of equalizing the impacts of the Tax Reform. The objective of this proposal is to make it possible for states that post gains as a result of the Reform to contribute to partially offsetting the losses suffered by other states.

While the Reform includes a transition period for the progressive elimination of benefits already granted in the fiscal war, there is an added concern with avoiding any new incentives that could be granted in an illicit manner. To achieve this objective, those states that grant new benefits in conflict with the new constitutional rules would be subject to suspension of transfers of revenue-sharing funds (FPE), FER funds and resources originating in regional development policy.

3.5. Tax Reductions

a) Reducing Payroll Taxes

The major cutback proposed would be a reduction in employer contributions to the Social Security system from 20% to 14%. This measure would be implemented at a rate of one percentage point per year, as of the second year following approval of the Reform. According to the proposed Constitutional Amendment, within 90 days following approval of the Reform, the executive branch would remit a bill to the Congress that would initiate the reduction process. In order to avoid the possibility of the change resulting in an increased Social Security deficit, other measures now under discussion would be taken to offset this impact.

In a complementary manner, the reduction in the employer contribution to the Social Security system, coupled with extinction of the Education Wage contribution, to be offset by creation of the IVA-F, would result in a reduction of more than 2.5% in payroll charges.

In aggregate terms, the two measures reflect a reduction equivalent to 8.5% of the value of company payrolls. This would represent a significant contribution not only to reducing labor market informality, but also to enhancing the competitiveness of national companies, while stimulating growth in labor intensive sectors.

b) Reducing Investment Taxes

One of the objectives of the Tax Reform is complete elimination of taxes on investments, primarily through gradual reductions in the period required for appropriation of the tax credits paid on acquisitions of machines and equipment.

For the ICMS, reduction of the 48-month period will be gradual and concomitant with the transition to taxation at destination. The process will begin in the second year following passage of the Reform and will be concluded in the eighth year. This period is necessary for states to be able to withstand the impact of the change.

7. Period for Appropriating ICMS Credits on Capital Goods (months)

Current Term	2010	2011	2012	2013	2014	2015	2016
48	44	40	32	24	16	8	0

In the case of the PIS/Cofins – credits on capital goods are now appropriated in 24 months – the proposal calls for implementation of the change within the shortest possible time. It was originally thought that it would be possible to make the transition in 2008 and 2009, completing it by the time the IVA-F is created. However, with extinction of the CPMF, it became necessary to

postpone the adjustment. It is now thought that the process will be concluded only after creation of the IVA-F.

c) Reduction of Taxes on Basic Food Staples

With creation of the IVA-F and the New ICMS, the country now has the opportunity to review the existent rate structure and, primarily, to broaden the process of reducing taxes on basic foodstuffs. In this way, the tax system will become more just and less burdensome for the lower income population bracket.

The objective of the Reform is to take advantage of this opportunity and move forward in the process of reducing taxation on items of essential importance to lower income consumers, encompassing such goods as, for example, bread, sugar and cooking oil, all of which are now subject to federal taxes.

Tax reductions on essential consumer goods is a much more effective income distribution instrument and aids in reducing the regressive nature of the Brazilian tax system, making it fairer and more in line with the country's need.

d) No Tax Load Increase during Transition

In order to guarantee that the alterations in the tax structure consequent upon the Reform will not generate losses for taxpayers, the proposal includes a provision that will be regulated by enabling legislation, designed to ensure that the overall tax load will not increase as a consequence of creation of the IVA-F and New ICMS. Though this does not mean that an absolute cap will be imposed on the tax load – a measure obviously incompatible with responsible management of public finance -, it does reflect a guarantee that there will be no increase in the tax load during the period in which the initial IVA-F and New ICMS rates are determined.

3.6. Correcting Tax System Distortions

The Tax Reform bill has the objective of modernizing the Brazilian tax system through adoption of a more simple and neutral model, for both the IVA-F and New ICMS, compatible with the best international practices. Completed by introduction of the electronic invoice, these changes not only simplify the work of companies but also make it possible to correct the major distortions that still exist among indirect taxes through adoption of a series of measures to be introduced into the new regulations:

- complete elimination of taxes on exports, made feasible not only by neutralizing state level resistance to refunding ICMS credits during transition to levying at destination, but also by implementing a system of tax debit and credit compensation among companies;
- sharp reduction in the cumulativeness of the Brazilian tax system, as a result of extinction of the CIDE-Fuels and, primarily, as a consequence of elimination of restrictions on appropriation of credits related to the goods and services acquired by companies. This issue is to be regulated at the time of creation of the IVA-F and New ICMS;
- end of import incentives, as a result of extinction of the fiscal war.

With elimination or reduction of taxes on investments and exports and levying of the ICMS primarily in the state of destination in interstate transactions, the Brazilian system of taxation on goods and services will come quite close to that envisioned by the bill: a transparent system of taxation of consumption in which the tax rate corresponds to what the consumer is effectively paying. The major exception will be continued cumulative levying of the ISS, though the impact of this will be significantly less than the distortions to be corrected.

3.7. Improvements in Regional Development Policy

Brazil's regional development policy is based mainly on two low rate financing mechanisms:

- credits through Northeast (FNE), North (FNO) and Central-West (FCO) constitutional financing funds backed by earmarking of 3% of income tax and IPI revenues;
- purchasing of corporate debentures through allocations of budget resources targeted to the Northeast (FDNE) and Amazônia (FDA) development funds.

Though current mechanisms are significant, they are insufficient to achieve all the objectives of regional development policy. There are many cases in which a region does not need credit, but rather investments in local infrastructure, including secondary roads, refrigerated storage facilities for fruit producers or regional tourism infrastructure, as well as worker training aimed at enhancing productivity and taking advantage of local vocations.

In this framework, the Tax Reform bill includes an important shift in the regional development policy (PDR) structure. The major characteristics of this change are as follows:

- creation of the National Regional Development Fund (FNDR), making it possible to coordinate investments of PDR resources;
- broadening of the volume of resources targeted to the PDR through channeling of 4.8% of income tax and IPI revenues to the FNDR (today, analysis of the constitutional funds, FDNE and FDA, shows that the current volume is 4.1% of the income tax and IPI);
- broadening of the scope of the PDR by making it possible to invest up to 5% of these resources in less developed areas of the Southern and Southeastern regions, thus guaranteeing that the volume of PDR resources to be targeted to all regions of the country will expand;
- guarantee that at least 60% of FNDR resources will be channeled into financing operations, through currently existent instruments, aimed at avoiding interruptions in the operations of the already implemented model;
- creation of new instruments for allocating FNDR resources:
 - “structural” investments, following the guidelines set down by regional offices and the Ministry of Integration;
 - transfers to state development funds for purposes of allocation in productive sector investments or support.

The proposed model represents progress in the sense of decentralizing investments of PDR resources either through transfers to state development funds or through management of federal investments. The proposal states that regional development organizations (SUDENE, SUDAM and, possibly, SUDECO, the re-creation of which is now under discussion at the National Congress) will define general guidelines for investment of these resources and that the projects - to be selected on an exclusively technical basis - will be implemented and managed in a decentralized manner by states, municipalities, municipal associations or local entities.

8. New PDR Model

Earmarked Resources

FNDR

Transfers to States

SUDENE		SUDAM		SUDECO*		OTHER REGIONS	
Prod. Sec.	Struct.	Prod. Sec.	Struct.	Prod. Sec.	Struct.	Struct.	
Financing	Invest.	Financing	Invest.	Financing	Invest.	Invest.	
FNE	FDNE	FNO	FDA	FCO			

According to the proposal, the new model will be implemented on a step-by-step basis, in order to avoid brusque changes, dilute the fiscal cost of PDR expansion and allow for maturation of the new model. Table 9 shows the proposed transition, together with its impact on the volume of PDR resources.

9. Regional Development Policy Transition US\$ billions (2008)

	2010	2011	2012	2013	2014	2015	2060
% of sharing targeted to FNDR	4.2%	4.3%	4.4%	4.5%	4.6%	4.7%	4.8%
% of FNDR targeted to financing	80%	76%	72%	68%	64%	62%	60%
Minimum % targeted to N/NE/CO	99%	98%	97%	96%	95%	95%	95%
Value	9.9	10.3	11.0	11.8	12.7	13.6	14.6
Financing	7.6	7.8	7.9	8.1	8.1	8.5	8.8
Struct. Invest./Transfers	1.9	2.5	3.1	3.8	4.6	5.2	5.8

Projections based on GDP growth hypothesis of 5% per year.

The proposed improvement in regional development policy used international practices as its point of reference, since they clearly demonstrate that “structural investments” and a model that stimulates competition among projects are the most efficient mechanisms for developing areas that have lagged behind others. These changes, considered important in themselves, take on added relevance in the framework of the Tax Reform, since they provide a more effective development alternative than fiscal war for the poorer regions of the country, at the same time in which they aid in putting an end to predatory tax disputes among different states.

3.8. Changes in Federative Relations and Government Transfers

In order to avoid the possibility that extinction and unification of taxes in the framework of the Tax Reform could impact the financing of public programs that now have their own specific sources of revenues, as well as the sharing of resources with states and municipalities, the proposal calls for alterations in the system of earmarking and sharing. The objective of these alterations is to ensure that the Reform will be totally neutral and will not in any way change the volume of resources now targeted to the states, municipalities and specific areas in which the public sector is now active.

In order to explain the proposed changes, it is important that one understand the current system of targeting tax revenues that will be affected by the Reform. In the framework of government transfers, 21.5% of income tax and IPI revenues are targeted to the State Revenue-Sharing Fund (FPE), 23.5% to the Municipal Revenue-Sharing Fund (FPM) and 3% to constitutional financing funds. Aside from this, 10% of IPI revenues are targeted to the states, in proportion to their exports of industrialized products (FPEX).

The taxes extinguished by the Reform are concentrated in several different areas: Social Security financing (Cofins and CSLL), the Workers Support Fund (FAT) and BNDES (PIS), basic education (“Education Wage”), the transportation infrastructure and several other objectives (CIDE-Fuels). Table 10 shows the situation in 2006, the year chosen as the base year for calibrating the model.

10. Current Situation (base: 2006) (R\$ billion)

Inflow		Destination	W/o DRU	W/ DRU
IR	125.8	Social Security (Cofins+CSLL)	119.5	95.6
CSLL	28.0	FAT/BNDES (PIS)	20.6	16.5
Cofins	91.5	Transportation Infrast, etc. (CIDE)	7.8	6.3
PIS	20.6	Basic Education (“Education Wage”)	6.9	6.9
CIDE	7.8	FPE (21.5% of In. Tax+IPI)	32.9	32.9
Education Wage	6.9	FPM (23.5% of In. Tax+IPI)	36.0	36.0
IPI	27.4	Constitutional Funds (3% of In. Tax+IPI)	4.6	4.6
Total	308.0	FPEX (10% IPI)	2.7	2.7

With the Tax Reform, the seven taxes listed in Table 10 will be replaced by just three: IR, IPI and IVA-F. To guarantee that the change will not impact current financing of programs, the constitutional amendment determines that a percentage of the revenues of these three taxes is to be channeled to each one of the areas that will lose their sources of financing.

Thus, 38.8% of these revenues will be targeted to the Social Security system, which is precisely equivalent to the proportion between Cofins and CSLL revenues and the total revenues of the seven taxes in 2006. A similar calculation was made for the other earmarkings with the following results: 6.7% will be channeled to FAT/BNDES, 2.3% to basic education and 2.5% to the transportation infrastructure.

The methodology adopted guarantees that there will be no loss of funding for any of these objectives. Only the tax base used to define these resources will be modified. The percentages channeled to Social Security and to FAT/BNDES are defined in the Constitution, while the percentages targeted to basic education and the transportation infrastructure may be changed by specific legislation. In the case of basic education, there is an additional guarantee that the percentage defined in legislation may never be less than that calculated on the basis of “Education Wage” revenues in the final year of its effectiveness.

In the case of State revenue-sharing funds, the basis chosen to define the amounts shared is precisely equal to current IR and IPI revenues. The purpose of this was to avoid alterations in the percentages of the FPE and FPM, since these are determined in the Constitution. The amount shared corresponds to total IR, IPI and IVA-F revenues, less the percentages channeled to the Social Security system, FAT/BNDES, basic education and the transportation infrastructure. Going beyond this, the proposal creates conditions so that the system of government transfers can be expanded in the future, through inclusion of the Tax on Large Fortunes (foreseen in the Constitution, but never regulated) and other residual amounts (new taxes that may be created by the federal government in the future).

The federative sharing system is the basis upon which the amounts channeled to the FPE and FPM are calculated, while maintaining the percentages already defined in the Constitution, as well as those targeted to the National Regional Development Fund (4.8%) and to the Revenue Equalization Fund (1.8%). In the latter case, the percentage defined corresponds to 10% of the IPI now channeled to the FPEX.

The results of the methodology utilized are shown in Table 11. As can be seen, the amounts resulting from the new methodology are equal to those that result from the current system (presented in Table 10), including the effects of the DRU, which frees up federal revenue

earmarkings. The residual differences in the amounts shown are the result of rounding-off when defining the percentages.

11. New Model (base: 2006) (R\$ billions)

	W/o DRU	W/ DRU
(A) Basel:IR+IPI+IVA-F(1)	308.0	246.4
(B) Earmarkings (% of A)	154.9	125.4
Social Security (38.8%)	119.5	95.6
FAT/BNDES (6.7%)	20.6	16.5
Transportation Infrastructure, etc. (2.5%)(2)	7.7	6.2
Basic Education (2.3%)(2)(3)	7.1	7.1
(C) Basel II: (A)-(B)(3)	153.1	153.1
(D) Federative Sharing (% of C)		
FPE (21.5%)	32.9	32.9
FPM (23.5%)	36.0	36.0
FNDR (4.8%)	7.3	7.3
FER (1.8%)	2.8	2.8

(1) Inflow of the new IR corresponds to that of the current IR + CSLL, while that of the IVA-F corresponds to the sum total of inflows of the PIS, Cofins, CIDE and the “education wage”.

(2) The current sharing levels of the CIDE-Fuels and the “education wage” with the states and municipalities are preserved.

(3) The earmarking to basic education and the base upon which the government transfer system is calculated are not altered by article 76, ¶ 1 of the ADCT.

In summary, all of the changes proposed in the earmarking and sharing system were made in such a way as to maintain absolute neutrality with respect to current inflows, including the requirement that 18% of taxes must be targeted to education. The Reform represents progress in the sense that all earmarkings and sharing are to be calculated on a broad tax base that is considerably less volatile than each one of the taxes considered individually.

3.9. Improving Federative Relations

One of the objectives of the tax reform is to contribute to improving the Brazilian federative model. This is to be the first step in a much broader process that will be carried forward in coming years.

One significant change introduced as a result of demands put forward by the major organizations that represent Brazilian municipalities concerns the criterion of distribution of the 25% share of the ICMS targeted to municipalities. Currently, $\frac{3}{4}$ of these resources are distributed proportionately to the value-added in each municipality. This system generates a significant imbalance in the distribution of resources, providing disproportionate benefits to those in which large industrial units are located, in detriment to the other municipalities.

As shown in Table 12, there are cases in which one municipality receives as much as 130 times more than another municipality in ICMS transfers per inhabitant, even considering that the two municipalities are located in the same state. The consequence is a situation in which revenues are left over in some municipalities, while others have to cope with enormous shortages of funding.

12. ICMS Transfers to Municipalities (R\$/year, 2006 data)

	Per Capita ICMS Transfers				
	Ave.	Median	Largest	Smallest	Largest/ Smallest
Pará	133.04	81.03	826.56	21.83	37.9
Bahia	137.48	79.01	4,620.01	43.45	106.3
Goiás	274.37	215.62	1,488.85	10.94	136.1
São Paulo	446.87	358.30	8,492.43	61.44	138.2
Rio Grande do Sul	405.51	336.09	3,369.15	49.03	68.7

In order to resolve this problem, the proposal states that the criterion of municipal sharing of a percentage of the ICMS, currently transferred on a value-added basis, would be defined in enabling legislation. Evidently, the change will require a long period of transition so as to avoid jeopardizing the stability of municipal finances. The final result, however, will be a much fairer federative model than we now have.

Another important advance introduced by the Reform is the change in the basis of federative sharing, upon which the amounts channeled to the State Revenue-Sharing Funds (FPE) and Municipal Revenue-Sharing Funds (FPM) are calculated.

Though they are neutral over the short-term - maintaining current FPE and FPM values - the proposed alteration of the sharing system would correct a series of distortions in our federative system, best described as the existence of federal contributions that are not shared with the states and municipalities. The truth is that, in the last two decades, the increase in federal government revenues has been based essentially on such unshared social contributions as Cofins, CSLL and the CPMF. This led to a loss of federative equity and a situation of profound discontent among subnational governments.

In the proposed Tax Reform model, sharing would be defined as a proportion of a broad tax base, including the IR, IVA-F and the IPI and excluding only the social security contribution on payroll, the ITR and taxes of a regulatory nature - the import tax (II), export tax (IE) and the financial operations tax (IOF) - which are not relevant in terms of inflow volume but do require a great deal of flexibility in rate setting due to their importance to economic policy. With the change, one of the major sources of attrition between the federal government and the states and municipalities will disappear.

Though the Tax Reform seeks to improve federative relations, it stands as a major challenge before the country in its efforts to achieve a fair, balanced and effective federative model. It is in this framework that the federal government has sent the Tax Reform bill to the Congress, in the hope that it will ignite a wide-ranging debate with the states and municipalities regarding the jurisdiction of the various levels of government and their financing, together with discussion of a system of sharing that is not only more just, but also an instrument that will result in higher quality services provided to the population.

On the basis of this discussion, which will doubtlessly require a long period of maturation, it will be possible to elaborate a wide-ranging proposal aimed at refining the Brazilian federative model, thus completing the process of change initiated with the Tax Reform.

4. Impacts of the Tax Reform

The Tax Reform bill was elaborated in such a way as to find the best possible middle ground between correcting the distortions of our tax system and minimizing political resistance to the proposal. The objective of this strategy was to facilitate processing through the National Congress, where the bill will be broadly discussed and, quite probably, improved.

The proposal put forward by the government benefits companies, workers and the states and municipalities. The costs consequent upon the change - tax reductions, increased resources channeled into regional development policy and payment of compensation to the states - are fully assumed by the federal government. This is being done not because there is a plethora of available resources, but rather because the current cycle of economic expansion has made it possible to absorb these costs and, primarily, because the positive impact of the Reform on growth will more than offset the fiscal effort being made by the federal government.

In an effort to consolidate the arguments presented to this point, we will try to summarize the way the Reform will affect companies, workers and states and municipalities.

Impacts on Companies

- significant simplification of tax obligations, with sharp reductions in the costs of calculating and paying taxes;
- enhanced competitiveness, through elimination of taxes on exports and, primarily, reduction of payroll taxes, thus aiding in strengthening Brazil's position in the framework of international competition;
- improvement in investment conditions through complete elimination of taxes on capital goods and removal of the element of uncertainty resulting from the fiscal war;
- reduction of informality and predatory competition on the part of companies that evade taxes;
- increased economic efficiency and productivity through reductions in the cumulative levying of taxes, correction of distortions resulting from the fiscal war and implementation of a more rational regional development policy.

Impacts on workers

- wide-ranging reductions in taxes on basic foodstuffs, thus sharply reducing the tax costs of low income families and attenuating the regressive nature of the Brazilian tax system;
- formalization of the labor market coupled with expanded Social Security coverage, with reductions in payroll taxes and the closing of loopholes that allow for informal economic activity leading to tax evasion;
- tax structure that is more favorable to the development of labor-intensive sectors, as a result of the lessening of payroll taxes;
- greater transparency in the cost of taxes charged on consumption of goods and services, resulting from implementation of the IVA-F and the New ICMS;
- more efficient regional development instruments than fiscal war, as mechanisms for generating jobs and increasing worker income in the poorer regions of the country.

Impacts on States and Municipalities

- increased tax inflows through reductions in tax evasion and an end to the fiscal war;
- adoption of effective mechanisms for developing the less advanced regions of the country, through regional development policy improvements;
- guaranteed refunding of any possible losses through the revenue equalization fund, in such a way that no state will be subjected to losses as a result of the Reform;
- creation of a federative environment characterized by greater fairness, with the end of the fiscal war, alteration of the municipal sharing criterion applied to the ICMS and expansion of the basis of shared federal taxes.

Finally, the most important impact of the Tax Reform will be enhanced economic growth in Brazil. It is possible to estimate this impact in the case of several of the alterations introduced by the Reform - reduction in payroll taxes, elimination of taxes on investment and reductions in the cumulative nature of the tax structure. As far as other alterations are concerned it was not possible

to estimate their impact on growth. These would include reductions in uncertainties and increased efficiency resulting from the end of the fiscal war, as well as increased productivity as a result of simplification of the tax structure and formalization of the economy.

Table 13 presents the results of these calculations. Two hypotheses regarding the cost of business capital were considered in calculation of the effect of elimination of taxes on investment (reduction of the period for appropriating ICMS, PIS and Cofins) credits: a) all companies are liquid and their capital costs equivalent to the Selic rate (11.25% per year); and b) half of the companies are liquid and half finance their operations at a rate equivalent to the average cost of working capital credits (27.9% per year).

13. GDP Increase Resulting from the Tax Reform (%)

Alterations Implemented	Cost of Capital	
	Hypothesis A	Hypothesis B
Elimination of taxes on investments	2.5	3.7
Reduction of cumulativity		2.6
Extinction of "Education Wage" (offset in the IVA-F)		1.3
6% reduction in the employer contribution to social security		4.1
Total	10.9	12.2

Calculations based on model developed in Fernandes, Gremaud and Narita (2004).

The results indicate that, once the economy has adjusted to the changes, the Tax Reform could result in a GDP 10.9% to 12.2% greater than would be achieved without a Reform. The economic models utilized do not define the transition period, though it is reasonable to presume that most of the changes will be implemented over the first 20 years.

Based on conservative hypotheses, this means that the Tax Reform will create conditions required for GDP to expand approximately 0.5 percentage points per year more than it would have expanded with no reform over the coming 20 years. In other words, if the outlook for growth stands at 5% per year without the Reform, then with the Reform this rate should increase to 5.5% per year. All Brazilians gain from increased growth: workers, companies, states and municipalities and the federal government itself, which will find itself in a much more solid fiscal position at the end of the transition than at the start, even considering that it has assumed the costs of the Reform.