Brazil's ICMS Tax

Origin, Changes, Current Situation, and Paths to Recovery

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Abstract*

The tax reform of 1965 in Brazil sought to streamline state taxation, replacing the old tax on sales and consignment (IVC) with a modern value added tax on the circulation of goods (ICM) as part of a profound change that aimed to build a national tax system. During the process of drafting the 1988 Constitution, the foundation of the ICM was expanded to include services and renamed ICMS. However, these changes have created increasing problems for the economy and the federation, which have worsened as successive attempts at reform have failed. Repeated attempts to improve the Brazilian tax system by adopting ad hoc measures have had little success. The diversity of interests and the complexity of the situation do not allow for isolated measures to make a big difference. It is important to seize the opportunity to advance towards a better understanding of the reforms in order to correct the many distortions that have accumulated in the tax system over more than four decades. For the first time, the federal issue precedes the discussion of tax reform.

JEL Codes: H25, H71
Keywords: tax system, tax reform, federalism, subnational taxation

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Introduction

Ever since the birth of the Republic, regional conflicts have marked the debates on the Brazilian tax system and the solutions found to reach an understanding concerning the distribution of the power to tax among the federated entities. The 1891 Constitution made no major changes in the tax system as it stood at the end of the Empire. It simply adapted that system to the federative regime by drawing the boundaries of the spheres of taxation authority reserved to the federal government and the states (Varsano, 97).[1] The principal change in state taxation came about in 1934, when states were given the authority to institute a tax on sales and consignments—the IVC (Imposto de Vendas e Consignações)—but saw their ability to tax exports restricted. Those changes probably were motivated by the need to increase collections on internal sales in light of the external crisis and its reflections on state revenues.[2]

According to Article 8, paragraph 2 of the 1934 Constitution, the IVC tax would be applied uniformly. No distinction would be made as to origin, destination, or type of product. That rule was intended to ensure equal tax treatment of sales of locally produced products in any given state, whether destined for internal consumption or shipment to other states, and for products imported from other states. That rule was changed by the 1946 Constitution, which, in an apparently innocuous move, deleted the requirement for uniformity among kinds of products.[3] With that change, taxes on sales in one state might vary according to the type of product, but the product would be taxed the same, regardless of the origin or destination of the goods.

The equality of tax treatment with respect to origin or destination of the goods was intended to prevent the same product from being taxed differently by different states. However, because incidence of the IVC was cumulative, the circulation of goods within Brazil was affected by the tax levied on interstate sales, which ultimately led to the presence of tax barriers to the free movement of products around the country. Consequently, states were able to use tax policy as an instrument to promote development.[4]

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[1] States were given authority to tax exports, rural and urban real estate, and the transfers of property. They were also permitted to tax industries and professions, to levy a stamp tax, and to operate the postal and telegraph systems.

[2] Taxation of exports was limited to 10 percent of the sales value, and surcharges were prohibited.

[3] Article 19, paragraph 5 "the tax on sales and consignments shall be uniform, without distinction."

[4] With that change, states could raise the rate on a given product to protect or encourage local production or, inversely, to reduce the rate on products on which they had a comparative advantage in order to boost sales to other states. Although parity was maintained between the taxation of local products and imported ones, the production in any given state was burdened by the tax on raw materials, intermediary products, and equipment obtained from other states in the Brazilian federation. Furthermore, differences in transportation and logistical costs, as well as financial costs, could result in significant advantages.

The 1965 reform sought to rationalize state taxes. It replaced the IVC with a modern tax on value added during the circulation of goods—the ICM (Imposto Sobre Circulação de Mercadorias) or Tax on Circulation of Goods. This was part of a comprehensive change in the constitutional distribution of responsibilities for tax collection and revenue sharing in the Brazilian federation, one that aimed to build a national tax system.

Despite the political conditions that reigned when the 1965 reform was adopted, the model conceived then was mindful of the need to promote equilibrium among the components of the federation by associating the changes in the nature and distribution of taxes with a modern regime of compensations intended to satisfy the financial needs of the less developed states. However, the adoption of the ICM did not calm the federative conflicts. Over time as hoc changes were made to satisfy criticisms from the less developed states with respect to the excessive concentration of revenue collection in the industrialized states. The constitutional reform produced after redemocratization afforded an opportunity to correct the problems that had been identified by then, but the specific conditions that presided over the drafting of the 1988 Constitution did not allow this to happen. On the contrary, the changes made in 1988opened the way for the Brazilian taxation system to begin accumulating larger problems for the economy and the federation, problems that were exacerbated as successive attempts at reform failed.

In order to add a new perspective to the debate on the reform of the ICMS—Tax on Circulation of Goods and Services (Imposto sobre Circulação de Mercadorias e Prestação de Serviços de Transporte e Telecomunicações)—, it is important to know something of its history. With the passage of time, the new generations of tax administrators who are taking part in this debate have lost contact with the origins of this tax. That is why this paper dedicates special attention to an analysis of the origin of the ICMS and the transformations it has undergone during the more than four decades that have elapsed since its creation. It is hoped that the knowledge of its history can help overcome the resistance that has prevented the building of a future.

1. Nature of the ICMS – Who Can Describe It?

The ICMS today is a tax in search of an identity. The various systems applied to the administration and collection of this tax make it almost impossible to identify its nature. The mosaic of situations formed by the juxtaposition of various regimes adopted by the states to facilitate collection and reduce evasion is composed of packages that exhibit the traits of a value added tax and others that resemble a monophasic tax on the production of goods. One large part is formed by a tax on industrial production, a tax on sales by small and medium-size companies (SMEs), and a kind of customs tariff applied to the entry of products from other states in interstate sales.[5]

None of those packages, furthermore, are characterized by adherence to the specific rules of each taxation mode. The packages that resemble a value added tax do not guarantee that the taxpayer will gain full use of credits accumulated in previous stages, primarily when the inputs come from other states and the product is intended for export. What results from the collection of the tax in advance during the industrial production phase (tax substitution) is based on the stipulation of arbitrary markup percentages for product sales, which runs counter to the logic that underlies a market economy. The application of a monophasic regime to the only two goods on which the destination principle is adopted in the ICMS (petroleum, its derivative fuels, and electricity) entails severe distortions in the case of sectors where use of both is highly intensive but that are not taxed in subsequent phases (services and activities that are predominantly export-related). Furthermore, new distortions are introduced by expanding a simplified regime applied to small and microenterprises and the widespread adoption of the practice of collecting the differential in rates on interstate transactions at the moment the product crosses state lines.

The relationship among companies that are subject to different regimes adds another element that contributes to the economic inefficiency of this tax. The adoption of a simplified regime for small companies facilitates life for those companies and reduces the compliance costs, but makes their dealings with the other companies burdensome since the tax credit to be taken

[5]Strictly speaking, the ICMS is still a tax on the circulation of goods, since the portion charged in advance of the retail sale via tax substitution is assessed against a pre-established markup. In practice, in an economy in which prices are freely fixed in the market, the MVAs result from a negotiation with industrial sectors, supported by technical studies and taking into account the interests of the tax authority.

advantage of later by third parties is smaller and the inputs they purchased do not generate credit.[6]

In general, the diversity of regimes is associated with the nature of the activities pursued, the size of the companies, and the degree to which production in the sector is concentrated. Parts of the manufacturing sector and providers of public utility services, among which a small number of large companies predominate and contribute to a majority share of the receipts, are in the monophasic regime or the tax substitution regime. Small and microenterprises, defined in terms of sales volume, are eligible for a simplified payment regime (known as SIMPLES Nacional) and pay a variable percentage of their sales. The remainder are said to be in the so-called "normal regime." That group has been shrinking as the process of expansion of the tax substitution regime advances, led recently by the states of Minas Gerais and São Paulo. The latter has accommodated almost all its state GDP in that regime.[7]

Prior to the adoption of the national SIMPLES procedure, simplified mechanisms for collection of taxes had been established by states independently, but since then the states, the federal government, and municipalities have banded together to apply a single rule to the collection of federal, state, and local taxes. Under that new regime, tax collection is centralized and revenue is shared according to agreed criteria. A tripartite collegial body is entrusted with its application.[8]

There are no published data on the relative importance of each regime in total ICMS collection, but evidence gathered in an earlier study (Rezende, 2007) has pointed to the fact that about half of 2007 receipts and of revenue obtained by tax substitution came from the three new sectors incorporated into the state tax base in 1988 (fuels, energy, and communications). That index must have risen with the recent expansion of that regime. In the less developed states, the so-called normal collection regime is becoming the exception, as indicated by additional evidence contained in the cited study for the states of Pernambuco and Mato Grosso.

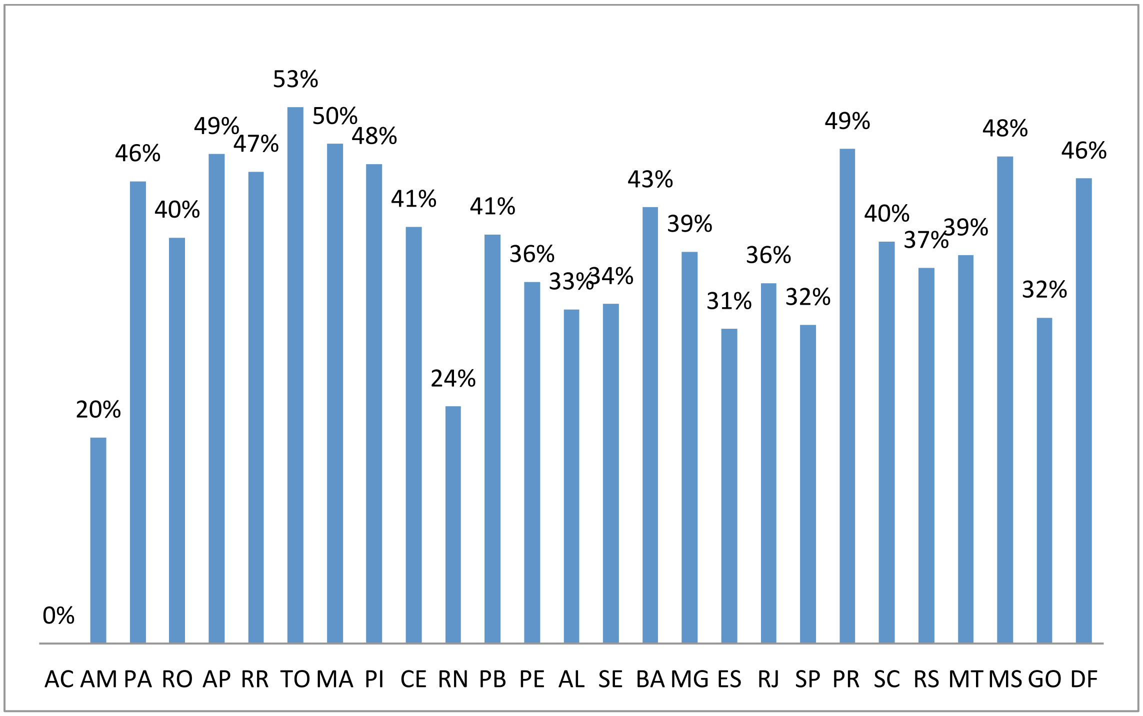
[6] The onus may be particularly severe when inputs that are heavily taxed, such as fuels, electricity, and communications, are purchased.

[7] Tax substitution in São Paulo began to expand in 2007, backed by an appeal filed by the state itself with the Federal Supreme Court to question the application of a provision of law that calls for the refund of money collected in excess in cases where the pre-fixed sales markup is demonstrably higher than the actual price at which the goods were sold.

[8] The importance of that regime in total revenue is small (about 2.5 percent but is growing in those less developed states that have a small industrial base.

In various states, recent figures show that just the revenue from the tax assessed against the so-called "blue chips"—fuels, electricity, and telecommunications—approximates, or even exceeds, half of total revenue. Note that this is observed even in the more developed states, like Paraná (Figure 1).[9]

Figure 1. Participation by Blue Chips in ICMS Revenue, 2010



Notes: States, identified by their official abbreviations, appear along the horizontal axis.

A recent study made by PricewaterhouseCoopers for the National Confederation of Industry CNI (2011), shows the dimensions that tax substitution has attained in recent years and highlights the expansion of the number of products classified under this regime in the states of Brazil's southeast. In 2004, in almost all states the number of products subject to tax substitution varied from 60 to 90. The exceptions were Santa Catarina, where 44 products were taxed that way, and the states of Rio Grande do Norte, Piauí, Goiás, and Rondônia, where that figure was more than

[9]The figures used in preparing this and the other figures presented throughout the paper combine data from the following sources: National Treasury Secretariat (STN); Institute of Applied Economic Research IPEA/DATA; the Permanent Technical Commission of the National Council on Financial Policy CONFAZ (COTEPE/CONFAZ); and the Treasury or Finance secretariats of the states and the Federal District.

100. The escalation of that regime in the states of Minas Gerais, São Paulo, Rio de Janeiro and Rio Grande do Sul, which began in 2008, accommodated 200 new products in the tax substitution system in those states (a few more in Minas Gerais and somewhat fewer in Rio de Janeiro), putting them easily ahead of the other states in the federation.

The expansion of tax substitution in four states that have the largest industrial bases in this country did not occur by chance. It reveals the trend toward centering the collection of the ICMS on the industrial production phase, even in cases where the reason that justifies it (i.e., pulverization of the retail trade) is not found. The same study by Price cited above estimates at about 40 percent the number of cases of tax substitution in which this justification does not apply.[10]

The predominance of special systems applied to the collection of taxes stems from the Brazilian preference for applying the principle of convenience.[11] This approach has several consequences for the quality of taxation, including the following:

(a) A high level of economic inefficiency

(b) A high degree of unfairness in the distribution of the tax burden

(c) Absolute absence of transparency with regard to the tax burden

(d) An important source of increased friction in conflicts among the states

The economic inefficiency of this tax, which results from the accumulation of different regimes applied to its collection, was recognized long ago,[12] but has assumed serious proportions in the present context of growing exposure of the Brazilian economy to international competition and the advance of new technologies that are making more and more mobile those tax bases that traditionally were mined for sources of revenue within the limits of national borders.

With the facilities that modern technologies afford for the circulation of goods and services on a global scale and at lower and lower costs, the tax burden takes on a significant role in the decisions to purchase products or to transfer their production, or some of it, to other countries or continents. As a result, trade relations among the different regions of this country

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[10] With the expansion of federal taxes on production and sale of goods and services (the PIS-COFINS levy) and the trend observed with the ICMS, it seems that we may be moving to a situation inverse to the one adopted in 1965. The federal government assesses a general tax on circulation and the states impose a tax on industrial production.

[11] The principle of convenience in terms of taxation refers to the preference among tax administrators for adopting systems that facilitate collection.

[12] See Rezende (1999).

can suffer significant transformations, loosening the economic ties among them and generating conflicts that threaten the preservation of federative cohesion.

The transfer of production to places outside Brazil is accompanied by a loss of jobs and tax base that, besides the harm they cause to the country, reduce the opportunities for growth in public revenues over the medium and long terms. The possibilities for exporting tax bases that are created by the convergence of the liberalization of markets with the application of new technologies to the process of producing and circulating goods and Vito Tanzi (2005) analyzed these services. In that paper, Tanzi calls attention to the erosion of traditional tax bases that has been provoked by the underground activities of what he calls "tax termites." That erosion, fostered by the progress of information technology in various areas of the economy, results from:

a) The advances made by e-commerce on both the domestic and international planes
b) The ease of moving financial resources from one place to another by electronic transaction
c) The creation of off shore financial centers
d) The presence of tax havens

In this context, a country's tax base is not restricted to its territory but can extend to parts of the global economy. Two issues are of special interest in this regard. The first refers to the exportation of tax bases that results from the outsourcing, by large organizations, of parts of the production process. With services such as software, call centers, and others being relocated to other countries and continents, along with the production of the parts and components used in almost all significant segments of industrial production, a good part of the tax bases that traditionally were exploited at the subnational level is disappearing, leading to the need to concentrate revenue collection on taxes that have little geographical mobility, such as property taxes, family income taxes, and taxes on consumption of goods and services.

Over the long term everyone loses, but the intensity of the reigning antagonism blurs our perception of this. Tax barriers to internal trade, such as those erected by the ICMS, encourage states in the more distant parts of Brazil to trade with other countries. These barriers sever links in domestic production chains, cause the loss of important segments of the country's industrial complex, and discourage the aggregation of value to exports of products obtained from exploitation of Brazil's natural resources.

The difficulties that antagonism and mistrust create for the approval of changes in taxation compromise the country's prospects for growth and ultimately obstruct its efforts to advance more rapidly in the direction of reducing regional and social disparities. To overcome resistance from the states to the progress of a broad tax reform Brazilian society must mobilize, but the absence of transparency of the tax burden prevents the public from exercising its civic consciousness with respect to taxes.

A recent study (Gaiger, 2011) made it clear that the ICMS is the tax that contributes the most to the regressiveness of the Brazilian tax system, but the disclosure of this fact finds no echo within the general public.[13] The practice of "building in" the amount of the tax to the price of the merchandise (the rate is part of the price and not 'ad valorem", giving an impression that it is smaller), the multiplicity of rates applied, the diversity of regimes and the absence of harmonization among the rules adopted by the 27 states in the federation make it impossible for the consumer to know how much tax is being taken out of his pocket. Low-income Brazilians are hurt the most, but their lack of knowledge as to the true dimensions of the problem prevents conditions from being created that would enable them to mobilize in defense of the need for change.

The current ICMS does not, therefore, have any of the advantages attributed to a value added tax. It has accumulated a number of distortions as it departed from the original model. Nevertheless, the difficulty of bringing about changes that have long been discussed seems to increase as time goes by. Some of those difficulties can be attributed to the loss of identity of that tax mentioned at the beginning of this section. It seems useful, therefore, to add some historical perspective to the ongoing debate, to explore the origins of this tax and the successive changes suffered over the years, in the expectation that this might contribute to an understanding about what needs to be done to correct its deformities. The next section will fill that gap.

[13] Measurements of the regressiveness of indirect taxes can always be flawed, which is particularly serious in the case of the ICMS, because of the difficulty of obtaining information as to the tax rates actually applied by the states. Furthermore, it is hard to verify whether a reduction in the tax rates on food and other staples actually work to the benefit of the consumer.

2. How and Why Did this Situation Develop?

2.1 Birth of the ICMS

Given the pressures of daily life, the lessons of history are often forgotten. Those who are tasked with administering the ICMS in a context marked by all kind of conflicts and pressured by the need to pay attention to the interests of the respective states do not have time to dedicate themselves to a study of the history of this tax or to concern themselves with its identity. It is worthwhile, then, to recount the facts and arguments that gave rise to the ICMS, originally the ICM, in the tax reform promoted in the mid 1960s.

The Ministry of Finance's Reform Commission, which was headed by Dr. Luiz Simões Lopes, created the ICMS then president of the Getúlio Vargas Foundation. The commission began its work in October 1963, therefore prior to the advent of the military regime. According to reports given at the time, those responsible for that work saw their mission as an effort to bring about comprehensive reforms that should not be limited to recommending changes in work routines, administrative restructuring, or the mere revision of tax laws. They believed they should formulate proposals of a broader scope that might require constitutional amendments in the fields of finance and taxes.

The change in the political regime that occurred on March 31, 1964 ratified the position adopted by that commission. By order of the President of Brazil, the Minister of Finance was instructed to review the constitutional distribution of responsibilities for tax collection and revenue sharing as a first step toward a national tax reform. A Special Commission was appointed to prepare the preliminary draft of the reform of the constitutional distribution of responsibilities.[14]

The work of that Special Commission proceeded in two phases. The first one ended in June 1965 with the delivery to the Minister of Finance of a preliminary draft of a constitutional amendment, accompanied by a report that outlined the justification for the proposed changes. This draft contemplated two amendments, designated as A and B, whose objectives were complementary and will be explained here later. Criticisms and suggestions from government

[14]Interministerial Directive GB-30, of 1965, issued by the ministers of finance and planning. The president of the Getúlio Vargas Foundation also assumed the chairmanship of this commission. Its members were Rubens Gomes de Souza (reporting), Gerson Augusto da Silva (executive secretary), Sebastião Santana e Silva, Gilberto de Ulhoa Canto, and Mario Henrique Simonsen.

agencies, businessmen, experts, and other elements of society regarding this preliminary draft were examined during the second phase of the Commission's work. It made some changes in the original proposal and the results of this were delivered to the Minister of Finance on October 30, 1965.[15]

In its report accompanying delivery of the original preliminary draft, the Commission had outlined its criticisms of the situation as it then stood, and pointed out what it considered to be the two principal flaws in the constitutional distribution of revenues at the time.[16] The first point emphasized the fact that the problem was treated as purely legal; its economic dimension was ignored. In addition to differences of opinion among the jurists themselves, that practice, which had been followed ever since the 1891 Constitution, provoked economic distortions as greater financial needs of governments demanded an increase in revenues, creating problems for the courts and increasing the complexity of the federal, state, and municipal taxes.

In order to expand the scope of its taxing authority and thus increase revenue collection, governments resorted to a proliferation of tax figures that were conceived in purely formal legal terms. They resorted to artifices that, with greater or lesser skill, consciously violated the constitutional restrictions on the exercise of the power to tax. That practice led to superimposition of economically identical taxes. The Commission affirmed that by that time the number of formally distinct taxes greatly exceeded the number of economic factors that could be the object of taxation.

Criticism by the Commission of the constitutional distribution of responsibilities for tax collection and revenue sharing extended to the fact that the Constitution had intended to distribute the tax bases attributed to the jurisdiction of the federal government, states, and municipalities so as to avoid the superimposition mentioned above.. However, this was not the case in practice, given the possibilities that the prevailing rules afforded for adoption of expedients that would circumvent constitutional limitations, including.by creating taxes not specified in the Constitution.

Those criticisms led the Commission to adopt two premises to guide its efforts. The first sought to distinguish taxes on the grounds of their economic base instead of their legal nature.

[15]With a few modifications introduced by the ministers of finance and planning, the draft was sent to the National Congress, discussed in a Joint Committee chaired by Deputy Raimundo Padilha, and, after some changes were approved, promulgated on December 1, 1965, and re-baptized as Constitutional Amendment No. 18/65.
[16] For details, consult Getúlio Vargas Foundation, 1966 and 1967.

The second rested on the concept of a national tax system, in opposition to the historical criterion marked by the coexistence of three autonomous tax regimes—federal, state, and municipal.

The first premise led to the classification of taxes into four groups, defined as a function of the nature of their economic activities: taxes on foreign trade; taxes on property and income; taxes on the production and circulation of goods; and special taxes—these latter considered because their characteristics exceeded the boundaries of the first three groups. To prevent later problems, the Commission proposed to abolish the residual field, since the four groups encompassed all the economic bases that were susceptible to taxation.

The Commission acknowledged that application of the second premise was more delicate, since the concept of a national tax system in a country of such vast territorial dimensions, accentuated socioeconomic disparities, and the presence of three levels of government would mean ignoring reality—which was impossible. It was also necessary to allow for the possibility of being able, in the future, to adapt to changes in economic conditions and the evolution of political ideas. On this point, therefore, the Commission sought to maintain the existing rules but to reinforce the concern for ensuring the economic, political, and juridical unity of the country. To this end, it sought to remove fiscal shackles from interstate and intercity activities by including measures that were intended to prevent the export tax and the tax that would replace the tax on sales and consignments from being used as weapons in what had become a genuine tax war between producing and consuming states.

The Commission's report warned that the reform proposal could be accused of being centralizing. It attributed this possibility to the fact that the division of taxing authority sought to observe the recommendations of economic order, seconded by political, juridical, and administrative reasons. To offset the fact that the proposal attributed a larger number of taxes to the federal government, the report proposed the creation of compensatory mechanisms in the revision of the prevailing regime of participation by states and municipalities in federal revenues. To ensure the flexibility necessary to the adaptation of that regime to changes in socioeconomic conditions, it transferred the authority to regulate the functioning of the revenue transfer regime to a Complementary Law and to resolutions by the Federal Senate.

The flexibility advocated by the Commission was the subject of Amendment A, which dealt with the use of complementary laws, and of resolutions by the Federal Senate, to regulate the provision in the constitutional text. According to the Commission, the use of two amendments was simply a recourse to legislative strategy, since Amendment A could, once approved, be incorporated into the text of the Constitution, while the integration of Amendment B into that text as it then stood would require extensive transpositions and renumbering of articles and other provisions that made it harder to understand. Hence the option to have Amendment B added to the Constitution was accompanied by repeal of anything that was in conflict.

The innovation introduced by Amendment A consisted of introducing rules that made certain that complementary laws would rank higher than ordinary laws, and regulating the conditions under which such laws could be proposed, the initiative for their proposal and the voting process. Since these were matters that regulated relations among the federal government, states, and municipalities, the initiative for and proposal of complementary laws dealing with taxation was attributed to the Executive Branch, to the Congress (by one-fourth of the members of either house) as well as to action by more than half the state legislative assemblies, each one by majority vote of its members. The other measure intended to furnish needed flexibility was the possibility that the complementary laws would give the Federal Senate the authority, by resolutions, to regulate tax subject matter that is of interest to the federation.

The Commission sought to use those measures to ensure the possibility that the constitutional distribution of responsibilities for tax collection and revenue sharing could be adjusted to changes in the nation's socioeconomic situation, to prevent changes in the composition and distribution of the tax bases and the population from contributing to an accumulation of disequilibria in the sharing of tax revenues among the states. That concern was reflected in the fact that the proposal for constitutional Amendment B used only one article and one paragraph to define the nature and characteristics of the state tax on the production and circulation of goods – the ICM. It is worthwhile to quote the tax of that proposal:

> Article 14 – It is the responsibility of the states, with due regard for the provision in Paragraph One of Article 17, to assess the tax on transactions related to the circulation of goods by merchants, industrialists and producers, except for exports to foreign countries.
>
> Paragraph One – The tax to which this article refers is:
>
> 1 – Uniform for all goods and does not exceed, in transactions destined for another State or for export to a foreign country, the limit stipulated in a resolution by the Federal Senate, as provided in complementary law;
>
> II – Not cumulative – the amount collected in preceding transactions by the same or another State is deducted from each transaction.

The distribution of the sphere of taxation corresponding to the production and circulation of goods was thus clearly drawn by the attribution to the federal government of the authority to tax manufactured products and to the states the power to tax the circulation of goods in general. The former was to take on the unique characteristics of a selective tax on consumption, and the latter would be a uniform tax on all goods. Both would adhere to the principle of non-cumulativeness.[17]

The ICM replaced the old state tax on sales and consignments (IVC) that had been instituted by the 1934 Constitution and was maintained, without major changes, in the constitutions of 1937 and 1946. One of the ICM's objectives was to correct an admitted distortion of the IVC, which was the taxation of interstate commerce. To correct this, the Commission proposal established that the Federal Senate, by resolution, would stipulate a ceiling on the rate applied to interstate transactions. The Commission also determined that its non-cumulativeness would extend to the tax collected in earlier stages, even if charged by a different state, so as to eliminate the interstate taxation by making it obligatory for the destination state to recognize the credit for tax paid in the state of origin. In the case of exports to other countries, the rate would apply only to stages prior to the export of the goods. This means that, in this initial version of the amendment that created the ICM, it had already been established that the tax would not burden exports, and that the credit for tax collected in previous stages would be preserved.[18]

With regard to the municipalities, the difficulty that they had in clearly defining the basis for calculating the Tax on Industries and Professions led them to adopt a practice that can be summed up as taxing the gross revenues of the activities, very often in the form of a surcharge on the tax paid to the State by the same taxpayer. In order to restrict the scope of incidence of the old municipal tax on industries and professions, the proposed constitutional amendment gave the municipality a tax on services of any kind—except transportation and communication services,

[17] Strictly speaking, the IPI—Tax on Manufactured Products—could not be classified as a tax on consumption, since although it adopted the model of a value added tax it did not extend to the stages subsequent to the manufacturing phase. But it did assume the features of a tax of that type because it employed selective rates that depended on the nature of the goods produced.
[18] Clearly that determination meant that the state that would export goods produced with inputs acquired in other states would bear the burden of the measure, since the question of the use of those credits had not been considered. That is why, as we will see later, the rule was soon modified.

which were reserved to the federal government's jurisdiction.[19] To offset the financial effects of the limitation imposed on the taxing authority of municipalities, the proposal included an obligation for the states to turn over to the municipalities 15 percent of the sum collected under the new state tax.[20]

One aspect of the proposed constitutional amendment is worth mentioning here: the preservation of the single taxes on fuels, lubricants, electricity, and ores that had existed before, known as "special taxes." The Commission believed that those taxes already resembled a tax system conceived on a national basis because it replaced all other state, municipal, and federal levies on those activities. The proceeds from its collection were shared with states and municipalities.

The idea of a national tax system was also reflected in the method adopted for distributing some of the revenue from the principal federal taxes to the states and municipalities. An innovative proposal for a constitutional amendment called for 20 percent of the revenue from the federal taxes on income and on manufactured products to be deposited in a States and Municipalities Participation Fund (Fundo de Participação de Estados e Municípios), a compensatory fund. Left for complementary law was the task of regulating the use of that fund, with the proviso that 60 percent of the resources in that fund were to be given to the states and 40 percent to the municipalities. The proposal also established an obligation for the beneficiaries to use on capital expenses at least 50 percent of the funds received. The purpose of this last requirement was to encourage the coordination of investment programs among the federal, state, and local governments so as to further the economic and social progress of the respective regions.

2.2 Modifications Introduced in the Original Proposal. Based on Suggestions Submitted

The Commission's proposal, as was to be expected given the magnitude of the changes it called for, was met with strong reactions, especially from representatives of the states, municipalities, and the productive sectors of the economy. With regard to the part that interests us here, which

[19] As we know today, what was to be a restriction on the scope of incidence of the municipal tax, since services were not at that time as important as they have since become, was transformed into a huge advantage.
[20] This rule was also intended to compensate those municipalities that were not state capitals for the deletion of the rule then in effect that had assured them 30 percent of the excess of what the state collected, in their territories, on total local revenues.

deals with taxation of production and circulation of goods, the criticisms of the initial proposal were based on the argument that the model adopted by the Commission was inconsistent with its declared premise of eliminating the superimposition of taxes that are economically identical.

The Commission's response to that criticism pointed to the fact that the model tries to lend a supplementary character to two taxes that were assessed at different phases of the production process. In that response, it was acknowledged that it would be better to invert the solution adopted by attributing the tax on production to the states and having the tax on circulation levied by the federal government, inasmuch as production was a localized taxable event, while the circulation of goods was dispersed throughout the whole country. However, that option would require that the tax on production be assessed only once, at a consolidated rate, which was not compatible with the economic conditions of that era.

Since a good part of the criticisms concealed a fact that to this day has been a source of conflict; that is, the resistance by states to giving up the right to tax exports, mainly when they were obliged to recognize the credit for taxes charged by other states in transactions prior to that exportation, the changes made by the Commission, in that case, were limited to deleting the proviso that state tax would not be assessed on transactions of exports to foreign countries.

The clout of the municipal interests in the tax debate was revealed in the breadth of the changes the Commission made in the original proposal as it responded to heavy pressure from entities that represented the municipalities. Municipalities argued that the authority to tax services would not be sufficient to offset the losses that municipalities would suffer with the abolition of the Tax on Industries and Professions. The new wording of the constitutional amendment maintained the authority of the municipalities to tax services, but they also gained the authority to employ a rate not higher than 20 percent of the rate adopted by the State, on the same base defined in state law for the ICM, but restricted to transactions occurring in the municipal territory, regardless of what had actually been collected by the state.[21] The new rule ratified the current practice, and established limits to prevent abuse in that area.

On the provisions that dealt with redistribution of revenues, criticisms referred to the loss of taxing autonomy by states and municipalities, but the complaints concentrated on the increase of the percentages to be shared. With the change mentioned above, the provision that ordered 15

[21] That rule anticipated suggestions contained in tax reform proposals to levy a municipal rate on the basis of a state tax that would combine the taxation of goods and services into a single tax.

percent of state revenue to be turned over to the municipalities was deleted and replaced by a new rule for participation in the state tax.

Another important modification was made in the Participation Fund. The new wording limited to 80 percent the federal government's share of Tax on Manufactured Products - IPI and Income Tax (IR) collections, and made the transfer of the remaining 20 percent to that fund independent of its inclusion in the federal budget. That same change split the fund into two: the States Participation Fund (FPE) and the Municipalities Participation Fund. Each one was to receive 10 percent of the revenue from those taxes. The automatic transfer of the funds to the beneficiaries was also guaranteed, and the obligation to use 50 percent of the funds on investments retained.

In order to give time for the tax administrations to get ready to assess the new tax, Amendment 18 established that the tax then in effect would be maintained until December 31, 1966, when it would be replaced. The amendment also established that replacement could be made gradually in 1967, 1968, and 1969, if the Complementary Law arranged it that way.

In the statement of justification that Minister of Finance Octávio Gouveia de Bulhões sent on November 1, 1965 to the President of Brazil along with the proposal for Constitutional Amendment No. 18, he emphasized the urgency of re-examining the taxes imposed in the federation in order to institute a system compatible with the requirements of Brazil's economic progress. He also pointed out that the multiplicity and accumulation of assessed taxes, despite their being formally separated, were a hindrance and a burden to production. And he mentioned that the number of obstacles to progress was becoming alarming. Does that sound familiar?

2.3 Regional Conflict and the Genetic Manipulation of the ICM

In addition to correcting the economic inefficiency of the former tax on sales and consignments, the change proposed by the Reform Commission sought to curb the fiscal competition that, as it observed in its report, had truly become a tax war among Brazilian states. At the root of that war was a vigorous effort to attract businesses, which fed the well-known regional rivalries.

Cascade taxes were the weapon of choice in this tax war. Since interstate commerce was taxed by the IVC, a state sought to attract producers of certain goods into its territory by reducing the rate applied to those products while, at the same time, raising the rate applied to products from outside the state. By standardizing the internal rate and extending the principle of non-cumulativeness to interstate commerce, adopting a uniform ceiling for application of the ICM to interstate transactions, the Commission proposal was intended to correct this problem.

But the Commission's own misgivings about the difficulties of sustaining a uniform rate for the ICM in a context of accentuated disparities among situations were soon manifested. The intention to adopt a single rate of 15 percent was soon abandoned and replaced by an 18 percent rate to be applied by the states in the North and Northeast, in order to make up for the fact that, because of the higher IVC rates already adopted in those regions, a single rate would put them at a disadvantage.[22] In that regard, it is worth quoting the following excerpt from the report by the Reform Commission:

> Despite the diversity of conditions among the various geo-economic regions of this country, the idea of stipulating, as an experiment, a single tax rate of 15 percent was suggested and ultimately adopted. This rate would be in effect in the tax systems of all units of the Federation (Art. 1(I) of decree-law No. 28 of November 14, 1966; Article 4 of Supplemental Act No. 27; and Article 6 of Supplemental Act No. 31, of December 8 and 28, 1966, respectively). Everything leads us to believe, however, that states belonging to the different geo-economic regions of this country will ultimately diversify the tax rates by adopting a multilateral convention, although within the limits of the federal law. The experiment with the single 15 percent rate is unlikely to be continued by all the states. The outcry already being heard is in favor of raising the rate to the maximum permitted by federal legislation.[23]

The process by which the proposal for the ICM degenerated can be divided into four phases, defined as a function of the political and economic factors that marked the option for the changes made in each of them. The first phase covered the period 1967-1979, and is marked by the initial years of consolidation of that tax and by the vigorous growth in collections resulting from the accelerated expansion of Brazil's economy. The second phase extends from 1980 to 1989, and covers the years of political distension that preceded the end of the military regime and the first four years of the government that assumed power after redemocratization.

The period 1990–1994 marked the third phase in the evolution of the ICMS. This was notable because of the implementation of the new rules adopted for collecting the state tax, now rebaptized as the ICMS, and its coexistence with the high rates of inflation that predominated at

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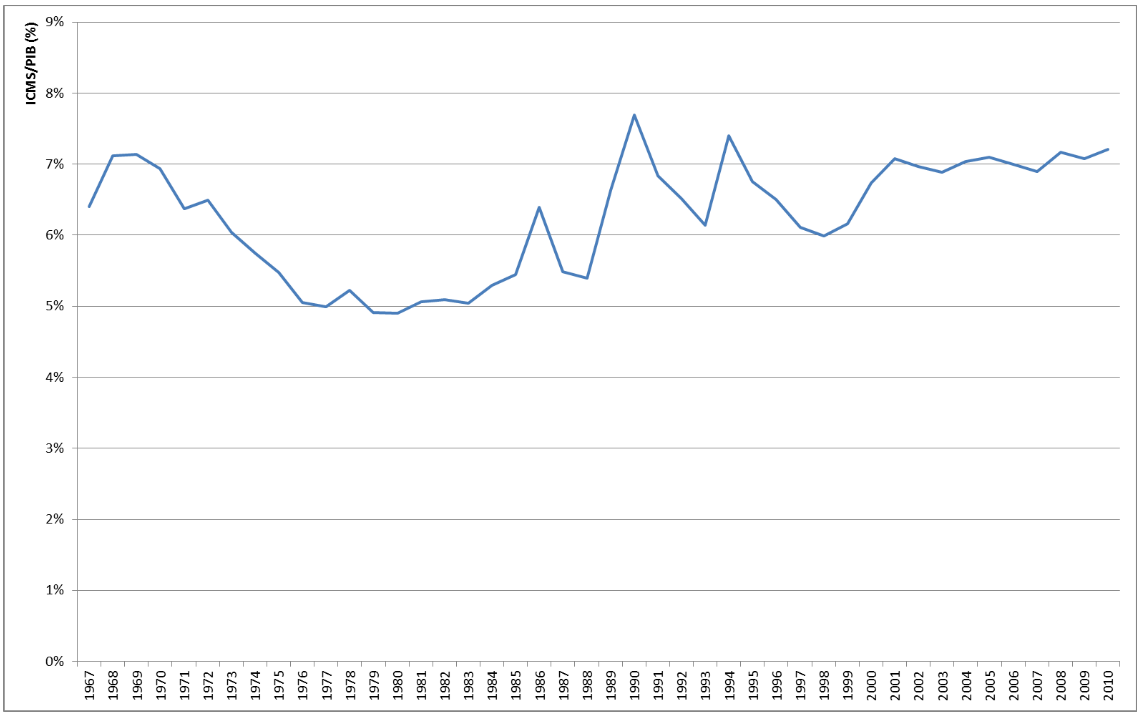
[22] Since those states had a limited productive base, a uniform rate would result in their collecting the ICM only on the margin added by local commerce.

[23]Getúlio Vargas Foundation, Ministry of Finance Reform Commission (1967).Final report, page 126.

the time. The current phase, which began in 1995, has as its principal features monetary stabilization, privatization of former government monopolies, and exacerbation of the tax war. ICM/ICMS receipts, as a percentage of national GDP, exhibited distinct behaviors during each of those phases, as Figure 2 shows. Some explanations for those differences are presented below.

Figure 2. ICMS Collections as a Percentage of National GDP: 1967–2010



1967–1979

The 1967 Constitution of Brazil retained the rules of Amendment 18/65, but with three important modifications. It extended to the Federal Senate the authority to act via resolutions to also establish ceilings on the ICM rates assessed on domestic operations as well as on exports. It reserved to the Office of President the initiative to propose those resolutions (Article 24(ii)(4). In addition, Supplemental Act 40, of December 30, 1968, established that the rates of that tax must be uniform for all goods in internal and interstate operations as well as for exports to other countries. The Senate retained its power to set ceilings on the rates for each of those operations.

It is true that the Commission recognized the fact that a concentration of productive activities in the southern part of Brazil would concentrate state tax revenues there and so it proposed the creation of a fund for state participation in federal revenues in order to compensate states whose economic basis was not large enough to generate a suitable volume of revenues on their own.

However, the technical soundness was not compatible with the sharp political rivalries and huge regional disparities among economies that prevailed at the time. Furthermore, the change meant a loss of autonomy in the realm of taxation that the states refused to accept. The elements considered in determination of the rate are not known. In theory, the rate to be applied when replacing a cumulative tax on sales with another tax that is non-cumulative would have to take into account data on the composition of the production chains, i.e., data on the number of stages traveled through until the final sale of the product, and the value added at each one of these. This entailed a lot of difficulty, because the substitution meant applying a uniform rate to the diversity of IVC rates assessed by the states. Since it is likely that the information available at the time did not produce a very reliable estimate, prudence recommended arbitrating values that would prevent problems from arising in the early months of adoption of that novelty.[24]

As was observed by Rezende (2009a), the states' fears that financial losses would result from the adopting of the ICM proved unfounded. Spurred by the calibration of the rate and the expansion of the economy, ICM revenues rose significantly in all states in the first year of the introduction of that tax, except in Amazonas, where at 11 percent the IVC rate had been the highest in the country. Total revenues rose about 60 percent in nominal terms, and this rate was easily exceeded in the Northeast (growth of 80 percent) and in the West Central region (100 percent growth).[25]

For the next five years, the expansion of the economy served to sustain high rates of growth in collections. In 1972, total ICM revenues more than quadrupled the amount collected in 1967.Increases on that order of magnitude were recorded in all regions, with the West Central and the South reporting somewhat higher indices and the North recovering from the initial losses recorded by the state of Amazonas. In the opposite direction, growth in revenues in the Northeast was slightly below average, which caused its share of total receipts to fall by 1.5 percentage points in that period (from 10.3 percent in 1967 to 8.9 percent in 1972).

[24] A rule of thumb might be based on the hypothesis that the goods would go through an average of three stages until final sale, which, taking into account the pattern of IVC rates, would lead to a rate of 15 percent to 18 percent.
[25] The intention to put an end to the fiscal competition among states by adoption of the ICM was not realized. With more fiscal space, the competition to attract investments was reactivated.

Despite the enormous gains experienced in all the states, the shrinkage in the Northeast's share of the ICM pie during the first years following introduction of the new tax sparked an intense debate centered on the loss that the new tax was bringing to Brazil's less developed regions. Lining up on opposite sides were the representatives of the states of the Northeast and those from the Southeast, led by the state of São Paulo.

The core of the arguments laid in the criterion adopted for taxing interstate operations. The application of a single rate of 15 percent to those transactions, as initially adopted, meant that most of the receipts from sales to other states remained with the producing state which, in the last analysis, entailed a transfer of income from consumers in the poorest states to the residents of the more developed states. The solution to that problem, representatives of the Northeast claimed, was to cut the interstate rate in half.

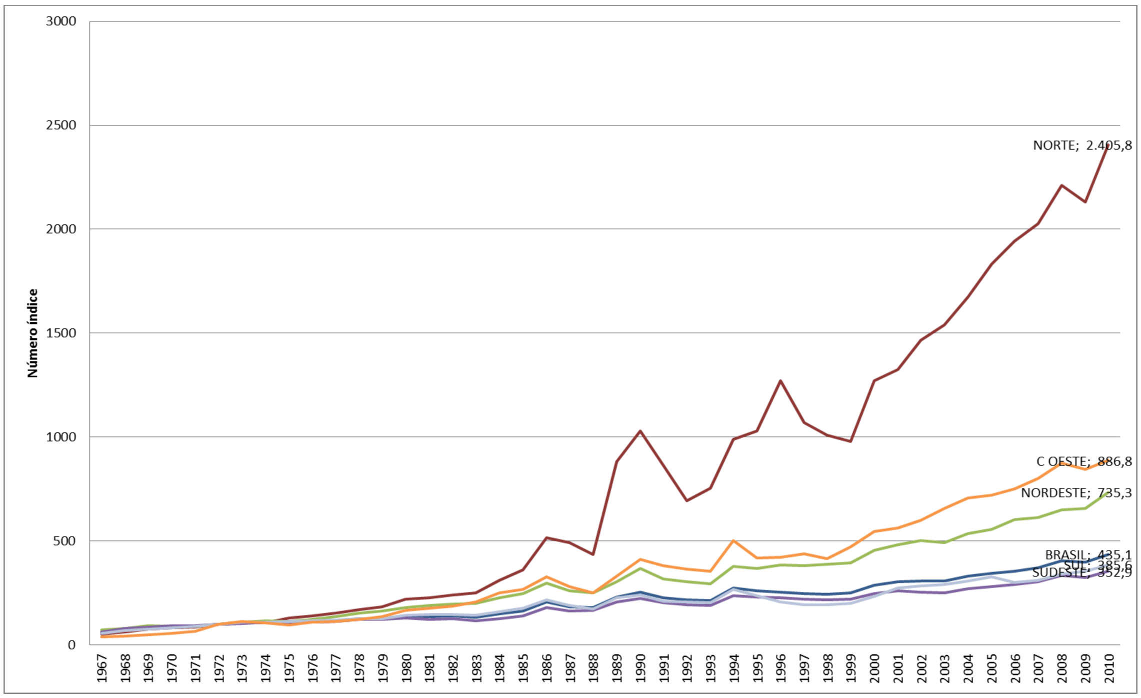
The temperature of the regional conflict increased with the publication, by the federal government, in 1968, of Decree-Law No. 406. It ordered that the ICMS not be charged on exports of manufactured products and, at the same time, raised to 17 percent the ICM rate applied to domestic operations in the states of the South and Southeast. Although it kept at 15 percent the rate applied to interstate operations in those regions, that decree-law added more fuel to the fires of regional conflict.

New palliative measures have been adopted since then, typical of the option for *ad hoc* changes to deal with problems in state taxation that has predominated throughout the history of the ICM, and still prevails these days. The dance of the tax rates was enlivened by the regional conflict and the performance of Brazil's economy. In the 1970s, the fine performance of the economy made it possible for the Federal Senate, in two successive rounds, to arrange for a gradual reduction in the internal ICM rates of a half percentage point per year. The first round (Resolution 65/70) caused the internal rates to fall to 16 percent in the North and Northeast and to 15 percent in the other regions, in 1974. In the second round (Resolution 58/73), those rates fell to 15 percent and 14 percent, respectively. In order to preserve the difference in favor of the less developed regions, the interstate rates fell to 12 percent in the first round and to 11 percent in the following round. The rate on exports was set at 13 percent.

With the strong expansion of the economy, ICM collections were able to support the reduction of the rates and still sustain real growth in revenues, although at a slower pace than obtained initially. The total collected as a percentage of GDP showed a significant decline, as

Figure 1 shows, but at 2010 prices, total revenue continued to rise, so that by the end of the 1970s, the total collected nationwide was much larger than reaped in the first year of effectiveness of the tax. Note that during this period the behavior of collections was similar in all regions, but that starting in the early 1980s, the less developed regions were gaining an advantage as the difference in the interstate rates was increasing (Figure 3).

Figure 3. Trend in ICM/ICMS Receipts at 2010 Prices: 1967 = 100

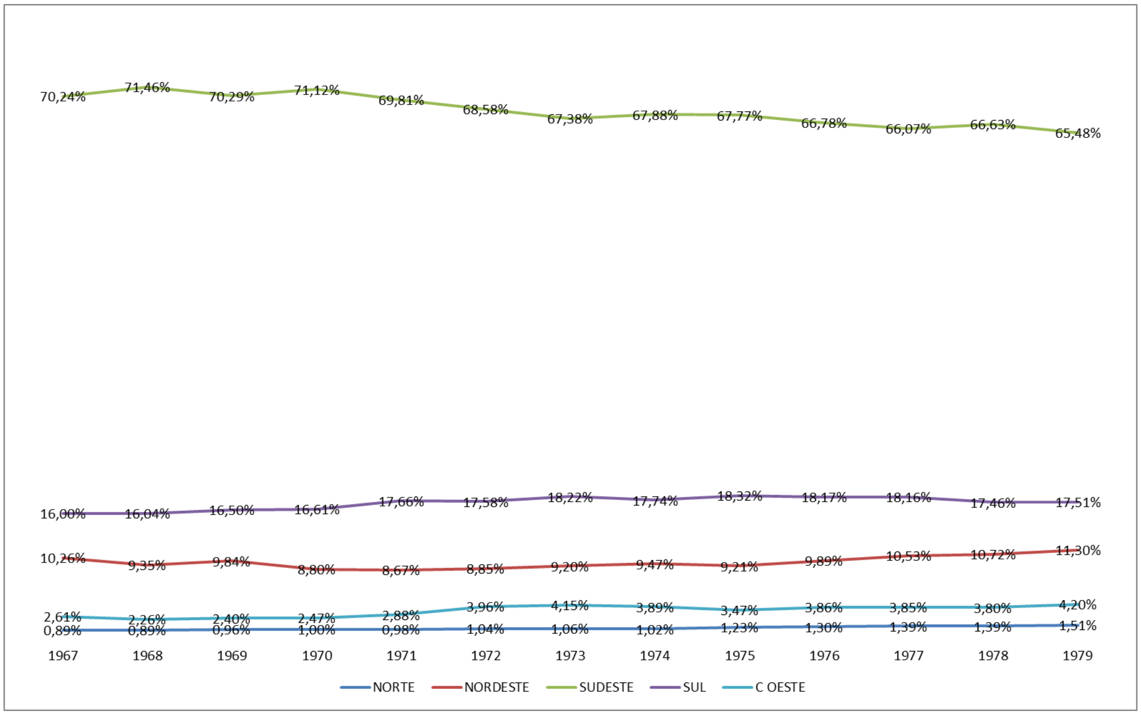


Notes: Vertical axis: *Index Number.*
Lines: Red: *North*; Orange: *West Central*; Green: *Northeast*; Dark blue: *Brazil as a whole*; Light blue: *South*; Purple: *Southeast*.

The reduction in interstate rates helped make the revenues received by the less developed regions grow at a faster pace, which made it possible to reduce by five percentage points the Southeast's share in total receipts at the end of the 1970s (Figure 4). However, that did not prevent the fiscal competition, which had resumed soon after the change in the state tax and despite the hope that the reform would put an end to that war, from continuing to expand.[26]

[26] As mentioned in a previous study (Rezende 2009a), only five years after the ICM took effect, fiscal incentives had already achieved significant figures, representing about 10 percent of the revenues of the state of Pernambuco in 1972.

Figure 4 – Participation by Regions in Total ICM Revenues – 1972-1979



Notes: Blue – North; Orange – Northeast; Green – Southeast; Purple – South; Light blue – West Central.

In an effort to curb competition among states that were using tax incentives to attract producers of goods, the federal government sponsored Supplemental Law No. 24, of 1975 (LC 24/75), that made it mandatory that conventions be signed between states when any kind of a tax benefit based on what was then the ICM was granted. These benefits included:

a) Exemption
b) Reduction in the basis for assessing the tax
c) Refund, full or partial, direct or indirect, whether or not conditional, of the tax to the taxpayer, to the responsible party, or to third parties
d) Concession of credits based on the presumed amount of tax owed
e) Any other tax incentives or fiscal or fiscal/financial favors granted on the basis of the Tax on Circulation of Goods from which results a reduction or elimination, direct or indirect, of the respective burden
f) Renewals and extensions of exemptions already in effect on the date the law took effect

LC 24/75 also established that the conventions be agreed upon at meetings, chaired by representatives of the federal government, to which representatives of all the states and the Federal District had been invited. The presence of representatives from most of the states was a condition for the holding of those meetings and it was stipulated that the granting of benefits would always require the unanimous decision of the states represented, and that the total or partial repeal of a benefit would require approval of at least four-fifths of the representatives in attendance.

Strictly speaking, the aforementioned law did not address the creation of a collegial body such as we see today. The purpose of that act was very specific: to create a rule that would restrict the states enjoyed in granting state tax incentives to taxpayers. According to LC 24/75, exemptions from ICM, as well as other benefits that would imply a reduction in the tax burden, came to depend on the unanimous approval by all the Brazilian states given at meetings convened and chaired by the federal government.[27]

Although LC 24 did not require that representatives of all states be present at the meetings, any convention that might be approved then would become valid only after formal or tacit ratification by all units in the Federation.

Failure to adhere to the provision of agreed conventions would result in annulment of the benefits thereof. Thus the tax credit would become ineffective and the tax would become due and payable. In addition, the Brazilian Audit Office (Tribunal de Contas) might argue that the state's accounts for that same year were not in order and so suspend payment of the quotas in the States Participation Fund (FPE).

Then, as now, the interruption in the fiscal competition generated pressure to ensure that benefits granted previously could still be enjoyed. And so LC 24 provided that benefits that had been granted under federal laws, or under national or regional conventions, would be maintained but stipulated that all the others would be revoked if not revalidated by the first convention to be signed under the terms of LC 24, which was to occur within 90 days of the date of its

[27] LC 24/75 did not mention the existence of a Council [such as CONFAZ]. At federal government initiative, representatives of the states would be convened by the government to decide on the granting or repeal of tax benefits.

publication.[28] To accomplish that revalidation, a quorum of 2/3 of the representatives was needed for either approval or ratification.

With the recovery by the states of autonomy to institute and legislate taxes in their realm of jurisdiction because of the reform accomplished by the 1988 Constitution, the discipline imposed by LC 24/75 started to crumble. Although the same rules had, at least formally, been retained, the iron hand that ruled the National Council on Financial Policy (Conselho Nacional de Política Fazendária, or CONFAZ) had been amputated. The federal government continued to manage the Council, but lacked an effective ability to resolve conflicts and conduct the decision-making process. This was more a sign of the impossibility of the states to reach agreement concerning a new format for that collegial body than of a collective willingness to grant the federal government the role of moderator of discussions and arbiter of disputes.

That view is implicit in the way that the bylaws of CONFAZ, in the version approved in 1997, defines its organizational structure. According to those bylaws, CONFAZ is composed of one representative from each state and the Federal District (their respective secretaries of finance) and one representative from the federal government (the Minister of Finance). The bylaws do not determine who should chair the council, although they mention, in some of their provisions, that it is up to the chairman, but no longer exclusively as before,[29] to call both regular and special meetings and that the meetings of the Council will be chaired by the Minister of Finance or his/her representative. They give us to understand, therefore, that the presence of the federal government is important in preserving the institution, but not to make it function as expected.

Indeed, the bylaws now in effect extrapolate the attributions that LC 24/75 had provided for regulating the granting of fiscal incentives by the states. According to the current bylaws, CONFAZ is formally assuming as its purpose the promotion of the harmonization of procedures and norms inherent in the exercise of taxing powers by the states, as well as collaboration with the federal government in matters related to the public debt and state financial institutions.[30]In practice, however, actions by the states are not guided by an effort to achieve harmonization. The differing procedures for recognizing the tax credits generated as a result of export transactions,

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[28] Except for benefits granted for specific time periods or by virtue of certain conditions that had already been incorporated into the taxpayer's legal property.

[29] Meetings may also be called by a minimum of one-third of the members of the council.

[30] Cooperation among the finance departments of the states for purposes of oversight of their respective taxes is provided for in the National Tax Code (Article 199).

the diversity of regimes applied to collection of the tax and, especially, the proliferation of benefits awarded outside the scope of the rules established by LC 24 reveal the inability of CONFAZ to achieve its objectives and replace the prevailing antagonism with a greater federative cohesiveness.

The truth is that the issue is more far-reaching and exceeds the ability of CONFAZ to deal with it. Ever since the Brazilian federation was formed, the regional question has been at the center of the debates about conflicts among its components, conflicts difficult to resolve in the absence of a regional development strategy conducted by the federal government. As we will see later, the dimensions of those conflicts increase when economic conditions expand the opportunities for investment and have taken on new contours since the economy was opened up and new and advanced technologies were applied to the production process. Without policies designed especially to address those questions, political realities are superimposed on the dictates of law, and the difficulty of enforcing the provisions in the laws allows the limitations contained therein to be circumvented. Fiscal competition policy needs to recognize the legitimate concerns of the political leaders of the less developed states about satisfaction of demands for urban job creation—demands that become more strident as the population becomes more urbanized.

1980–1989

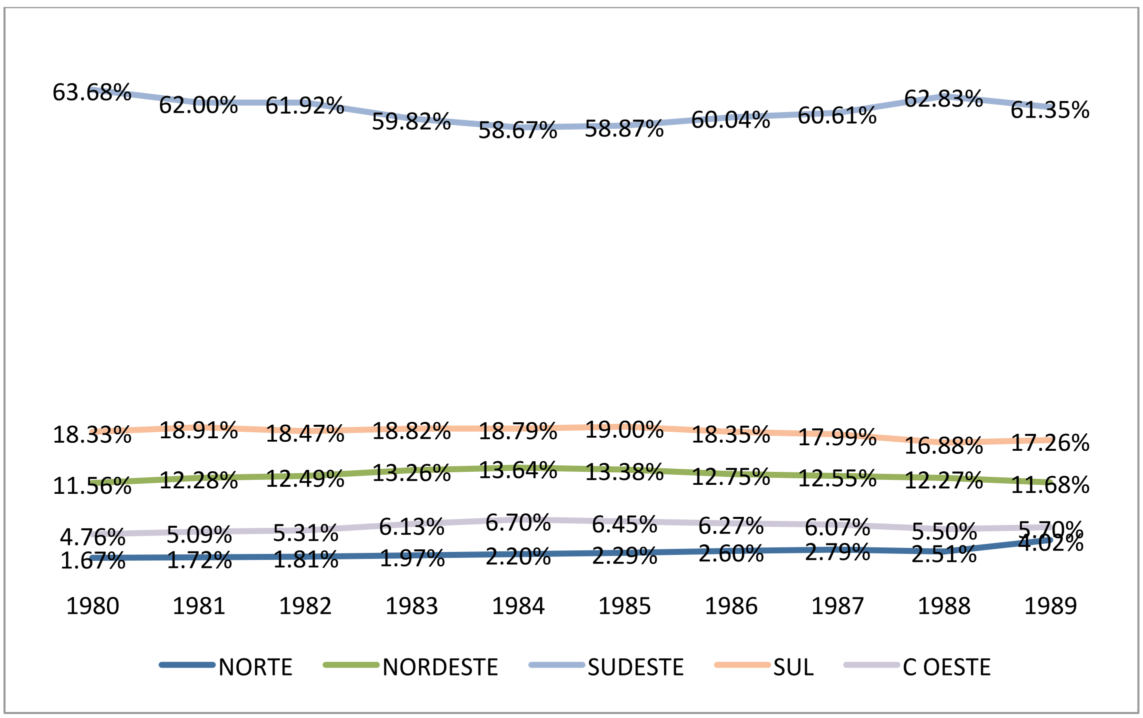
The outbreak of the economic crisis that extended through almost the entire decade of the 1980s and heavily impacted the revenues of the industrialized states reactivated the federative conflict and led to attempts to unify, at 16 percent, the interstate rate by means of a Senate Resolution as early as November 1979. But the reaction to that attempt provoked a new change. By Resolution No. 7 of April 22, 1980, the Federal Senate not only held the interstate rate at 11 percent but also introduced a differentiated rates regime for those transactions based on the origin and destination of the goods. That system is still in place today. According to that resolution, the rates applied to shipments of goods from the South and Southeast to other regions fell to 10 percent in 1980, 9.5 percent in 1981; and 9 percent starting in 1982. That resolution gave the state of Espírito Santo the same treatment as was given to the states of the North and Northeast.[31]

[31] According to an eyewitness, extension of that benefit to Espírito Santo was necessary to obtain the consent of the senators from that state to the proposed change. Another report by a privileged observer mentions that the states of the South/Southeast (except Espírito Santo) banded together to defend the proposal to adopt a reduced interstate rate only for inter-regional operations, which, in principle, would serve the interests of the so-called consumer states.

Now that the floodgates had been opened, new resolutions expanded the difference in interstate rates in interstate commerce. In 1983, the rate applied to goods leaving for destinations in the South and Southeast was raised to 12 percent, a level that was maintained by Resolution No. 22 of May 1989, which cut to 7 percent the rate applied to the shipment of goods from those regions to the other ones and took effect in 1990.[32]

The effect of the reduction in interstate rates on the behavior of regional ICM collections can be seen in Figures 5 and 6. The Southeast's share of total receipts fell to 60 percent and, even with a slight recovery, ended the decade at a level well below that reported at the end of the previous decade (1970s).

Figure 5 – Participation by Regions in Total ICMS Revenues – 1980-1989



Notes: Dark blue – North; Green – Northeast;– Light blue - Southeast; Orange – South; Purple – West Central.

The changes made during the 1980s reflect the transformation in the political scenario that resulted from the transition to democracy during the final period of the military regime, which

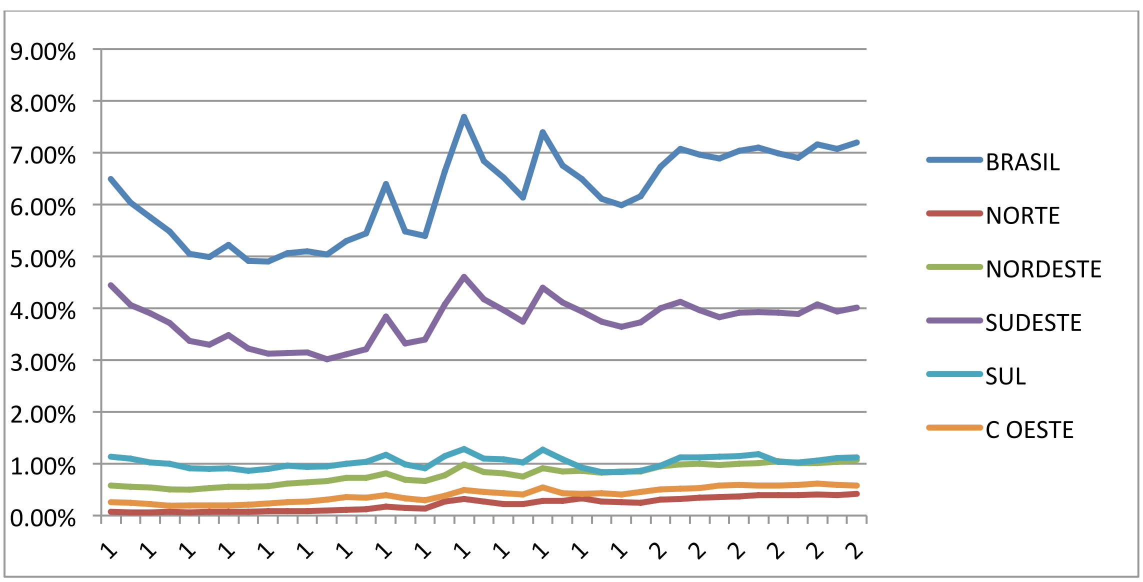
This proposal, however, was modified in the Senate, which adopted the rates that differ according to the direction of the inter-regional commerce, the system we are familiar with today.

[32] The broad majority held in the Senate by the delegations from the less developed regions facilitated the approval of that measure.

ended with the 1984 elections. Not by chance, the breach of the principle of uniform interstate rates, advocated by the 1965 Reform Commission, did not occur until 1980, when the demand by the less developed regions was met with a more receptive environment. The expansion of that benefit occurred in 1989, during the first term of office of a post-redemocratization president.

The lack of synchronization between the new political order and the economic situation marked the dance of the tax rates in the 1980s. The economic crisis that took hold during the early years of that decade lasted throughout it, except for a few moments of short-lived euphoria such as experienced in 1986 during the Cruzado Plan. As a result, in the first half of the decade, ICM collections remained at about 5 percent of GDP and did not manage to sustain the gains obtained in 1986. In 1988, when the work of the Constituent Assembly was coming to an end, that rate had already declined to near that level (see Figure 6), which reinforced the demand by states for an expansion of the base of that tax. Note that the decline in the ICM/GDP ratio seen until 1983 was almost exclusively due to the behavior of the Southeast region. The Northeast and West Central regions maintained an upward trajectory during the period.

Figure 6 – ICMS Receipts as a Percentage of GDP, by Region – 1972-2010



Notes: Dark blue – Brazil as a whole; Red - North; Green – Northeast;– Purple - Southeast; Light blue– South; Orange– West Central.

Expansion, in 1983, of the difference in the tax rates applied to inter-regional commerce enabled ICM receipts in the less developed regions to rise continuously as a percentage of national GDP throughout the period, while the participation of the Southeast and South did not stabilize until 2002.

Outside the dance of the tax rates, no sizeable change occurred in national rules during the first 21 years of the life of the ICM. That did not, however, prevent the proliferation of certain administrative practices that violated the original intent of a national tax by reducing the basis for determining the amount of tax owed, for example. Furthermore, the high rates of inflation recorded during the entire decade of the 1980s amplified the effect of the economic retraction on state revenues, which had already been falling since the end of the 1970s, especially in the South and Southeast.[33]

Because of the crisis that afflicted the Brazilian economy throughout the 1980s, investment plans were canceled or postponed, helping to disassemble the scenario that had fostered the increased aggressiveness of the tax war during the first half of the previous decade. In that environment, the willingness to confront changes in LC 24 or look for clever ways to circumvent its limitations cooled down, even during the phase of political distension and the first few years that followed redemocratization. However, the prolonged fast imposed by the law and maintained by the absence of favorable conditions whetted the appetite for competition, once more favorable conditions had been established.

1989–1995

The effects of the long economic crisis on state tax revenues were reflected in the debates on the reform of the tax chapter during the process of drafting the new (1988) Constitution. With the unexpected death of President-elect Tancredo Neves, the preliminary draft of the constitutional revision prepared by a committee chaired by Afonso Arinos was set aside and the drafting process then followed a completely different procedure.

[33] Following the 1988 reform, the regulation of the ICMS called for a shortening of the deadlines for paying the tax, in order to curb the corrosive effect of inflation on receipts, but actual adoption of that measure depended on the initiative of each state. According to reports obtained from experts in the field, this action was not taken in Paraná until 1994, thus shortly before the Real Plan. And in São Paulo, the provision for transforming the debts into São Paulo State Fiscal Units was adopted in 1989, but the plan to readjust the amount of the debts every two days was not implemented until 1994.

The creation by the federal government of the Tax Reform and Administrative-Political Decentralization Commission (CRETAD, or Comissão da Reforma Tributária e Descentralização Político-Administrativa) under the Ministry of Planning, which was given the responsibility for studying the tax regime and developing suggestions for revision of both taxes and the system of transfers, marked the intention to offer suggestions to the National Constituent Assembly on that subject. However, almost nothing that the commission proposed was used. What was included in the text, although not threatening the whole, ended up helping to generate distortions from the economic, regional, federative and social standpoints.[34]

With respect to the state tax, the analysis by that Commission attacked what was seen as the central problem with the ICM: the prevalence of a mixed regime for taxing interstate commerce that, although it was a birth defect, had gained new dimensions because of the *ad hoc* measures that had been adopted in the previous years. The solution, accepted by the majority of experts in the field, was to adopt the principle of destination for the imposition of that tax so that it would affect consumption rather than production. Besides correcting its economic inefficiency, such a change would foster gains in federative equilibrium, since the distribution of consumption is less concentrated than is the distribution of production.[35]

Note that the preference for a tax imposed on consumption was expressed during the era when the ICM was created, but it was acknowledged that the conditions of the time did not recommend its adoption just then. In order to circumvent the criticism that the adoption of the destination principle could open the way to tax evasion, given the difficulties of control and oversight, the paper produced by CRETAD proposed the adoption of a clever method intended to remove that risk (Varsano, 1987). It also recommended that the state tax incorporate services into its base. Once again the effort was made to adapt the tax system to a new economic reality in which services were occupying an increasingly important space in composition of the national product. To offset the loss that municipalities would suffer, such incorporation would be accompanied by an increase to 25 percent in the portion of the revenues from that tax that would be shared with the municipalities.

The adoption of the destination principle would permit a relaxation of the restriction of the autonomy of the states with respect to determination of the rates of that tax, since if the tax

[34] For an analysis of these distortions, consult Rezende et al (2007) and also Rezende (2009).
[35] The CRETAD proposals were published in a collection of texts by the Institute of Applied Economic Research - IPEA in 1987. A summary of them can be found in Rezende (2007).

were to be levied on consumption, an increase in rates by a given state would affect only its own residents and would, therefore, be subject to the political control by its citizens.

However, as usually happens, recommendations that make sense only if adopted as a group lead to disastrous results when just one of them is accepted. In this case, the states supported the grant of autonomy to define the internal rates of the ICMS, but rejected the idea that this be accompanied by the transition to the adoption of the destination principle. Coming simultaneously with an enlargement of the state tax base, that decision contributed to an expansion of the distortions of this tax and exacerbated conflicts among states.

In the first years that followed the change made by the 1988 Constitution, the fluctuations in receipts under the new tax reflected the instability of the economic and political situation of the times. After the constitutional provisions were fully implemented ,in 1989, ICMS revenues reacted positively in 1990, but could not sustain the recovery and declined, in 1993, to a level close to what had been achieved in 1989 (Figure 6).

The possibility that the states could legislate on the ICMS rates applied internally, while maintaining the mixed origin-destination regime used to collect that tax, aggravated the problem of taxing interstate commerce. Furthermore, the new rules applied to the taxation of interstate commerce helped increase the possibilities of tax evasion by encouraging the fraudulent practice of simulating sales of goods to states where the tax rate for interstate transactions was low, a practice that became known as the *passeio da nota fiscal* – or “taking the invoice for a walk. “In other cases, the difference in rates applied to interstate transactions came to encourage the displacement of marketing centers to regions farther away from the centers of consumption, which added inefficiency to the taxation.[36]

Even more serious was the use of tricks to circumvent the prohibitions against granting of incentives established in LC 24/75, referred to earlier. One of the most commonly used was to adopt the method of financing the payment of the tax, which predominated when the inflation rates were high. In short, the transaction amounted to recording on the books the tax owed by a company that had set up shop in the state because of the benefit, and then grant it long repayment

[36] Without violating the legislation, the differences in rates between states produced a significant gain for companies that moved to states of the less developed regions, since a product purchased in the South-Southeast at a rate of 7 percent returns to be sold to consumers in those states at a rate of 12 percent. In one landmark transaction, the government of the Federal District made an agreement with the Martins group to share the gains—five percentage points—that resulted from the difference in rates.

terms and special interest rates based on a fund administered by the state-owned financial institutions. In practice, this amounted to reducing to zero the tax owed.[37]

Since the tax debt had been recorded at the origin the taxpayer acquired the right to use that credit when he sells the product in the destination state, which then bore the burden of having to give up a portion of revenues because of a tax that, in practice, was not actually paid in another state. As a result, the consuming state was financing the production generated in another state, thereby feeding the federative conflict. Other practices adopted contrary to the legislation, such as the concept of "presumed credit," widely applied even today, generate similar effects.

The volume of litigation among states was growing, inasmuch as they were looking for new ways to fill the vacuum left by the failure of the federal government to apply policies intended to reduce regional disparities. Various ways to reduce the effective rate imposed internally, based on rules that are not always transparent, have made it practically impossible to reveal the true nature and magnitude of the benefits granted. As a result, meetings of the CONFAZ have become a mere stage show for complaints and disputes among states. The council has been stripped of any ability to mitigate conflicts and promote a harmonization of state tax policies.

During the first half of the 1990s, the economic situation prevented the conflict from expanding, because the demand for investments had fallen. Furthermore, the customary practice of holding down the tariffs of the public services produced by the state enterprises also prevented the collection of the ICMS from benefiting from the expansion of its base which, along with the impact of the policy of maintaining high interest rates in state budgets, limited the opportunities for boundless expansion of fiscal benefits.

The inflection point in the long trajectory of the decline in ICMS receipts occurred in 1994, as a result of the impact of privatization and of the dissemination of a 25 percent rate applied to the new sectors that were incorporated into the state tax base, as well as the expansion of simplified regimes for collection in order to close the loopholes that were contributing to tax evasion.

[37] With monetary stabilization, old ways to reduce the tax, such as prolonging the repayment terms were abandoned and new methods are being adopted. Among these are the credit presumed, or granted, and the almost complete discount given for payment of the tax prior to the due date—a date that had been artificially extended.

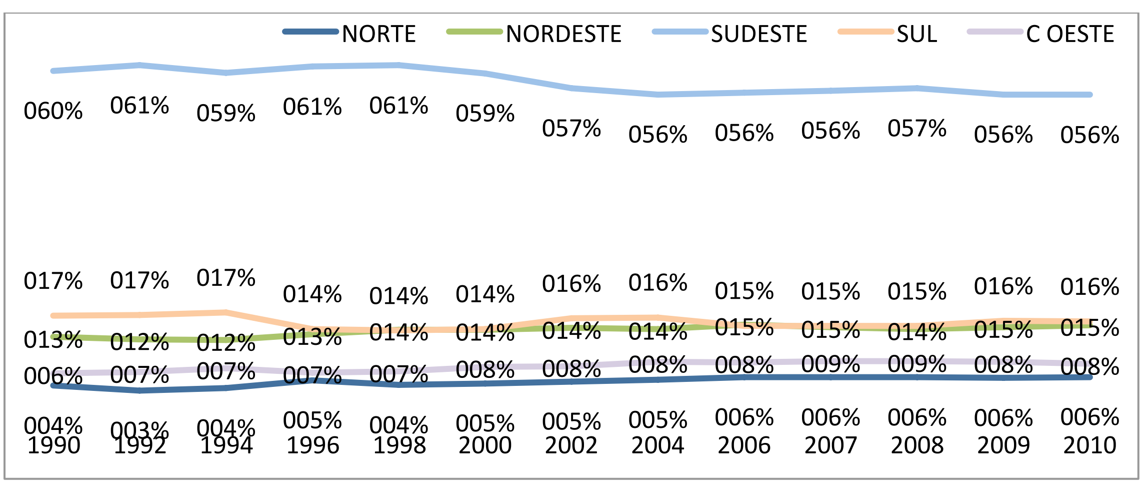
1995–2010

The past 15 years marked a new period in the history of the ICMS. The principal events that have helped the behavior of the ICMS diverge from that of its earlier periods are the following (not in order of importance):

a) Privatization of state-owned enterprises in the fields of energy and telecommunications, and adoption of new rules for the fuels industry
b) Passage of Supplemental Law 87, of 1996, known as the Kandir Law
c) Adoption of the Real Plan (*Plano Real*) and the new monetary stabilization policy
d) Reactivation of the economy, albeit in fits and starts.

The impact of the privatization of public services greatly enhanced the effect of the high ICMS rates imposed on those sectors. Along with the increase in tariffs—above the rate of inflation—these rates made it possible, in only two years (1994 and 1995), for state revenues to recover all the losses they had accumulated in the two previous decades. Receipts declined again with the crisis that broke out at the end of the 1990s, returning to the level of 7 percent of GDP that was recorded in the early years of the creation of the ICM, starting in 2002 (Figure 6). Note that throughout that period, the less developed regions experienced an increase of about two percentage points each in their share of total ICMS revenues, while at the same time the South and Southeast lost some of their position (Figure 7).

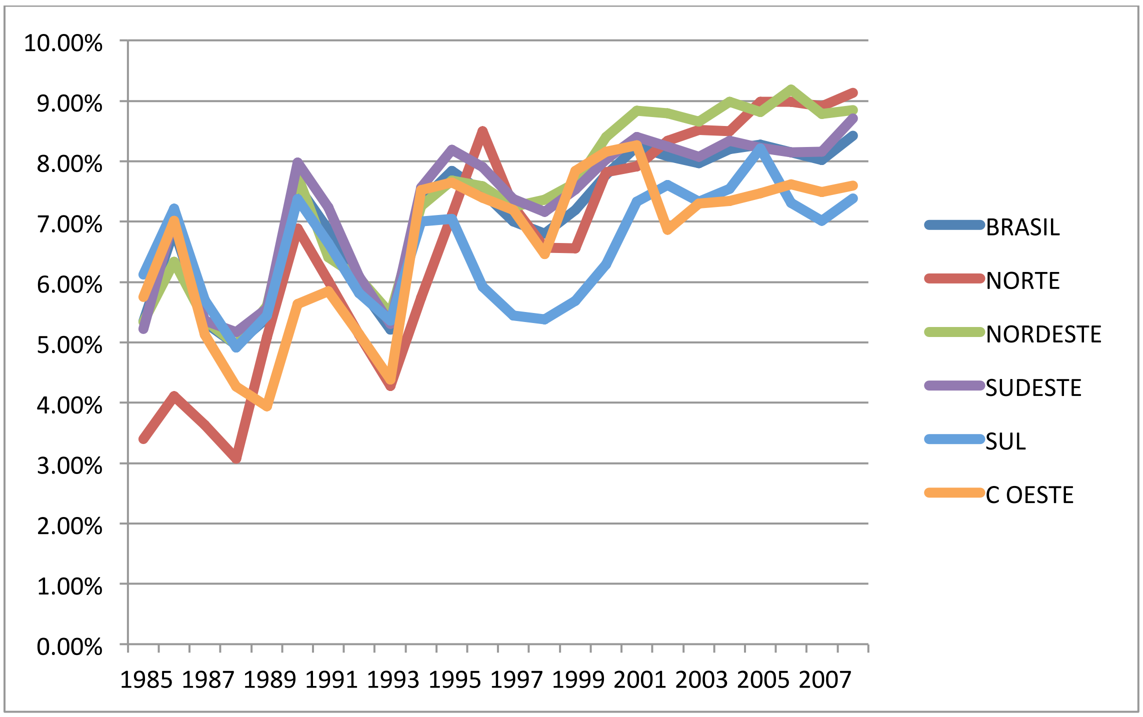
Figure 7 – Participation by Regions in Total ICMS Revenues – 1990-2010



[Key] Blue – North; Green – Northeast; Light blue – Southeast; Orange – South; Purple – West Central

Two important consequences of that process were the opportunities for expansion of fiscal benefits, and the gradual concentration of collections of that tax in sectors of high fiscal productivity. In the first case, expansion of receipts enabled the states to build up their weapons for the fiscal war, which by then extended into the retail trade and, more recently, to imports.[38] In the second case, state revenues were moving further and further from state GDP, so that differences in the economic base were not reproduced in the form of differences in tax bases. ICMS revenues as a percentage of regional GDP were converging (Figure 8).

Figure 8 – ICMS Receipts per Region, as a Percent of Regional GDP



[Key] Dark Blue – Brazil as a whole; Red – North; Green – Northeast; Purple – Southeast; Light blue – South; Orange – West Central.

In large part, the distancing of ICMS receipts from state GDP reflects the concentration of state revenues among the so-called "blue chips" (energy, fuels, and telecommunications) and the increased recourse to simplified mechanisms for collecting the ICMS from small and micro-enterprises is not very significant in national terms but are gaining prominence in the less developed states. Additionally, even though the ICMS is assessed directly only on

[38] Additionally, it also enabled states to extract political advantages with the reduction to 7 percent of the tax rate applied to the basic goods consumed by Brazilian poor families.

telecommunications and interstate and intercity transportation services,[39].since the other services "of any nature" are taxed by the municipalities, in practice all the services used in producing manufactured goods are being taxed because they do not generate ICMS credits.[40] And that effect is even greater in sectors where energy, fuels, and telecommunications are used intensively. This is because of the extremely high tax rates applied to those sectors, and the widespread use of those inputs throughout the entire cycle of production and marketing of goods and services.[41]

Enactment of Supplemental Law 87/96, known as the Kandir Law, also affected the trajectory of the ICMS during that period. The 1988 Constitution maintained the exemption on exports of manufactured products that had been adopted in 1968, but in the case of products classified as semi-finished, the exemption depended on them not being included on the list of those that could not enjoy that benefit as required by the complementary law. Furthermore, exports of primary products remained subject to ICMS. This situation was not only a source of distortions, but sparked conflicts arising out of the difficulty of clearly distinguishing semi-finished from manufactured products..[42]

The Kandir Law sought to solve that problem.[43] The exemption from state tax granted to exports to foreign countries contemplated in the original proposal by the 1965 Tax Reform Commission was not approved at the time, because of resistance by the states. The 1988 Constitution took one more step in that direction, but did not complete the journey. In the constitutional plan, Constitutional Amendment No 42, of 2003, resolved the matter. However, in practice, the full exemption for exports is still limited by the difficulties that an exporter faces in using the credits accumulated during the transactions that preceded the sale to another country.

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[39] In the case of transportation, the ICMS applies to interstate and intercity transportation, by any means, of persons, property, merchandise, or valuables.

[40] All services that do not appear on the list of those that are taxed by municipalities indirectly increase the ICMS revenues because of the constitutional rule that establishes that the ICMS is assessed on the total value of a transaction when the merchandise is furnished along with services that do not fall within the taxing authority of the municipalities.

[41].This means that the usual expectations as to the substantial gains in collection that could result from the joint taxation of all goods and services may be unfounded, but the gains from the standpoint of the economic efficiency of taxation and the contribution to economic growth should more than offset small financial gains over the medium term.

[42] The exemption for exports could be extended, by supplemental law, to services and other products not explicitly referred to in the Constitution

[43] The Kandir Act ordered that exports be completely free of the tax, thereby eliminating conflicts that stemmed from the fact that it had been up to CONFAZ to define the rules applicable to semi-finished products.

The most important impacts of the Kandir Law were economic and federative. The impact on state revenues was still significant, although it affected to a lesser extent certain states that had a strong export-oriented agricultural and mining base.[44] In the economic field, the combination of the non-assessment of tax on sales abroad and the levies against interstate sales severed important links in the production chains and helped reduce the value added in the exportation of products derived from the exploitation of natural resources. In the federative realm, the measure fed the conflict among states, both because of the incentive it provided to the displacement of the activity of processing natural products toward the farming phase (when not displacing it to other countries), and for the friction it provoked in relationships between the states and the federal government with respect to compensations for losses in revenues suffered by the states, thereby exacerbating the atmosphere of distrust that hindered the reaching of agreements about tax reforms.

Another important measure promoted by the Kandir Law was the granting of credits on the purchase of capital goods and goods intended for use and consumption, thereby correcting an unsatisfactory situation that dates back to the origins of the tax. However, the actual use of ICMS credits generated on purchases of equipment and other goods incorporated into fixed assets suffers limitations resulting from the concentration of the production of those goods in a few developed states, since it is the purchasing state that must grant the credit. Complementary Law 200/2000 stipulated that those credits be made available in 48 monthly installments, but the application of that rule is still subject to separate rules adopted by the destination states in order to assist or encourage local production or importation.[45] Furthermore, the decision to grant credits on goods intended for use or consumption has been repeatedly postponed.[46]

The Kandir Law is a good example of how the benefits from a favorable measure did not materialize, inasmuch as it was not accompanied by additional actions to prevent undesirable

[44] For the states as a group, the volume of exemptions on exports of agricultural and semi-finished products, as well as of capital goods incorporated into fixed assets, stood at about 10 percent of the total collected, according to estimates by the Mato Grosso do Sul State Finance Department that were presented at a CONFAZ seminar.
[45] Some states are said to be granting immediate credit, or adopting the deferral associated with the debiting, in 48 installments, of the payment of ICMS when the goods were purchased in the same state or imported from abroad.
[46] In addition to diluting the credit pertaining to the purchase of capital goods, LC 102/2000 also prohibited the ICMS credit from being used on purchases of communications services, unless that purchase results in a product for export, and limited the electricity credit to power consumed directly in the industrial process or when its consumption results in a product for export. The use of those credits is being postponed in the same way as that of the goods intended for use and consumption. The most recent postponement was made by LC 138/2010 that extended the suspension of its use until December 2019.

side effects. In the economic realm, the impact of the monetary stabilization policy on states originated with the changes in national tax policy that stemmed from the requirements of the fiscal adjustment undertaken after the 1998 crisis. In that year, Brazil faced an external crisis that led to adoption of a major program of adjustment of government accounts that was, essentially, supported by the expansion of federal government tax revenues. Recourse to mandatory "social contributions" (*contribuições socias*) to achieve the primary surplus generation targets required since then served to overturn the rule established in 1988, which had reserved to the states exclusively the taxation of fuels, electricity, and telecommunications. Consequently, other taxes also came to be assessed on those industries, such as the Economic Intervention Contribution – CIDE (Contribuição de Intervenção do Domínio Econômico) imposed on imports of fuels, and fees created to finance the regulatory agencies of other sectors of the economy.

The consequence of the re-occupation, by the federal government, of that taxing "space" was the placement of additional burdens on industries that supply inputs that are of strategic importance for the entire productive sector, making production more expensive and depriving Brazil of competitiveness. To some extent, the impact of that measure on state revenues has softened in recent years, in light of the growth in world demand for agricultural and mineral commodities and the enormous natural advantages that Brazil has in those areas. However, it is not very likely that there is room for any new increases in the tax burden now borne by fuels, electricity, and communications.[47] On the contrary, it is more likely that it will be necessary to reduce that burden, once again putting the states and the federal government in competition with each other to tax those bases. Since revenue from the social contributions is tied to the social sectors of the economy, the conflict is not only a federative one, but involves actors that are well mobilized to defend the financial guarantees of social rights assured by the Constitution.

The occupation of the state taxation arena resulting from the accelerated growth in social contributions was not limited to the three industries mentioned above. As the tax rates under the Contributions for Financing Social Security, PIS and COFINS have risen to accommodate the increase in spending by the federal government, as well as to generate high primary surpluses, the states' option to concentrate collection on a half dozen products, largely to sustain the tax war, has allowed the federal government to invade the tax territory that had been reserved to the

[47] Although exports of agricultural and mineral commodities are not taxed, their contribution to the growth of the Brazilian economy in recent years has had a positive repercussion on state revenues.

ICMS, thus transferring to the taxpayer the burden created by the multiplication of tax incidences on the production and circulation of goods and services.

The corollary to those changes created a shrinkage of the states' share of the national tax pie and a limitation on their ability to regain lost ground. As demonstrated in an earlier study (Rezende 2007), the states' share of the national tax pie declined by three percentage points between the start of the 1990s and the first half of the 2000s, contrasting with the increase in the share held by municipalities and the recovery of the losses that the federal government had suffered in the wake of the 1988 reform.

The maneuvers adopted to sustain state tax collections in the past 15 years (concentration of receipts in a few sectors and adoption of special tax regimes) were only sufficient to maintain ICMS collections at the 7 percent of GDP level that had been achieved in the initial moments following the birth of the ICM (Figure 2). Now that the possibilities for continuing to expand the use of those expedients have been exhausted, the need to revisit the strategy pursued during that period is blatantly obvious. As part of that review, it will be vital to find answers to the question of whether it is possible to regain the space that, having been abandoned, has been occupied by federal taxes, and how to cope with the increasing difficulty of drawing boundaries to mark the territories into which the authority to tax goods and services is divided.

There is another component in the ICMS saga that needs to be properly emphasized. I refer to the importance that administration of that tax has acquired in the exercise of state policy. As we have seen, the history of this tax has always been closely associated with regional and interstate disparities that have intensified as the federal government has failed to play an active role in promoting a reduction in the imbalances among states. At the same time, rapid urbanization has dumped a numerous contingent of young people into Brazil's cities in search of work and better living conditions. In a context of greater political openness and fragmentation of party politics, these youths are putting pressure on government officials and demanding actions that can meet their needs.

With rigid budgets and almost no room to legislate on other areas of public policy, state leaders are left with recourse to the only instrument on which they enjoy a certain amount of autonomy to make politically advantageous decisions—the granting of fiscal benefits to attract investments and thus to satisfy, if only partially and by violating provisions of law, the expectations of their citizens. In this context, any proposal to change the current situation that ignores the political component in the role the ICMS has assumed is doomed to failure.

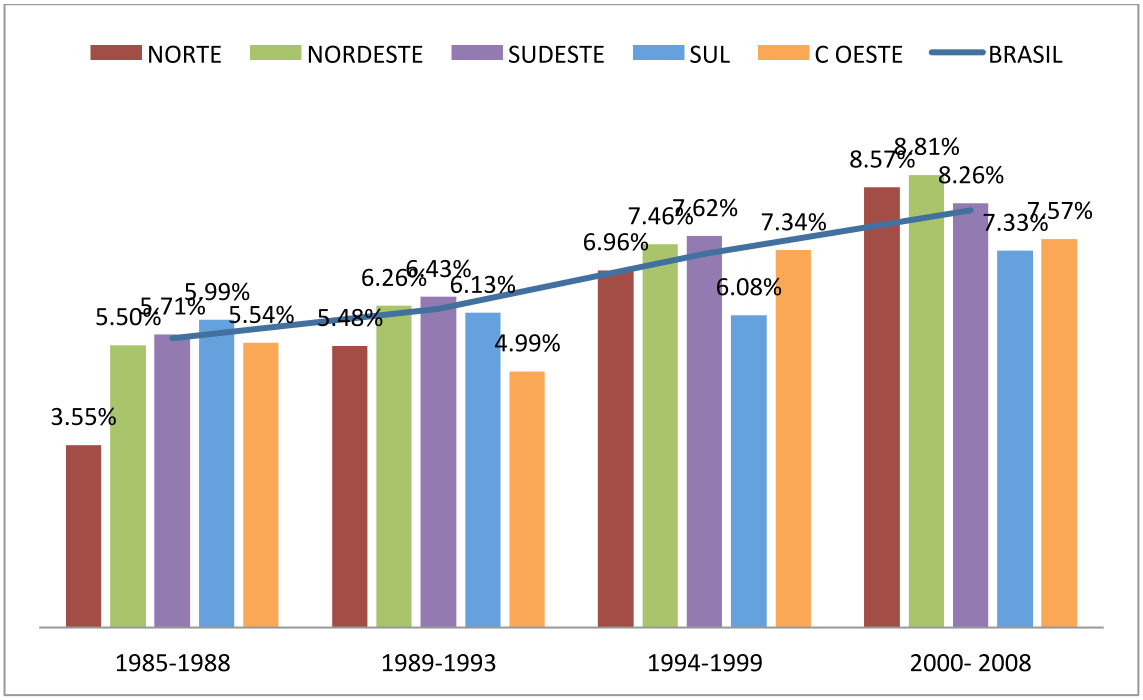
3. The Present Situation – What is the Future of the ICMS?

The disfiguration of the model as originally conceived led to a situation in which the agenda of the debates on the ICMS is becoming more and more complex. As we have seen, over the years that tax has been losing all the features of its predecessor and becoming something impossible to describe, so many are the methods used to collect the tax, and so numerous the economic distortions it brings with it, not to mention the maneuvers by the states to attract businesses without bearing the onus of those practices.

As the ICMS has moved further from its theoretical image, the revenue it generates has become detached from the value added by regional economies. The concentration of the tax bases on basic inputs,[48]the expansion of special regimes applied to small business, and the proliferation of the practice of tax substitution have helped produce a pasteurized blend that has been distributed more or less homogenously over the Brazilian territory. The term homogenous, properly understood, is applicable in relative terms, since the ratio between each region's receipts and its respective GDP has been converging, without regard to the enormous differences among regional productive structures and the present diversity among tax rates (Figure 9).

[48] The use of those inputs in the production process generates ICMS credits, but not all these credits can be used because of the high tax rates assessed against those inputs, the portion incorporated into exported products (that depend on their use), the part used in the production of services, and the part purchased by companies that qualify for simplified collection regimes.

Figure 9. Trend in the Ratio Between ICMS Revenues and GDP, by Region



[Key] Red – North; Green – Northeast; Purple – Southeast; Light blue – South; Orange – West Central; Dark Blue – Brazil as a whole.

As a result, the business cycle has a less significant impact on state revenues. This affects the dynamism of the collection process, which may perform better when the economy slows (although the change in GDP in 2009 was negative, ICMS revenues remained virtually unchanged), but generate the opposite effect when the economy enters an expansionist cycle. In that case, the state tax anchor, represented by the "blue chips," would prop up collections in hard times but could hold back the growth in good times.

The behavior of the ICMS accompanies the erosion of the base of incidence of this tax that results from the growing importance of services in the nation's income and the advance of new technologies in trade, manufacturing, and telecommunications. These factors provoke internal conflicts such as the dispute over the appropriation of revenues derived from e-commerce. They also creates a possibility that tax bases will be exported to other countries—right next door or very far away—by the transfer of parts of the process by which goods are produced and services rendered.

The erosion caused by the export of tax bases is stimulated by the intensification of the tax war in the context of a liberalized economy. The most recent example of this is the granting of incentives on imports. Apart from the federative battle, this development has serious macroeconomic and social implications. There is no incentive to attract export-oriented industries, because not only do they not generate revenues for the states but also they increase the problems encountered with the use of the credits that were earned on the inputs acquired internally to produce the exported goods. Nor is there any interest in consolidating the nation's production chains, since the exporting state would have to honor the credits for taxes paid in some other part of the country. Better to attract automobile assembly plants or electronics manufacturers that bring parts and components from abroad, even though they accelerate the denationalization of a large part of the Brazilian production complex.

The macroeconomic implications go beyond something that is already a serious problem: that is, the contribution to the deterioration of the balance of trade. If the current rules and behavior are maintained, a negative trade balance will be beneficial to state revenues in the short run but, by compromising the growth of the economy, it is a guarantee of future losses. This and other aspects of this tax that impair competitiveness and economic growth, such as the tax burden on basic inputs and the absence of full tax exemptions for investments and exports, have led the Brazilian economy into a low-growth trap. That trap takes the form of an inhibition of investments and exports, which means that growth in GDP depends on the expansion of domestic consumption, which is also required to offset the increase in imports. Without an expansion of investments, production capacity does not grow fast enough to prevent the expansion in consumption from creating inflationary pressures. This means that expansionist cycles are short, since the threat that inflation may get out of control leads the government to take steps to cool off the economy.

Under this scenario, the effort to bring about the *ad hoc* changes that are on the agenda of an ICMS reform faces enormous difficulties, such as the need to end the tax war and arrange for full exemption of investments and exports from tax, because the impact of the reform on state finances cannot easily be absorbed without a good dose of compensations from the federal government. And this is where the problem lies. Since the impact is differentiated, the conflicts are bitter and the basis for developing reliable estimates is precarious.[49] The tendency is for the bill to be submitted by the states to adopt the highest figure, in order to avoid surprises.

[49] With the progress in implementation of the electronic invoice (*nota fiscal eletrônica*) the problem created by the absence of reliability of data to make these estimates become less significant.

Furthermore, in light of the distrust that developed around the compensations of the Kandir Law, the method used to process the compensations poses yet another challenge in the negotiations.

If Brazil is to escape the trap that encircles the negotiations about figures and procedures, the focus of the debates will have to be broadened and lengthened. It is important that the debate about the ICMS goes beyond the narrow boundaries of the fiscal issue in order to incorporate the economic, federative, and social dimensions associated with it. Since the possibility of further increases in the tax rates applied to the "blue chips" is remote, and the battle for space in the realm of the ICMS tax is heating up, maintenance of the states' share of the national tax pie during the next two decades is at risk.

The outlook is particularly severe for the less developed regions. Given the firmness of the intention now demonstrated by Brazil's Supreme Court to put an end to illegal granting of tax benefits, and the intervention by the Office of the Public Prosecutors, which has pointed to the social harm done by waivers of the requirement to pay taxes, legal uncertainty is growing and the willingness of businessmen to sign up for incentive programs when deciding where to put their investments is declining, or even disappearing. Furthermore, if circumstances change so that contracts assumed in the past cannot be maintained in force on the same terms as agreed, there is a real risk that enterprises that set up in those regions will shut down or move elsewhere.

The prospect that Brazil may be imprisoned in a low-growth tax trap needs to be fully understood by its national political leaders. It is clear that the problem lies not simply with the ICMS, but it is the most difficult one to solve, since it involves bitter disputes among states. And it is exactly because of this situation that a fragmented discussion of aspects of the ICMS is very unlikely to prosper.

Despite appearances, an agreement about a reduction in the tax rates applied to interstate operations is far from being achieved. Proposals to abandon what was decided in 1980, with the introduction of the differential in interstate rates based on the geography of the interstate commerce, would be resisted by interests that have been crystalized for more than two decades..
In this regard, any proposal to reduce interstate tax rates that would eliminate the 5 percent differential on trade between the less developed regions and the others seems to have little chance of success, as is indicated by the position now championed by the states in the North, Northeast, and West Central to set at 2 percent the basic ICMS rate on interstate commerce,

while maintaining a 7 percent rate for shipments of goods from those regions to the other parts of Brazil. With no alternative in sight, the option is to keep a firm grip on the prevailing situation.

A reduction in interstate rates would lessen the problem associated with the accumulation of credits that results from the purchase of inputs and capital goods in other states, thus benefiting exports and investments in the less developed regions, but would increase the accumulation of problematic credits in the more developed states in the event that the majority of a state's production is destined for sale in other states, because of the difference between the internal and interstate rates.

The arguments by those who defend the differential in the rates applied to inter-regional commerce are economically and politically important. If that difference were abolished, the incentive that the tax barrier now affords to shift the processing of agricultural production closer to the regions where the agricultural frontier is expanding will be significantly less attractive, and perhaps not sufficient to offset the costs of logistics and distribution. Similarly, the chances of relocating productive activities, if the prospect for reduction in the tax benefits is not accompanied by specific actions to reduce the negative externalities, such as deficiencies in infrastructure and labor skills, would be greater. In the proposal mentioned above, the cost of the investments in the less developed regions would benefit from a more expeditious use of credits earned from purchases of equipment in the other regions, which could help the national industry of those goods.

Strictly speaking, the dispute over the reduction in interstate rates encloses questions that are much more profound than the exhibition of figures that are hard to verify about losses and gains in revenue resulting from such a change.[50] Even those states that would probably see financial gains may decide that the economic and political losses that would result from a measure of that nature may be greater than those gains, unless they can gain from both sides. In the environment of fervent antagonisms that have been accentuated over the years, regional interests trump national interests, and render unfeasible any change that does not contemplate an alternative to that dilemma.

Another item on the ICMS agenda deals with appropriation of the revenues that are obtained from sales processed by e-commerce. Strictly speaking, this question is part of a

[50] The use of information gleaned from electronic invoices makes it possible to refine the estimates of financial gains and losses, but also has flaws, such as the overestimation of losses, resulting from the entry into the account books of a tax that was not actually collected, or was refunded.

broader topic that refers back to the constitutional provision that requires that the tax on sales to non-ICMS taxpayers must be collected at the origin. The question should not, therefore, be treated separately. If the proposal is to transfer the bulk (or all) of the collection to the consumer states, it is important to examine what is happening with other operations of that type.

With the expansion of services, sales to non-ICMS taxpayers are rising, in a direction that seems to be the opposite of what we are seeing in e-commerce. This is because of the concentration of modern services in the more developed regions of this country. It does not make sense, therefore, to adopt yet another casuistry when the intent is to rationalize collection of the ICMS. Since any change would involve a redistribution of revenues among states, it is important that these aspects be addressed together.

A question that has not yet been officially placed on the agenda for discussions about the ICMS deals with the erosion of one of the most important bases of the ICMS: telecommunications services, which were responsible for the addition of the "S" to the old ICM. During the drafting of the 1988 Constitution, the inclusion of some services in the ICM was based only on the argument that the old single taxes on fuels, energy, communications and interstate transportation should be incorporated into the tax that the states had authority to levy, in order to expand the base of incidence of that tax.[51] No one anticipated the changes that have occurred in the way those services are provided because of the rapid advance of new technologies.

It is worth repeating that the states imposed high rates on telecommunications and energy in order to be able to tax, indirectly, the services sector, principally the modern services that used those inputs intensively. While communication services were almost exclusively produced domestically, high rates did not threaten the volume of collections, although they might impair the competitiveness of certain sectors. However, as technology made it possible to import some of those services, and new forms of internal communication overflowed the traditional frontiers of ICMS incidence, maintenance of high tax rates begins to erode collections. The impact still seems to be minor, but the subject has already awakened the interests of the state secretaries of finance.

[51] The technical justification was that inclusion of those bases in the ICMS would make it possible to eliminate the cumulativeness derived from the adoption of independent tax regimes for those inputs, but political adherents to that proposal were focusing instead on the prospect of obtaining significant gains in collections.

Paradoxically, however, the deteriorating outlook may generate an environment that is more favorable to negotiation. As the intensification of the conflicts comes to be perceived as a circumstance under which everyone loses, the willingness to negotiate may gradually gain adherents. If this is to happen, however, the federal government must assume leadership of the debate, and that discussion must go beyond the bounds of consideration of fiscal impacts from an accountant's standpoint, to involve political leaders and others actors whose interests are being harmed by the delay in promoting the necessary reforms.

4. What are the Possibilities and Paths for its Recuperation?

4.1 The Backdrop

Ever since the ICM became the ICMS during the 1988 constitutional reform, various attempts at tax reform have been made, all of them contemplating changes in the ICMS. Also in all of them, a central aspect of the recommendations for reform was the harmonization of state rules that regulate the collection of that tax, along with the replacement of physical credits with financial credits[52] and the adoption of the destination principle in the appropriation of the proceeds of the collection resulting from interstate transactions. None of the recommendations addressed the delicate problem of treating the reform of the ICMS as part of a proposal to construct a new model of fiscal federalism so as to increase the chances of winning approval by simultaneously revising both tax regime and the revenue sharing system,.

Since any important change in the rules applied to the state tax changes the distribution of the revenues within Brazil, creating winners and losers, if the change is accomplished in isolation it will become viable only if someone—in this case the federal government—is willing to pay the bill. Since that bill will invariably be much higher than the reality, because those who gain from the change will keep silent and those who lose will inflate the estimates of their losses, none of them considering the dynamic effects of the improvement of tax efficiency for economic growth and for future revenues, the discussion drags on and the matter is set aside until a new government takes office.

[52] In tax jargon, the physical credit regime allows a tax credit only when the input is incorporated into the product that uses it (for example, the electricity used to produce aluminum; the electricity used in the offices does not result in entitlement to a credit). In the financial credit regime, there is no restriction; all purchases made by companies related to the management of their businesses generate tax credits.

Resistance to the reform of the ICMS has been based on two issues besides the financial impact: the loss of autonomy by the states that would result from tax harmonization, and the destruction of the weapons used in the tax war because of the adoption of the destination principle. This is important to remember, since those two questions are at the center of the debates about proposals for change.

The alleged loss of autonomy has, erroneously, been associated with a weakening of the Brazilian federation, when the primary reason for that weakening is the intensification of conflicts and antagonisms. The strengthening of the federative system does not require the presence of distinct tax territories like those that have been built in Brazil. The federated units compose a single nation, so the tax system needs to be conceived in national terms. It is urgent that the need to reclaim this principle be recognized.

As we saw at the beginning of this paper, the tax system that was conceived during the 1965 reform established a regime that featured the constitutional distribution of responsibilities for tax collection based on the economic nature of the tax bases, rather than on their legal concept. The authority to tax those bases was shared according to the recommendations of specialized literature and in tune with international best practices. Seeking to adjust the theoretical recommendations to prevailing economic realities, the states were given authority to tax the circulation of goods and the municipalities were given authority to tax the provision of services. It was the responsibility of the Union to tax, selectively, industrial production.

A national tax system cannot be rigid. It needs to be given the flexibility to adjust to transformations in the productive structure that change the nature and distribution of the tax bases. Aware of that situation, those who proposed adoption of a tax on value added as part of the jurisdiction of the states, in 1965, made the constitutional text as concise as possible and introduced the figure of the complementary law to regulate the application of that tax.

However, as conflicts were arising and mistrust was growing, all the casuistries that had been adopted, one after the other, to deal with them were ultimately incorporated into the constitutional text, in order to prevent the hard-won advantages from being easily reversed. In the process of drafting the tax chapter of the 1988 Constitution, that process gained unheard-of dimensions and led to tremendous rigidity, making all proposals for reform unviable.

And so it seems opportune to propose that the resumption of debates about ICMS reform take a different path: return to its origins. What sense is there in going back to the beginning? The sense of this proposal is to reclaim the principle that was adopted in the 1965-67 reform, to institute a national tax system in which the tax bases are defined as a function of their economic nature and not by legal formalities and in which the distribution of those bases is aimed at conciliating the economic neutrality of the tax with federative equilibrium.

If a national tax system was seen, as early as 40 years ago and in the context of a closed economy, as a necessary condition for economic growth, then today it is a condition of absolute necessity. Four decades ago, fiscal competition among Brazil's states was displacing production and jobs to other parts of Brazil. Today, fiscal competition is exporting production, tax bases, and jobs to other countries.

In the debates and proposals for reform made in the past 20 years, two paths for re-establishing the national character of this mode of taxation were laid out. One approach advocated the institution of a national VAT, accompanied by a constitutional determination of the rules applied to revenue sharing and the distribution of the portion attributed to the states. The other proposed adoption of a dual VAT. The federal government and the states would share the same tax base, but each would administer its portion separately. Both proposals expressed a concern to recover the national nature of the tax.

The difference, compared with the procedure adopted in 1965, was to deal partially with the problem of constitutional distribution of revenues and ignore the need to address, simultaneously, the question of revenue sharing. The documents prepared by CRETAD to assist the work of the constituent assembly that drafted the 1988 Constitution discussed this question, but the failure of the federal government to lead the process of reform of the tax chapter of the Constitution contributed to a situation where the changes in that area were limited to an expansion of the states' tax base and an increase in the percentages of the Income Tax (IR) and the Tax on Manufactured Products (IPI) that form the Participation Funds.

Traveling the path back to the origins of the tax, it will be necessary to break down two barriers to the approval of changes: autonomy, and mistrust. In the case of autonomy, it is necessary to hold a debate that is devoid of prejudices as to what the word actually means. At first glance, autonomy is limited, since the rules that govern the incidence of the tax are national rules, established in complementary law, and the states have only the power to determine the tax rates and procedures they employ to collect and oversee, as well as to decide on tax disputes. But, when combined with the differences in the rates applied to inter-regional commerce, autonomy gains unprecedented dimensions and becomes the most powerful weapon in the tax war, acquiring a political dimension that goes beyond the narrow bounds of the taxation debate.

The question of mistrust and antagonism is more complicated. As these grew, they soured the atmosphere of discussions in the arena that is supposed to promote harmony among state tax policies—CONFAZ. As mentioned earlier, the 1988 reform did not try to rebuild the institutions that were charged with mediating federative conflicts in the field of taxes. It preserved CONFAZ, but deprived it of the conditions that would enable it to function effectively.

The difficulties encountered in making viable changes that would reassemble a national tax system are widely known. And they will only be removed in the context of a comprehensive proposal for reform whose objective is to install a new model of fiscal federalism, one adapted to current conditions and the new characteristics that Brazilian fiscal federalism has been acquiring in recent years.

Until conditions propitious to the progress of such a reform emerge, it is time to take advantage of the opportunity in which the demands for tax exemptions that can stimulate the competitiveness of the economy are joining with the various issues of interest to the federation, demands that are on the agenda of the national debates, in order to take a first step in the direction of a future reform of Brazilian fiscal federalism.

4.2 Reform of the ICMS

With respect to the ICMS, the question is not to determine what needs to be done, but rather to discover a way to break through the barriers that have blocked the approval of old recommendations, such as the transition to the destination principle, full relief from taxes for investments and exports, the adoption of the financial credit, and the harmonization of state legislation. Luckily, a new way of conducting the negotiations about ICMS reform can be adopted now.

As mentioned earlier, efforts to make changes in the ICMS may run aground on two severe restrictions: the prevailing climate of mistrust and antagonism and the resistance of states to giving up the ability to adopt fiscal policies that may contribute to their development. The mistrust and antagonisms that have accumulated in the recent past are now exacerbated by the dispute over petroleum royalties, the need to revisit the criteria for apportionment of the FPE, the recent Supreme Court decision about the unconstitutionality of tax benefits, and the addition of new topics, such as taxation of e-commerce.

However, contrary to appearances, the increase in the temperature of the debates sparked by the expansion of the federative agenda is a positive development. Viewed in isolation, changes in the ICMS to curb the waging of a tax war heavily impact the federation and demand financial compensations that the federal government finds it hard to satisfy. Besides compensation for losses of revenue, one must deal with a new socioeconomic reality created as a result of the installation of enterprises that set up shop in various parts of Brazil with the assistance from incentives they were granted. This cannot simply be ignored.

Therefore, a joint appreciation of these questions may help to facilitate, rather than hamper, an understanding. Losses of revenue due to changes in the ICMS can be offset by gains obtained from revision of the criterion for apportionment of the FPE, and vice versa. Furthermore, a reorientation of the debates on the sharing of royalties from pre-salt petroleum exploration could favor the decomposition of the physical and financial instruments of a new regional development policy that would prevent regression in that area.

Treating these questions as a group might also facilitate the understanding necessary to resolve the impasse that has been dragging on for years with regard to the pacification of the tax war. The solution of that impasse runs up against the t the scope of the preservation of benefits already granted. As has been demonstrated through the years, the discussion of this topic in isolation has no chance of succeeding. If treated in the context of a negotiation that involves the other questions that are on the agenda of the federative debates, the chances of success will be considerably better.

The earlier observation that reaching an agreement on a reduction in interstate rates is not, essentially, a problem of financial compensation for revenue losses, but rather a political question, emphasizes how important a solution to the problem mentioned in the previous paragraph is to progress in the reform of the ICMS. Another measure important to achievement of that same objective is the rebuilding of institutional mechanisms that are endowed with the capability to mediate federative conflicts and help to harmonize national tax policy. For reasons already presented here, CONFAZ in its present form is unable to play this role. The creation of an entity that is in a position to perform that function is a prudent action that should be taken.

Parallel to measures that would aid in the modernization of the ICMS, it is also necessary to consider actions in the administrative field that might make life easier for taxpayers, reduce the burden of compliance costs, and promote cooperation by the tax authorities. The proposal to create a national virtual Secretariat of Finance—the national SEFAZ—that is being studied at the Fiscal Studies Unit of the Getúlio Vargas Foundation School of Law in São Paulo, hopes to achieve this objective (Rego 2011). Although it was expected that the implementation of the Public Digital Bookkeeping System – SPED (*Sistema Público de Escrituraçãl Digital*) might offer a rapid response to the problem of reducing the compliance costs, the system is still a long way from achieving this goal.[53]

As it stood in late 2011, neither the Federal District nor the state of Pernambuco have agreed to join the SPED, and the rules adopted for introducing the system on a national scale still need to be perfected. By the end of 2012 all states and the Federal District have adopted the SPED. The processing of the electronic invoices is fragmented (invoices from 13 states are processed in Rio Grande do Sul, the Federal Revenue Authority of Brazil handles invoices from five other states, and the state of São Paulo processes its own invoices). Furthermore, states are still requiring that tax records be kept on paper, resulting in duplication of data and costs. Frequent modifications of the SPED and the unpreparedness of tax administration personnel to work with the new system are increasing the costs for taxpayers and feeding disputes among states.

Harmonization of the states' administrative procedures faces serious difficulties. In order to overcome these and other problems mentioned here, the study referred to above suggests a federal norm that establishes the rules and the criteria to be adopted by all states in order to standardize the requirements pertaining to the accessory obligations required of the taxpayers, so as to make feasible the introduction of the virtual SEFAZ.

5. Final Comments

More than a year has passed and the repeated official promises to promote improvements in the Brazilian tax system by adopting ad hoc measures are still on the drawing board. This is not for lack of efforts by those responsible, or due to ill will among our governing officials. The problem

[53]The Public Digital Bookkeeping System – SPED was established by Decree 6.022/2007 and intended to modernize the routines for complying with the accessory obligations that are imposed on taxpayers by the tax administration offices.

is that the diversity of interests and the complexity of the situation leave no room for ad hoc actions to have a chance of success.

As time moves on, the need to remove tax-related obstacles to growth becomes more urgent. There's no time to keep insisting on propositions that, if they did have a chance of being approved, would require at least a decade of transition time. Under the present situation of an open economy and stiff international competition, the survival of part of Brazil's productive structure demands immediate results. In this context, ICMS reform becomes a priority, in view of the importance of this tax in the Brazilian tax system and the urgent need to find a solution to the antagonisms among states that protect regional interests in the short term but create difficulties in satisfying national interests in the medium and long term.

The opportunity to advance in the direction of an understanding about the reforms needed to correct the deformations accumulated by the ICMS during more than four decades must not be lost. Now, for the first time, the federative question precedes the debate about tax reform, but recommendations to treat as a single unit the topics that are being discussed—sharing of petroleum revenues, revision of the criteria for apportioning the FPE, a change in the indexer applied to state debts, and the reform of the ICMS—are not receiving the attention they deserve. Maybe the failure to achieve a satisfactory solution by tackling each one to those issues in isolation could help prevent the opportunity for a comprehensive solution from being wasted.

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