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TAX REFORM - THE MODERN VAT AND BRAZIL GOODS AND SERVICES
TAXATION

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ABSTRACT

The main purpose of this paper is to compare both the current and the proposed Brazilian tax system, concerning taxes on goods and services, with the modern Value-Added Tax (VAT) presented by the International Monetary Fund (IMF).

The proposed tax system is presented as it is in the Proposed Constitutional Amendment (PCA) nº 233/2008 while the concept of the modern VAT is extracted from the book The Modern VAT (2001. IMF).

Furthermore, the principles of a sound tax system, as presented by Brunori (2011) are used as benchmarks in order to analyze the three systems.

Based on the pros and cons of each tributary arrangements it will be possible to recognize that, although the PCA nº 233/2008 promotes some advances in the direction of a more efficient and, in many senses, better taxation on goods and services, the VAT would be able to deliver better results, even considering its downsides.

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1. Introduction

The complexity of Brazilian's tax laws is a well-known obstacle to a more efficient and less costly production. Since the Federal Constitution of 1988 was enacted, some attempts have been made in order to address this issue. For example in 1995 the Proposed Constitutional Amendment (PCA) nº 175 was sent to the National Congress, but was archived. In 2008 a new attempt was made, and the PCA nº 233 was sent, but until the present date it was not voted.

The need to simplify the procedures and reduce bureaucracy, eliminate distortions in the tax structure, bring forth better exemption policies, enhance the development policies, end the fiscal war and improve the federal relations are some of the main objectives of the PCA.

For example, the most important tax concerning the States is the Goods and Services Tax (ICMS in Portuguese). It has 27 different tax laws, with different rates and different criteria of tax calculation. Besides this, according to the Brazilian Institute of Tax Planning (IBPT in Portuguese), in 2013 there were a total of 23,412 tax rules¹ in Brazil. The Institute also estimates that each company has to attend to over 3,500 tax rules a year. This may explain why Brazil is the country where it takes more time to prepare and pay taxes, according to the World Bank's research.²

In 2001 the IMF published the book The Modern VAT, which describes the modern VAT: a simple, broad based, with good economic characteristics and high collection capacity VAT.

¹ <https://www.ibpt.org.br/img/uploads/novelty/estudo/1266/NormasEditadas25AnosDaCFIBPT.pdf>

² <http://data.worldbank.org/indicator/IC.TAX.DURS>



In the second section the principles of a sound tax system will be presented.

In the third section, the actual tributary system will be summarized, and the main taxes and contributions will be shown, as well as the main problem faced by the States, concerning their federative relation: the fiscal war.

In the fourth section, the PCA 233 will be summarized. This PCA was selected over the other attempts on changing the tributary system for two reasons: first it is the current proposed amendment, not yet voted, and second, to study all PCAs would make this work too extensive. In this section, only the changes concerning a theoretical calculus basis of a VAT are going to be presented and discussed. Thereby, although Brazil only has one specific good and service tax, there are other taxes that act as "parts" of a theoretical VAT. The industrialized products tax (IPI) being an example.

In the fifth section the IMF modern VAT will be presented, and this concept will be compared to the current and proposed tributary systems under the light of some political features and tax principles. This analysis will take place in the sixth section and the principles presented in the second section will be used in order to analyze the pros and cons of each system.

The conclusion of this paper will be presented in the seventieth section.

The focus of this paper is to analyze the Brazilian current tax system as well as the proposed tax system by the use of the modern VAT concept, concerning the taxes on consumption of goods and services.

2. Principles of a sound tax system

The literature does not appear to be homogeneous on what should be the principles a tax system should rely on in order to be a good tax system. In this regard there

may be wide variations on the specific implications of each principle on a given case, as well as on what should be the most important principles to be applied within a tax system.

Nevertheless, the principles established by Adam Smith (1776) in the first release of An Inquiry into the Nature and Causes of the Wealth of Nations may be considered the basis of all other formulations of tax system principles.

As put by Brunori (2011): “although policymakers and tax specialists continue to debate the particulars of good state tax policy, they generally agree on five broad principles”³. These principles are: raising adequate revenue, neutrality, fairness, ease of administration and compliance and accountability.

For the purpose of this paper the principles appointed by Brunori will be used in order to compare both the current and the proposed tax system with the modern VAT.

2.2.1 Raising adequate revenue

“The primary purpose of any tax system is to raise revenue to cover the costs of public expenditures”⁴. In this sense, the system must demonstrate sufficiency, stability and certainty.

Sufficiency requires that the tax system must be built in order to absorb the expenses of the public programs and services demanded by society.

For stability it can be understood the ability of the tax system to resist economical fluctuations and keep delivering a rather constant revenue.

Certainty requires the tax system not to be subject to constant changes.

³ Brunori (2011). State tax policy: a political perspective. Third edition.

⁴ Brunori (2011). State tax policy: a political perspective. Third edition.

2.2.2 Neutrality

By a neutral tax it must be understood a tax that does not affect the economical and spending decisions of companies and consumers. Thereby, a neutral tax is one that does not affect the relative prices, and is used solely for the purpose of revenue raising.

2.2.3 Fairness

This principle is, maybe, the subject of most of the discussions. The idea that the tax system should be fair and equitable is widespread, but the problem resides in how this fairness and equity can be achieved.

It is largely accepted though that the fairness on the tributary system can be achieved by the use of the horizontal and the vertical equities.

This paper's subject, as stated in the introduction section, is the taxes on consumption, both on goods and services. Those taxes are known as being mainly regressive, for consumption is often, as a percentage of income, higher for the lower income people than for the higher income ones.

The horizontal equity relies on the idea that equal people in similar economical conditions should bare similar tax burdens. The vertical equity relies on the idea that those who are better off should bare a greater tax burden than those worst off.

2.2.4 Ease of administration and compliance

According to this principle both, the private and the public administration, should spend as little as possible in order to account and pay, on one side, and audit and control, on the other, the tax. This notion can be understood as the efficiency of the tax system, and, in this sense, the law's simplicity is important.



2.2.5 Accountability

According to Brunori (2011), this principle is mainly composed of three requirements: that “those in charge with the administration and enforcement of the tax laws are performing their duties efficiently and fairly”, that “the government must enforce the laws” and that the “tax decisions should be made openly.”⁵

The first two requirements, despite being important pieces of a tax system as a whole, don’t have direct influence nor are directly influenced by the tax laws, especially when concerning taxation on consumption⁶. So only the third requirement concerns, in some way, tax laws and for this will be considered in the discussions ahead.

3. The current tributary system

The current tributary system dates to 1966, the year the actual National Tributary Code⁷ was enacted. After the 1988 Federal Constitution, some changes were made to the tax system, especially on the tributary decentralization. The 1996 law, know as Kandir Law, may be considered the greatest change since 1988.

To best show the principal taxes and their distribution, the following table is presented⁸:

⁵ Brunori (2011). State tax policy: a political perspective. Third edition.

⁶ Besides maybe by the complexity of the tax law, but this issue was addressed under the “ease of administration and compliance” topic.

⁷ Law 5.172/1966

⁸ Although the tax list is exhaustive, the same does not happen to the contributions and other forms of public taxes in general. Thereby the contributions shown are only the most important ones, on the revenue point of view.

			Competency	Revenue Distribution		
				Federal	States	Municipalities
Taxes	Export Tax	IE	Federal Government	100,00%		
	Import Tax	II		100,00%		
	Income Tax	IR		78,50%	21,50%	
	Industrialized Products Tax	IPI		56,00%	21,50%	22,50%
	Financial Operations Tax	IOF		100,00%		
	Rural Property Tax	ITR		50,00%		50,00%
	Goods and Services Tax	ICMS	States		75,00%	25,00%
	Ownership of Automotive Vehicles Tax	IPVA			50,00%	50,00%
	Heritage and Endowment Tax	ITD			100,00%	
	Services Tax	ISS	Municipalities			100,00%
	Urban Property Tax	IPTU				100,00%
	Donations and Transfer Tax	IMT				100,00%
Contributions	Contribution on net profit of companies	CSLL	Federal Government	100,00%		
	Contribution for Social Welfare financing	COFINS		100,00%		
	Social Integration Plan	PIS		100,00%		
	Assistance Program for Civil Servant	PASEP		100,00%		

The revenue distribution of the federal income to the states and municipalities, as well as the states revenues to the municipalities, is mainly made through tax distribution funds. The resources of the two funds, the States Holding Fund (SHF) and the Municipalities Holding Fund (MHF), are then distributed among the states and municipalities according to the specific laws. The Complementary Law nº 62/1989 deals with the SHF. According to this law, 15% of the total income of the SHF will be directed to the South and Southeast regions, the two most developed regions in Brazil. 85% will be directed to the North, Northeast and Middle-East regions.

Another important data concerning Brazilian tax system is the tax burden and the effective participation of each tax on the total revenue.

According to a report published by Receita Federal (Brazil's IRS), in 2012, the total tax burden was 35,85% of the GDP⁹. The contributions correspond to roughly 45% of the total tax revenue. The ICMS was 20,8%, and the IR 16,83%. Thereby, almost half of all tax income is not subject to distribution among the other federative entities.

⁹ <http://www.receita.fazenda.gov.br/publico/estudoTributarios/estatisticas/CTB2012.pdf>

3.1 The ICMS

On 1996 the Complementary Law nº 87, also known as Kandir Law, was enacted. It caused some turmoil between the States because, among other reasons, it brought the exemption of certain transactions, which could cause some damage to the States' finances. It was even considered an "offense to the federative pact"¹⁰.

The Kandir Law introduced important changes to the economic characteristic of the ICMS making it closer to the theoretical concept of the VAT, changing the VAT-Product approach to a VAT-Consumption and adopted the destination principle on foreign trade, in an attempt to stimulate the improvement of the trade balance.

This change may be a result of a new phase in Brazilian federalism, when there was an increase on the central government power, according to Abrucio¹¹.

There may be five aspects of interest concerning the ICMS.

The first aspect is how it is computed. ICMS is computed on an invoice method. This means that all of the productive chain, as a general rule, is taxed. This also means that ICMS is mostly a consumption-based tax, which means that usually the consumers support the tax burden.

The invoice method consists of fully taxing all operations, input and output, and on the end of the tax calculation period take account of all the taxes on the inputs and outputs. If the output tax is greater than the input tax, the company must pay the tax, otherwise it can keep the credit or get reimbursed. There are two other methods of computing, addition and subtraction, but they are out of the scope of this paper.

¹⁰ According to congressman Alceu Collares.

¹¹ Abrucio, 2005. "A coordenação federativa no Brasil: a experiência do período FHC e os desafios do governo Lula". Where the author quotes the Real Plan as one of the reasons that led to the "strengthening of the federal government and weakening of the states government, changing the inter-governmental dynamics".



Secondly, while import is fully taxed, export is zero-rated. Here it is important to make clear the difference between zero rate and exempts. As the invoice method is used, the tax due on inputs and outputs are recorded. The exempt totally rids the company from paying any tax on its outputs, but does not allow it to keep the credits of the inputs. The zero rate, on contrary, fully taxes the output, but with a 0% rate, and allows the company to keep the credits of the input.

The third aspect is how investment is treated under ICMS. Although the tax on investment, meaning the purchase of fixed assets, is recoverable, there is a time lapse in order to do so. Nowadays, the company must only credit itself 1/48 of the tax paid on the input, a month. Which means that the company will only recover the tax on the investment on four years.

Fourth, the interstate operations are taxed using a mixed of origin and destination principles. For this purpose, Brazil may be separated on two big regions: The South, which consists of the states on the South and South-East regions, except Espírito Santo, and the North, which consists of all other states and the Federal District.

All operations started on a South state with a final destination on a North state, has an interstate tax of 7% due to the origin state, or an interstate tax of 12% if the final destination is a South state. On the other hand, all operations started on a North state have an interstate tax of 12%, no matter the state of destination. For example, as the regular internal tax rate is 18%, if a product is sold from a company on a North state to a consumer (final or reseller) on a South state, the North state will keep 12% as an interstate tax, and the South state will have only 6% of tax on the product.

The last interesting aspect is the method of calculation. ICMS uses an "inside" tax basis. This means that the total tax burden is already built-in the product or service price. For example, a product that has a price tag of 100.00, if the tax rate is 20%, the total amount of tax would be 20.00, but the consumer would pay 100.00. So the actual product



or service price is 80.00. Therefore, there is a difference between the nominal and effective rate. The nominal rate is 20%, but the effective rate is higher: 25%¹², for this example.

3.2 Fiscal war

Although the Kandir law was enacted on 1996, the law governing the granting of tax benefits is the Complementary Law (CL) nº 24 from 1975. This law prohibits the granting of tax benefits unless it was approved by an agreement on the CONFAZ (which stands for “Treasury National Counsel”), which is composed of representatives of all the states and the federal district.

The law established that to enact a tax benefit there is need for a unanimous decision, and there would be penalties for the states that do not comply with it.

The fiscal war consists, basically, of a state granting tax benefits, despite the CL nº 24/1975. The main tax benefits granted by the state of Rio de Janeiro are¹³: tax breaks, deferral to pay the due tribute, presumed credit on outputs, reduction of the tax basis, exemptions and credit maintenance permission¹⁴.

The main goal of a state government when granting tax benefit is to attract investments to the state. From the perspective of the state government, it is very interesting to grant tax benefit, for the attracted investments, create jobs and enhance the economical activities on the state. But, in many cases, the costs of the tax benefits are grater than the fiscal benefits earned by the increment on the commercial activity.

¹² The math is that, while the price tag is unchanged, the 20% rate, means that the consumer pays 20.00 on a 80.00 effective price, which means that the consumer pays 25% of the product or service price on taxes [$(20/80) * 100\%$].

¹³ Information available on the annex of the Decree 27.815/2001 (RJ)

¹⁴ Some operations don't allow the company to maintain the credit of the inputs. Exempted operations are an example. This benefit allows, for example, the company subject to an exempt policy, to maintain the tax credit.



This would mean that the state itself would be responsible for its deteriorated budget. But very often this is not the case, for the costs of the tax benefits policy can be “exported” to another state, meaning that as one state grants the benefit, the actual bearer of the cost would be another state.

There is an example shown by Varsano:

“Consider a company located in the state A, whose production is fully and directly exported. Due to the exemption of exports, the company’s outputs do not generate ICMS debts. But the purchase of inputs generates credits, which, in the absence of debts that offset it, must be reimbursed to the exporter to ensure the exempt of the total value of exports. If its inputs are bought from other companies inside the state's territory, reimbursement exactly matches what the state previously raised from taxes on the producers of inputs. If, however, the raw materials are acquired from [a company located on] state B, the collection of tax on inputs is up to this state, and the state A grants the correspondent tax credit. The export, besides not generating revenue, creates a burden on state [A] budget.

However, if the export, rather than direct, is made by a firm located in the state C, the state B collects the tax corresponding the value of the inputs, the state A collects [the tax] related to the value added by the producer, and the state C pays all the account for the earlier incident tax. In this case, it is an excellent deal for the state A to attract to its territory the company that produces the exported good. State A can give up only part of their revenue and, in addition to the economic benefits, still collect some revenue. The system of taxation of interstate operations stimulates the incentive.”¹⁵.

Although the example shown before is concerning an export operation, the similar method can be used for a company that operates mainly on the national market.

¹⁵ VARSANO, Ricardo. “A guerra fiscal do ICMS: quem ganha e quem perde”. <http://www.ipea.gov.br/ppp/index.php/PPP/article/viewFile/127/129>.



Thereby, the fiscal war may be only feasible because of the diffuse tax laws concerning the ICMS and the mixed origin-destination principle adopted on the interstate operations, allowing some states to “export” the cost of a tax benefit policy.

Besides that, granting tax benefits, in violation of current legislation, may lead to an increase on legal uncertainty for, in many cases, the states file lawsuits on the Brazilian Supreme Court (STF, in Portuguese) alleging unconstitutionality of the tax benefits laws. Those lawsuits are called Direct Action of Unconstitutionality (ADI, in Portuguese). A search on the Supreme Court website (www.stf.jus.br) with the parameters “ADI” and “guerra fiscal”¹⁶ returns 37 results¹⁷. Those lawsuits may lead to the revoke of the granted benefits, which may offset the economical viability of the investments made only because of the benefit.

Kahir¹⁸, through a mathematical model, estimated the effects of changes on the interstate tax rate, using 0%, 2% and 4% interstate tax rates simulations¹⁹.

According to his article, although some states would lose revenue, the cost for the central government, in case it decides to compensate the lost revenue, could sum up to R\$ 84.2 billions if the transaction would occur in 10 years, or R\$ 45.6 billions if it took 5 years (approximately 30 and 16.3 billions dollars, respectively). For comparison purposes, it would represent 1.6% of total central government tax revenue, in 10 years, or 0.8%, on the 5-year simulation²⁰. This could mean that, adopting mainly the destination principle could end the fiscal war at a relatively low cost to the central government, if it decides to compensate the states.

¹⁶ Literal translation of “fiscal war”.

¹⁷ Search date: 01/21/2015

¹⁸ KAHIR, Amir. “Avaliação do impacto de mudanças nas alíquotas do ICMS nas transações interestaduais”. IDB, 2011.

¹⁹ The PCA 233/2008 proposes the final interstate tax rate of 2%.

²⁰ According to Kahir.

4. The proposed tax system

According to Campello²¹, the PCA 233 may be resumed as a “profound alteration in tax jurisdiction, where there will be repercussions, also on the allocation of tax revenues.”

Among these alterations is the ICMS. Twelve years after Kandir Law, the PCA 233 proposes the unification of the ICMS law, called “New ICMS” (N-ICMS), with only a small degree of flexibility, creating a centralized tax law, establishing nationally uniform rates²² and basis of calculation and exemptions.

The IPI, PIS and COFINS are also among the taxes that would be changed by the PCA 233.

4.1 N-ICMS

4.1.1 The power to tax

Maybe one of the most important changes proposed by the PCA 233 concerning the ICMS is the change in the power to tax.

The current tax system provides, in the article 155 of the Federal Constitution, that “the States and the Federal District are competent to institute the tax on operations concerning the circulation of goods and the rendering of interstate and inter-municipal transportation and communication services, even when such transactions and renderings begin abroad”²³.

²¹ André Emmanuel Batista Barreto Campello. "Reforma Tributária: uma breve análise da PEC nº 233/2008"

²² EXPLAIN THE UNIFORM RATE

²³ Article 155, Federal Constitution.



Thereby, the PCA 233 revokes this article and creates the article 155-A that says “the states and the Federal District are jointly responsible, through the institution of a Complementary Law, for the tax on circulation of goods and provision of interstate transportation and communication services, even when such transactions and renderings begin abroad.”²⁴

In this sense the federal government would now be responsible for a new tax, similar to the ICMS. And the states and Federal District would receive a constitutional delegation to collect and control the tax, as well as the revenue of the tax activity, except the compulsory transfers set forth in the amendment itself or in the Complementary Law that the article 155-A describes.

4.1.2 Core alterations

According to the Tax Reform Manual, provided by the Ministry of Finance, the N-ICMS would have “probably 4 or 5 rates,”²⁵ defined by the Senate. The CONFAZ would suggest which rate each good or service would be subject to.

The interstate tax would virtually end, for the PCA 233 proposes the establishment of an interstate tax of 2% on any transaction, no matter the origin or the destination state. Thereby, although the mixed origin-destination principle would still be in place, the possibility to use it as a fiscal war instrument would be undermined, for the rate of 2% would be too low to allow the states to work with it.

Regardless, mainly the destination principle would be applied.

As presented in the previous section, the change of the interstate tax rate would, according to Kahir, enhance some states’ revenue and jeopardize others. In order to

²⁴ Article 155-A, PCA nº 233/2008

²⁵ Tax Reform Manual. <http://www.fazenda.gov.br/divulgacao/publicacoes/reforma-tributaria/cartilha.reforma.tributaria.pdf>



“compensate the states for possible loss of revenue due the Tax Reform”, the PCA 233 creates a Revenue Equalization Fund.

For the purpose of equalization, one year would be selected and the indexes concerning this selected year would be used to realize the transfers, ensuring, this way, that all states would have the same percentage of revenue despite the changes brought by the reform.

The Tax Reform Manual also commits to not raising the tax burden. For this, the tax burden of a select year would be used in order to calibrate the rates and basis of calculation.

Investments also would be affected. The 48-month period for complete recovery of inputs tax would be extinguished; the taxpayer would be able to use the credit in its entirety in the same period of assessment.

The end of the fiscal war, one of the main objectives of the PCA, according the Tax Reform Manual, would be achieved by the change of the interstate tax rate, adopting largely the destination principle. Besides that, punishments for the state that grants illegal tax benefits are clearly stated in the PCA, like, among others, the suspension of revenue distribution to the state, as well as direct sanctions on public agents.

4.2 Other taxes

As stated in the introduction, only the taxes that have a tax event similar to one of a VAT would be presented. The IPI, ISS, PIS and COFINS may be those taxes.

Although their basis of calculations are different from each other, they are, essentially a tax on an added value²⁶.

²⁶ PIS and COFINS are taxes on the income. Nevertheless, as the modern VAT should include barely all transactions, it would be interesting, for the purpose of this paper, to study the changes brought by PCA 233

4.2.1 Federal taxes: IPI, PIS, COFINS and CSLL

The Industrialized Products Tax (IPI) is a tax levied on, in the internal operation, the product output of an industrial property, or qualified as industrial. The IPI is also due on imports, when the taxable event is the customs clearance of foreign products.

The IPI is, by definition, noncumulative, being computed, for that, on an invoice-credit method.

The PIS and COFINS are taxes on income. In this sense, their basis of calculation is the import, production and sales of goods and services. They have a mixed nature, sometimes being cumulative, and sometimes noncumulative.

Exports are exempted for IPI, PIS and COFINS.

The PCA 233 aims to combine all of them, and other taxes not as relevant concerning the total revenue, in a single tax called IVA-F (meaning Federal VAT). The proposal also stands for the end of CSLL, whose basis of calculation is the company's profit. This tax would be incorporated into the company's income tax.

4.2.2 ISS

The Services Tax (ISS) taxable event is the providing of any service listed on the annex of the Complementary Law nº 116/2003, even if these do not constitute the main activity of the service provider. The ISS is a Local Government tax, as described by the Federal Constitution.

The PCA 233 does not affect the ISS in any form.

on these taxes. Besides that, as their basis of calculation is the income, they are, indirectly, a tax on added value.

5. The IMF Modern VAT

Maybe the very first VAT, which stands for Value Added Tax, introduced in the world was the French “*taxe sur le valeur ajoutée*” in the mid 1950s. From then on the VAT has had some modifications on its structure and principles.

In 2001, the IMF (International Monetary Fund) published a book, called *The Modern VAT*, using the Fiscal Affairs Department experience as a source. The main definition of VAT is as follows:

“A broad-based tax levied on commodity sales up to and including, at least, the manufacturing stage, with systematic offsetting of tax charged on commodities purchased as inputs - except perhaps on capital goods - against that due on outputs.”²⁷

Although the characteristics of the VAT vary from country to country, there are some features that are common to them all, like “credit/invoice method and credit all inputs; have broader bases than the predecessor taxes (even when there are still a questionably large number of exemptions); exempt agricultural production; have a single, or few, positive rates; zero-rate exports; include all levels of production but exclude much retail trade and other small businesses by means of a threshold; and treat domestic production and imported goods the same.”²⁸

Because of its broad-base noncumulative nature, the VAT may be considered an efficient tax. The reduced number of rates and exemptions makes it a more neutral tax, since there would be no distortions of the relative prices of the goods and services provided in the economy. If there were distortions, they would be of a reduced impact.

²⁷ The Modern VAT. IMF. 2001.

²⁸ The Modern VAT, IMF. 2001.



According to the book, “The VAT is particularly well suited to avoiding the trade distortions associated with the cascading indirect taxes that it replaces” as well as delivers a “greater economic integration” and is seen as a “more efficient revenue-raising tax.”²⁹

Nevertheless, as any consumption tax, it is considered a regressive tax. For this, on the equity side, the VAT could be counterbalanced by some indirect actions.

5.1 Taxable event and calculation basis

The VAT is a tax on any added value produced or provided by any element on the production chain. This means that, not only the goods, but also the services, accompanied or not by a good, should also be taxable.

The VAT is generally presumed to be most appropriately levied as a central tax. Although there are some examples to the contrary, in general the VAT is levied by the central government. This issue will be addressed on the next section.

5.2 Number of rates

The main suggestion is to have only one positive rate. With this, the tax would be basically neutral, for it would not affect the decisions of the economic agents by not altering the relative prices of the products and services.

Besides that, the efficiency of the tax would raise, both on the government’s side and the taxpayers’ side. On the government side, the costs of control and tax inspection would be diminished to its lowest, since the single positive rate is easier to account.

On the taxpayer’s side, both the administration and the compliance costs would be reduced. Since there is only one rate, all the accounting system would be simplified.

²⁹ The Modern VAT. IMF. 2001.

Besides that, the possibility of fraud, for example by accounting an output with an under valued rate or an input with an over valued rate, are minimized, if not ended.

Nevertheless, rate differentiation is a rather common practice.

Approximately 47% of all countries adopting a VAT have two or more rates, and about 23% have three or more rates³⁰. Besides the efficiency criteria, perhaps the issue of equity is the main reason why the countries adopt more than one positive rate.

But the equity goal is not always achieved, for there are some indirect factors that affect the result of rate differentiation, like an effective income tax, for example³¹.

The number of exemptions can also affect equity, even on a single positive rate VAT system, for it would create several different effective rates in the economy. A high threshold or the widespread use of zero-rates could also have a similar effect on equity.

Besides the efficiency and the equity criteria, the total revenue could be another reason to do tax differentiation. Although the idea to more strongly tax inelastic demand products is interesting to raise tax revenue, the costs included, both with compliance and auditing increase with the number of rates. As matter of fact, Agha and Haughton (1996)³² find that “for a sample of OECD countries [...] the ratio of actual VAT revenues to the estimated yield with perfect enforcement is significantly lower the greater is the number of VAT rates.”³³.

5.3 Exemptions

³⁰ The Modern VAT. IMF. 2001. Table 7.1.

³¹ For more information, see A. B. Atkinson and J. E. Stiglitz. The design of tax structure: direct versus indirect taxation. *Journal of Public Economics* 6 (1976)

³² A. Agha and J. Haughton. Designing VAT systems: some efficiency considerations. *The Review of Economics and Statistics* (1996)

³³ The Modern VAT. IMF. 2001.



In theory, the VAT is supposed to bare no exemptions. Nevertheless, in practice, some areas are usually a common place when it comes to exemptions. They are: the public sector, education, health, financial services, real estate and construction.

The reason for some of these exemptions is the equity issue, like education and health. On the other hand, the rationale for the exemption on financial services is basically a technical issue. Maybe real estate and construction rationale is a specific one.

The recommendation, concerning education and health, is to exempt only the basic services. Professional services and specific training should be taxed normally. The main problem concerning the change of exemption to a zero-rate approach is that of the refunding method, specially on the developing countries, where the private provision for such services is small, compared to the supply provided by the government.

Taxing financial services, by a value added method, may raise technical problems. "The difficult arises for services charged for in the margin between the return paid to lenders and the charged to borrowers. Even though the aggregate value added created by intermediation can be identified, to the extent that the financial services are used by registered firms, one needs further to allocate the aggregate value added between the two sides of the transaction. This is difficult."³⁴.

The real estate and construction are basically considered durable goods and the main idea of taxing them is by the same method durable goods are taxed. Once sold, the real estate should be subject to another taxation, and the invoice method should be applied. Nevertheless, apart from the apparent simple method of taxation, this would mean a rise on the prices for first time homebuyers.

5.4 Threshold

³⁴ The Modern VAT. IMF. 2001.

Under the VAT the optimal choice is to establish a threshold. The problem is on its level.

The threshold will often cause some distortion with equity and efficiency aspects.

From the equity standpoint, the threshold should be high enough to help small companies. On the other hand, from the efficiency standpoint, it should be low enough to minimize the distortion on economical decisions.

Besides that, it is recommended to tax the companies below the threshold at some extent.

6. Analysis on the tributary systems

On this section the actual and proposed tributary systems, as well as the VAT, will be analyzed under the light of some important features and tributary principles.

6.1 Centralization and federalism

Maybe the first issue to be addressed, concerning the tax system with a VAT, is whether the power to tax should or not be concentrated on the central government.

Although in more than 120 countries some sort of VAT is used, there are not many examples on the use of VAT as a source of the state or local government finance.

The problems that arise from a sub-national taxation by means of a VAT may be presented by different standpoints. Both the jurisdictional and the technical problems should be considered, but maybe the most important factor is the cross-border trade, as put by Bird and Gendron:



“The reasons why independent VATs applied simultaneously by two different overlapping jurisdictions have widely been considered to be either undesirable or infeasible vary. Some authors emphasize the high administrative and compliance costs of imposing two sales taxes on the same base. Others stress that divided jurisdiction over such an important tax base might unduly limit the scope of central macroeconomic policy. Still others have simply noted that central governments are obviously most reluctant to allow others to share this attractive tax base. The major technical problems that have been emphasized in the literature, however, arise from cross-border trade.”³⁵

Still according to Bird and Gendron, while traditionally the way to implement a sub-national VAT passes through the adoption of an origin principle, the destination principle may pose the best solution for internal commerce or even for countries looking for a single market without internal fiscal borders.

The destination principle, widely adopted by the nations that implemented a VAT, may serve as a help to inhibit differentiation of goods and services according to the origin.

On the other hand, the concentration of the power to tax on the central government may affect autonomy issues, especially on the federal nations, where the state governments often have responsibilities and prerogatives, which may be addressed by autonomy concerning its financial structure.

So far most of the countries that adopted a VAT maintain its centralized characteristic, and, in some cases, delegate to the state or local government some degree of autonomy to levy a tax similar to the national VAT, or use a revenue distribution method. In some cases the state or local government autonomy is maintained and agreements are reached in order to harmonize the federal and state or local taxation.

³⁵ BIRD, Richard M. and GENDRON, Pierre -Pascal. VATs in Federal States: International Experience and Emerging Possibilities (2001).



Concerning the PCA 233/2008, one of its main objectives, according to the Department of Treasury, is to eliminate the fiscal war. Maybe, between all others, two proposed changes address this problem directly: the adoption of a destination principle concerning the ICMS and the shift of the jurisdiction of the ICMS, from the state level to the federal level.

As presented on the first section, through the work of Kahir, the adoption of a destination principle would be able to decrease the fiscal war with little expenses for the central government, if the compensation should take place.

Despite all other changes proposed by the PCA 233 the shift on the tributary jurisdiction may be considered the more impactful. A central government levied VAT would contribute directly to reduce the range of possible policies the states have to implement the fiscal war, specially concerning the possibility to "outsource" the burden of the tax benefit policies.

Nevertheless, the autonomy issue rests unaddressed. The PCA 233/2008 implies that the states' tax revenue would not change, but two direct issues arise from that: the first is the guaranty itself and the second is the enlargement of the revenue distribution instrument.

The PCA 233/2008 creates a Revenue Equalization Fund (REF) that aims to "allow states that gained from the change contribute partially to offset the eventual losers, with the assurance that, under any circumstances, transfers of the Fund will be reduced to States that have loss of ICMS revenue as a result of the Reform".

For this, probably, an index will be used, fixed on a specific year, in which the relative revenues of the states would remain constant.

This not only would reduce the states autonomies, but also would discourage the implementation, by the states, of state of the art tax policies that could improve their fiscal situation. Besides that, the guaranty of a tax revenue based on a specific year could be



seen as arbitrary, in sense that the revenue may fluctuate depending on the specific tax or fiscal policies adopted by the states in a given year and the seasonality of the Brazilian and even the world economy, which could influence the tax revenues of the states differently than others.

The revenue distribution enlargement could lead to an increase in the need of the states to rely on federal support, which could increase the states' political dependence.

At last, although the PCA 233/2008 adopts the destination principle, concerning the ICMS, with a 2% interstate tax rate due to the origin state, the transactions with petroleum, including liquid and gaseous fuels derived, and electric energy are subject to a full destination principle, leading to further distortions on the interstate commerce.

6.2 Principles of a sound tax system and the presented systems

In this section, the principles presented in the second section will be used to compare and analyze the three tax systems.

6.2.1 Raising adequate revenue

According to a report by "Receita Federal" (Brazil's IRS)³⁶, consumption taxes account for almost 50% of the total tax revenue. This represents the revenue under the current tax system. There doesn't seem to be much evidence in the Tax Reform Manual to support a change on this percentage, since the tax burden is expected not to change.

The stability issue is addressed, as it would be by any consumption tax. As put by Brunori (2011) "revenue raised through broad-based sales taxes tends to be relatively consistent during economic swings"³⁷.

³⁶ <http://www.receita.fazenda.gov.br/publico/estudoTributarios/estatisticas/CTB2012.pdf>

³⁷ Brunori (2011). State tax policy: a political perspective. Third edition.



The current system has some problems with the certainty requirement. The different legislations, high number of different rates, combined with the unilateral grants of tax benefits, with its juridical uncertainty, may be seen as a lack of certainty.

Under the proposed system, since the power to tax, and ultimately legislate upon, would be transferred to the central government, there seem to be evidence supporting an increase on the certainty.

The VAT is seen as an efficient revenue-raising tax and, because of its broad base, it can raise enough revenue with low rates, addressing the sufficiency issue, as well as keep steady revenue during economical cycles, which addresses the stability issue. Besides that, there seems no need of constant changes in its legislation.

6.2.2 Neutrality

According to the concept presented in the second section, all three systems infringe the neutrality in some extent.

The current tax system, with its more than 10 different positive rates, exemptions and zero-rate, leads to a change on the relative prices, affecting economical choices in the market. Because those changes on economical choices are due to tax law, there are biases on the political environment at the time a change on the tax law or a tax benefit is enacted. Besides that, the other taxes on consumption, both federal and local, and its different rates, bases and taxable events, may cause a bigger change on the relative prices of the products and services offered in the market.

The proposed tax system addresses some of these issues. By reducing the number of positive rates and the flexibility in which the states can change nominal and effective rates, as well as other changes proposed, the PCA reduces some of the non-neutral features. The maintenance of other consumption taxes, under different legislations, may be a negative factor on the impact of the neutrality increase.

The VAT goes further. Under a single positive rate, or even two or three rates, the VAT can maintain a certain degree of neutrality. The decrease of neutrality brought by more than one positive rate, if in place, or even the existence of zero-rate and exemptions, under a single positive rate or more, can be balanced, by the broadening of the tax base and reduction of concurring taxes.

6.2.3 Fairness

As stated in the second section, the fairness principle can be divided in the horizontal and vertical equities.

Concerning the horizontal equity, both the current and the proposed tax system have a separated tax on services (the ISS) with smaller rates than the ICMS. Besides that, the use of a tax on industrialized products (the IPI) which can be considered cumulative after the good leaves the industrial facility, and the use of a similar tax by the proposed system (the IVA-F), which is not recoverable in sales steps after industrialization, may lead to a horizontal inequity, since even the equal consumers, meaning in the same income bracket, may pay (in some cases very) different taxes.

The VAT, on the other hand, tends to obey the horizontal equity. By the use of one positive tax rate, all the goods are taxed the same, which leads to the perfect application of the horizontal equity. Nevertheless, the more the number of positive rates, the higher the probability of the VAT becoming horizontally unequal.

Concerning the vertical equity, the current tax system, the proposed tax system and the VAT fail on some extent. The current tax system may present a solution, by the use of many different rates. This solution implies that, one way or another, the tax legislator may know exactly which are the goods or services consumed by the rich and the ones consumed by the poor. In this sense, for many goods and services, it may be very difficult to determine which is the main consumer and whether the specific rate is heavier



on the poor or on the rich³⁸. For this, maybe the best solution, which could be adopted by either tax system, is the one proposed by Gale and Harris, although speaking of VAT the observation is that, “it is straightforward to introduce policies that can offset the impact of the VAT on low-income households. The most efficient way to do this is simply to provide households either refundable income tax credits or outright payments.”³⁹.

6.2.4 Ease of administration and compliance

The current system is flawed concerning efficiency. Although the data cited in the introduction refers to taxes in general, the taxes on consumption, in general a state tax, are no more efficient than the World Bank data shows for the Brazilian tax system. Maybe the high number of positive rates, summed with the different rates each state imposes, and the number of tax benefits granted by the states are mainly responsible for the low efficiency that the current tax system presents.

Although the proposed system has some improvement over the current system, like the uniformity of the ICMS law, the reduction of the number of positive rates, the simplification of some federal taxes and the adoption of the destination principle (although not entirely), it is still behind the efficiency the VAT can deliver.

The VAT, especially under a single positive rate method, can be very simple to account and pay as well as to audit. Under this method both the administration and the companies could use the income tax declaration as the basis for the tax accountability⁴⁰, for example.

³⁸ Take televisions for example. Although it is known that high-income people own more televisions than low-income people, nevertheless, low-income people still buy them. If television, because it is more consumed by high-income people, is highly taxed, would it be, after all, heavier on the low-income household budget?

³⁹ GALE, William G. and HARRIS, Benjamin H. A Value-Added Tax for the United States: Part of the Solution (2010).

⁴⁰ This is not true on all the cases, especially for the companies that have operations under zero-rate or exemption. Nevertheless, the comparison with the income tax basis of calculation can deliver, especially for the administration, a good estimate of the consumption tax due by the taxpayer.

In this sense, the compliance costs would be lower under a VAT system than under the current or the proposed systems. On the other hand, the VAT offers administrative advantages to audit companies, not only by the small number of rates, but also by its broad base, which includes services and rejects exemptions, in most cases.

6.2.5 Accountability

Under the current tax system, in part due to the decentralization, in part due to the tangle of the tax laws, some tax decisions seem not to be taken openly; especially concerning the tax benefits policies. The rate differentiation can be appointed as another problem. Rio de Janeiro for example has twelve different rates, considering the interstate rates, and some mechanisms that could increase this number. For example, it could be difficult to explain why alcoholic beverages in general have a rate that is double that applicable to beer.

Under the proposed system, the checks and balances between the Senate and the CONFAZ can lead to an increased transparency. On the other hand, the centralized tax law, combined with Brazilian economical diversity among states, could make policy decisions become not too transparent.

The VAT has some transparency improvements. First fewer rates leads to fewer discussion on rate differentiation. Secondly, since the main idea of a VAT is to raise revenue in a broad way, there should not be too much turmoil when and if a change is enacted⁴¹. On the other hand, the centralized tax issue remains.

6.3 Some experiences around the world

⁴¹ The equity issue has already been addressed.



6.3.1 Canada

Canada has enacted, in 1991, a 7% federal VAT, called GST, which stands for Goods and Sales Tax. To address the regressive characteristic of the VAT, and achieve better distributional effects, the government used a combination of zero-rate to some first necessity goods and a refund on the income tax.

In fact, although the VAT is thought of as a great revenue raising tax that could lead to an increase on the government size and expenses, which could actually happen, Canada has shown otherwise. According to Gale and Harris, "Federal spending in Canada has in fact gradually declined from 22.6 percent of GDP in 1991 - when the VAT was implemented - to 14.9 percent in 2009. The standard VAT rate has declined over time to 6 percent in 2006 and 5 percent in 2008. Federal tax revenue in Canada has fallen from 17.6 percent of GDP in 1991 to 16.3 percent of GDP in 2007 (and fell further to 14.6 percent during the 2009 recession). In terms of both revenues and expenditures, the size of the Canadian federal government has shrunk significantly since the introduction of the VAT. Since 1991, Canadian inflation and economic growth rates have been similar to those in the United States."⁴².

The provinces have been harmonizing their sales taxes to a province/federal VAT. With different arrangements, the provinces are still able to levy taxes and maintain relative autonomy concerning their own budgets, policies and expenditures.

Quebec has its own VAT, known as Quebec Sales Tax (QST) with the same tax base of the federal GST. The Atlantic provinces (New Brunswick, Prince Edward Island, Nova Scotia and Newfoundland and Labrador), Ontario and British Columbia, since 1997 have a Harmonized Sales Tax (HST) which is, in fact, the GST with different rates for each province.

⁴² GALE, William G. and HARRIS, Benjamin H. A Value-Added Tax for the United States: Part of the Solution (2010).



Until 2014, only three out of ten provinces - British Columbia, Manitoba and Saskatchewan - have not harmonized their sales taxes with the federal GST. The province of Alberta does not have a sales tax.

6.3.2 European Union

The European VAT can be traced back to the late 1960s, to the First and the Second Council Directives (Council Directives 67/227/EEC and 67/228/EEC), both in 1967, when the EU had only 6 members. Nowadays, it reaches all the EU members, affecting 28 countries.

The Council Directive 2006/112/EEC, known as the VAT Directive, is the main rule regarding the EU VAT and establishes some of the definitions used by all member states. In its article 9 it can be read that a taxable person is “any person that independently carries out in any place any economic activity, whatever the purpose or results of that activity.”⁴³ In this sense, the EU VAT has a broad base tax (nevertheless, some member states have different legislations).

Some member states have registration thresholds. This means that companies whose revenues are below the thresholds are not required to register, account or pay the VAT.

The destination principle is mainly used. In this sense, imports are taxed, and exports are not. Furthermore, transactions among state members are not subject to taxation, since these transactions are not considered imports, except in the case that the consumer of the good or service is a non-taxable legal person.

⁴³ Council Directive 2006/112/EEC. <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:347:0001:0118:en:PDF>



According to the VAT Directive Title IV, there are four taxable transactions: supplies of goods, intra-Community acquisitions, imports and supplies of services. Thus virtually all transactions with goods and services should be subject to VAT.

The EU VAT has exemptions. Some of them are with the right of deduction (which *in fact* are zero rate transactions), other are with no right of deduction (which means that companies cannot maintain input credits). In 2006, a study by PwC, appointed that the “EU VAT treatment was hurting the global competitiveness of EU-based industry.”⁴⁴

The VAT rate must be between 15% and 25%, and a special 5% rate can be applied by the member states on goods and services referred to in a list. In this sense, the member states have autonomy to set the VAT rate, or rates, or even further, to have different sub-national rates. Some member states have zero rates other than for exports.

The companies that are below the registration threshold could be able to apply for a refund on the VAT eventually paid on inputs.

The bureaucratic part is defined by the member states, both on the tax laws and the auditing methods, as well as the penalties. Exception is the invoice rules, which has some minimum details defined for all member states.

7. Conclusion

Historically, Brazil was one of the first countries to ever enact a tax with the characteristics of a VAT, with the IPI, in 1964. Concerning a sub-national VAT, with the enactment of the Constitutional Amendment nº 18/1965 the ICM was created. This tax was the predecessor of the current ICMS that was enacted in 1988.

⁴⁴ (PwC, “Study to Increase the Understanding of the Economic Effects of the VAT Exemption for Financial and Insurance Services,” Nov. 2006, <https://global.vatonline.pwc.com>).

Since 1988, changes have been made on the ICMS, some punctual others broader, like the Kandir Law. However, the ICMS and the taxation on consumption, perhaps even the tax system as a general, still are considered a bottleneck to the development of Brazil's economical potential.

The PCA nº 233/2008 addresses some of those issues. According to the tax reform manual, provided by the Ministry of Finance, the estimated GDP growth, due to the simplification of the tax system, would be about 0.5%, and the tax burden is intended not to grow.

Without examining the merit of these predicaments, which is not the scope of this work, it seems that a more complete reform could lead to the same, or even better, GDP growth and lower tax burden.

In this sense the adoption of a broad-based VAT may be an interesting option.

As presented in the sixth section, the VAT delivers better results concerning the principles of a sound tax system, addressing the efficiency, the horizontal equity, the accountability and the neutrality principles directly. As it is with most consumption taxes, it would be able to raise enough revenue.

By harmonizing the Brazilian taxation on consumption with modern methods, Brazil could simplify the tax system, increase efficiency, reduce administrative and compliance costs, make the tax system more transparent, both for the investor and for the Brazilian consumer. The adoption of such changes, accompanied by changes in company law and improvements in labor laws could bring even greater benefits.

By including all taxes on consumption (ISS, ICMS, IPI, PIS and COFINS) under the same tax law, the VAT has a gain on efficiency and transparency. By broadening the tax base, some of the equity issues would be addressed. The broader base and the inclusion of the ISS's tax base would increase the vertical equity, since the current ISS



rates are lower than the ICMS rates, and usually services are more used by high income households.

Including exempted goods and services in its taxable base the VAT would be able to raise enough revenue to use lower rates, especially a one-digit rate, as proposed by The Modern VAT.

Although not addressing directly the vertical equity issue, and, despite being a tax on consumption, and its regressive characteristic, the adoption of a VAT could pave the way to a more efficient non-distortive tax system, especially if accompanied by other structural changes. The equity issues, as pointed earlier, can be addressed, even more efficiently, by increased use of earned income tax credits and higher threshold for income exemptions.

The federalism issue is also of major importance. The VAT as a central tax, as it is usually enacted, has the downside of eroding the fiscal autonomy of the states. This problem could be addressed, using Canada's example, enacting the central VAT with a low rate and allowing states to establish their own sales tax, maybe with some limits concerning the rates and bases.

Other possibility is a central VAT law and the state level collection, similar to the EU VAT.

In the end, there are some possibilities to compensate the downsides of a VAT and still enact a tax that could leave the country better off. Thereby the subject is not pacified, and it would be an interesting issue to be introduced on the agenda for future tax reforms.

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