Brazil's Tax System: The Dilemmas of Policy Reform

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EXECUTIVE SUMMARY

Since the return of democracy and the new Constitution, enacted in 1988, Brazil's tax system is constantly evolving following the country's political and economic dynamics. The discussion highlights and examines the critical issues faced by Brazil's current tax system to adjust to new global demands and the difficulties in reconciling these demands with (a) commitments to a more decentralized fiscal system; (b) claims for reducing the amount of taxes paid by taxpayers; and (c) the need to invest more public resources to tackle poverty, social and regional inequality and to overcome the deficiencies of economic infrastructure. The paper argues that reforming a complex and constitutionalized tax system of a federal country like Brazil depends on the design of the institutions and on the existence of a consensus in support of economic reforms. The lessons of Brazil's experience with a tax system in constant reform may be applicable in other developing countries. The general lesson is that efforts to adjust highly indebted countries to global demands are possible given certain conditions, but such efforts may also trigger political dilemmas when major social and economic constraints have not been addressed.

RÉSUMÉ

Depuis le retour de la démocratie dans le pays et la promulgation de sa nouvelle Constitution en 1988, le régime fiscal du Brésil ne cesse d’évoluer en fonction de la dynamique politique et économique du pays. Ce document met en évidence et analyse les principaux défis du régime fiscal actuel du Brésil pour s’ajuster aux nouvelles demandes mondiales et les difficultés à faire coïncider ces demandes avec a) des engagements envers une décentralisation accrue du régime fiscal; b) les réductions d’impôt réclamées par les contribuables et c) la nécessité d’investir davantage de ressources publiques pour s’attaquer à la pauvreté, aux inégalités sociales et régionales et compenser les insuffisances de l’infrastructure économique. Le document fait valoir que la réforme d’un régime fiscal complexe et constitutionnalisé d’un pays fédéral comme le Brésil dépend des projets des institutions et de l’existence d’un consensus pour soutenir les réformes économiques. Les leçons tirées de l’expérience brésilienne dont le régime fiscal est en constante réforme peuvent être appliquées à d’autres pays en développement. La leçon générale est que les efforts pour ajuster les pays lourdement endettés aux demandes mondiales sont possibles dans certaines conditions, mais que ces efforts peuvent également donner lieu à des dilemmes politiques si les principales contraintes sociales et politiques n’ont pas encore été abordées.
RESUMEN

Desde el retorno a la democracia y la promulgación de la nueva constitución de Brasil en 1988, el sistema tributario brasileño ha estado en constante cambio acorde a las realidades políticas y económicas del país. El presente documento destaca y analiza los aspectos más fundamentales que el sistema tributario brasileño actual debe resolver para ajustarse a las nuevas exigencias mundiales y los problemas que implica conciliar tal ajuste con: a) la necesidad de disponer de un sistema tributario más descentralizado; b) las exigencias de reducir los impuestos que pagan los contribuyentes; y c) la necesidad de destinar más recursos a resolver los problemas de pobreza, las desigualdades sociales y regionales y las deficiencias de la infraestructura económica. Este trabajo expone que la reforma de un sistema tributario complejo y refrendado constitucionalmente en una federación como la brasileña depende de la estructura de las instituciones y de la existencia de un acuerdo en favor de las reformas económicas. Las experiencias adquiridas en el caso de Brasil podrían aplicarse en otros países en desarrollo. La lección general que podemos sacar es que los esfuerzos de las naciones sumamente endeudadas por ajustarse a las exigencias mundiales pueden tener éxito bajo determinadas condiciones; sin embargo, tales esfuerzos pueden acarrear dificultades políticas si antes no se resuelven importantes problemas económicos y sociales.

INTRODUCTION

Following the country's political and economic developments since the return of democracy and the 1988 Constitution, the Brazilian tax system has been constantly evolving. After almost 20 years under military rule, the main goal of the constitution makers was to legitimize the new democratic regime. Thus, economic issues such as the public deficit, inflation control, fiscal adjustment and globalization, issues that would later confront the new democracy, were neither on the drafters' nor on the country's agenda due to enthusiasm at the prospect of the restoration of democracy (Souza, 1997). Furthermore, because the Constitution was written during the process of the transition to democracy, constitution makers were unsure of its outcome, and therefore opted to deepen the trend of previous democratic constitutions to constitutionalize a wide range of issues, including the tax system.

The 1988 Constitution was designed to legitimize the return to democracy rather than to deal with economic issues; as a result reform was on the agenda of the government and of multilateral and business organizations soon after its approval. Many constitutional amendments and new federal legislation were approved (since mid-1990s), introducing, for example, mechanisms for fiscal adjustment and control and for increasing the amount of resources at the disposal of the federal government in order to fulfill commitments to foreign and domestic creditors.

This paper analyzes the changes brought about in Brazil’s tax system by the 1988 Constitution, in which a more decentralized system was introduced, and the changes later approved to adjust Brazil to new economic paradigms. These changes have promoted a re-centralization of public resources, altering the previous path of financial decentralization towards sub-national levels and posing more constraints on the states than on the municipalities. The discussion highlights and examines the critical issues faced by Brazil's current tax system to adjust to new global demands and the difficulties in reconciling these demands with (a) commitments to a more decentralized fiscal system; (b) claims for reducing the amount of taxes paid by taxpayers, which has increased over the years; and (c) the need to invest more public resources to tackle poverty, social and regional inequality and to overcome the deficit of economic infrastructure. These demands are constrained by fiscal austerity, the policy of budget surpluses and the payment of interest to fulfill debt commitments.

This paper argues that reforming a complex and constitutionalized tax system of a federal country like Brazil depends on the design of the institutions and on the existence of a consensus endorsing economic reforms. At the same time, the macroeconomic agenda brought about by globalization makes it difficult to reconcile this agenda with the demands mentioned above.

The lessons of Brazil’s experience of a tax system in constant reform may be applicable in other developing countries. In particular, the general lesson is instructive: efforts to adjust highly indebted developing countries to global demands are possible given certain institutional conditions, made incrementally and supported by a wide consensus, but reform may also trigger political dilemmas when major social and economic constraints have not been addressed.
The current design of the Brazilian tax system is a result of the legacies of three different political and economic periods in history. The first legacy comes from the military regime, which ruled the country from 1964 to 1985, when financial centralization was the main characteristic of the tax system and when the trend to raise taxes started. Public revenue increased from 17% of GDP in 1960 to 26% in 1980; the federal government revenue increased from 10.4% of GDP in 1960 to 17% in 1980; the states' revenue decreased from 5.9% of GDP in 1960 to 5.5% in 1980; whereas the municipalities increased their revenue from 1.1% of GDP to 2.1% in the same period. The military regime, however, deepened a previous system of intergovernmental transfers aimed at addressing Brazil's enduring regional inequality that has marked the Brazilian federation since its early years. As a result, regional economic disparity decreased slightly. This decrease can be attributed neither to centralization of public resources nor to authoritarianism but rather to good economic performance during decades of accelerated economic growth. Economic growth rates of almost 10% a year for more than a decade allowed decision makers to adopt policies aimed at decreasing regional inequality. Despite attempts by the military regime and the subsequent 1988 Constitution, inequality remains one of Brazil's main constraints (Souza, 2002).

The Constitution made profound changes on the tax system, mainly by increasing resources to sub-national governments vis-à-vis the federal government. This Constitution, as much as previous ones, grants taxation authority to the three levels of government. Some taxes are exclusive to one order, others are collected by the federal government and shared with states and municipalities, and still others are collected by the states and shared with their municipalities. The rates and rules for certain taxes, including state and municipal taxes, are determined either by the Constitution or by federal legislation.

The 1988 Constitution expanded the complex mechanism for intergovernmental tax transfers introduced by the military. Federal revenues from Income Tax (IR) and from the Tax on Industrial Products (IPI) are shared through participation funds established for this purpose. The states receive 21.5% of these tax revenues, 85% going to the North, Northeast, and Centre-West regions and the remaining 15% to the South and Southeast regions, Brazil's two economically better-off regions. The formula for determining state shares is based on population size and an inverse of per capita income. The municipalities receive 22.5%, 10% going to the state capitals and the remaining 90% disbursed using a formula based on the same criteria of population and income. All these rates and formulas are stipulated in the Constitution. These formulas, however, do not compare to the extensive systems of equalization payments found in Canada and Germany. The new mechanisms introduced by the 1988 Constitution have not decreased horizontal imbalance in either absolute or proportional terms. One important feature regarding the tax system in this period was the decision to increase sub-national resources made not by the government but by constitution makers thereby politicizing and constitutionalizing the system and influencing its further reform.

The third legacy began with the launching of a stabilization plan, in 1994, which has succeeded in controlling Brazil's hitherto unstoppable inflation. Following the plan, a fiscal adjustment program became a priority and constitutional amendments were passed to address new issues in an attempt to take the country in a new economic direction. The plan had another important consequence as regards the fiscal system: it raised interest rates to unprecedented levels, thus aggravating the debt burden. The debt burden was further troubled by the devaluation of the national currency, the real, in 1998, following the financial crisis affecting other developing countries. As a result, Brazil and its neighbours remain heavily indebted and must constantly acquire new debt to cover interest and repayment on the old debt.
Brazil has also kept interest rates extremely high to maintain creditors’ confidence, to attract short-term foreign resources, and to avoid capital flight and the return of inflation. In September 2004, interest rates were 16.75% in absolute terms and 9.97% in real terms (i.e., without taking inflation into account). Brazil’s interest rates are third in the world, after Turkey and Venezuela and are high compared to Argentina (3.1%), Canada (2.4%), and Chile (1.9%). This policy has, of course, restricted the government’s room for tackling Brazil’s main dilemmas: regional and social inequality, poverty and the infrastructure deficit. The new macroeconomic agenda has also led to a re-centralization of resources at the federal level and to an unprecedented increase on federal taxes, relative to GDP, to fulfill debt commitments and to achieve budget surpluses. As was the case during the military regime, the states’ finances were the most affected vis-à-vis other levels of government. Brazil’s main fiscal indicators are shown in Table 1.

### Table 1: Brazil: Main Fiscal Indicators, 1985-2004 (%)

<table>
<thead>
<tr>
<th>Tax Regime</th>
<th>Year</th>
<th>Revenue/ GDP</th>
<th>Annual Inflation Rate</th>
<th>Distribution of Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Military 1964-85</td>
<td>1985</td>
<td>24.1</td>
<td>52.7</td>
<td>Federal: 26.2 State: 11.1 Local: 11.1 Total: 100.0</td>
</tr>
<tr>
<td></td>
<td>1986</td>
<td>26.2</td>
<td>65.0</td>
<td>Federal: 26.5 State: 21.3 Local: 12.3 Total: 100.0</td>
</tr>
<tr>
<td></td>
<td>1987</td>
<td>23.8</td>
<td>41.8</td>
<td>Federal: 24.2 State: 17.0 Local: 16.6 Total: 100.0</td>
</tr>
<tr>
<td></td>
<td>1988</td>
<td>22.4</td>
<td>1,037.6</td>
<td>Federal: 23.3 State: 13.6 Local: 13.6 Total: 100.0</td>
</tr>
<tr>
<td></td>
<td>1989</td>
<td>24.1</td>
<td>1,781.9</td>
<td>Federal: 25.0 State: 15.9 Local: 15.9 Total: 100.0</td>
</tr>
<tr>
<td></td>
<td>1990</td>
<td>28.8</td>
<td>1,476.7</td>
<td>Federal: 27.6 State: 17.5 Local: 15.5 Total: 100.0</td>
</tr>
<tr>
<td></td>
<td>1991</td>
<td>25.2</td>
<td>480.2</td>
<td>Federal: 26.1 State: 15.7 Local: 15.7 Total: 100.0</td>
</tr>
<tr>
<td></td>
<td>1992</td>
<td>25.0</td>
<td>1,557.8</td>
<td>Federal: 28.1 State: 14.9 Local: 14.9 Total: 100.0</td>
</tr>
<tr>
<td></td>
<td>1993</td>
<td>25.8</td>
<td>3,008.2</td>
<td>Federal: 26.6 State: 18.4 Local: 18.4 Total: 100.0</td>
</tr>
<tr>
<td></td>
<td>1994</td>
<td>29.8</td>
<td>1,039.3</td>
<td>Federal: 31.5 State: 15.6 Local: 15.6 Total: 100.0</td>
</tr>
<tr>
<td></td>
<td>1995</td>
<td>29.4</td>
<td>14.8</td>
<td>Federal: 27.2 State: 16.6 Local: 16.6 Total: 100.0</td>
</tr>
<tr>
<td></td>
<td>1996</td>
<td>29.1</td>
<td>9.3</td>
<td>Federal: 27.6 State: 16.3 Local: 16.3 Total: 100.0</td>
</tr>
<tr>
<td></td>
<td>1997</td>
<td>29.6</td>
<td>7.5</td>
<td>Federal: 27.7 State: 16.1 Local: 16.1 Total: 100.0</td>
</tr>
<tr>
<td></td>
<td>1998</td>
<td>29.6</td>
<td>7.5</td>
<td>Federal: 26.6 State: 17.2 Local: 17.2 Total: 100.0</td>
</tr>
<tr>
<td></td>
<td>1999</td>
<td>31.7</td>
<td>20.0</td>
<td>Federal: 26.0 State: 17.0 Local: 17.0 Total: 100.0</td>
</tr>
<tr>
<td></td>
<td>2000</td>
<td>32.7</td>
<td>9.8</td>
<td>Federal: 26.4 State: 16.9 Local: 16.9 Total: 100.0</td>
</tr>
<tr>
<td></td>
<td>2001</td>
<td>33.6</td>
<td>10.4</td>
<td>Federal: 25.9 State: 16.7 Local: 16.7 Total: 100.0</td>
</tr>
<tr>
<td></td>
<td>2002</td>
<td>34.9</td>
<td>26.4</td>
<td>Federal: 25.3 State: 16.7 Local: 16.7 Total: 100.0</td>
</tr>
<tr>
<td></td>
<td>2003</td>
<td>35.8</td>
<td>9.41</td>
<td>Federal: 24.8 State: 16.1 Local: 16.1 Total: 100.0</td>
</tr>
</tbody>
</table>

**Note:** Sub-national revenues include taxes directly collected at this level, constitutional transfers from the federal government to states and municipalities and from the states to the municipalities, plus transfers to the municipalities to provide primary education and health care services. Federal and state specific revenues are accountable for 90% of total revenue. Taxes collected locally are of significance for large municipalities.

### TAX REVENUE SOURCES

Although Brazil has a great number of taxes, the bulk of these resources come from five sources: one collected by the state governments and the other four by the federal government. Together they are accountable for almost 70% of revenue collection. Chart 1 displays the percentage breakdown of these taxes.

**Chart 1. Revenue from Major Taxes**

**Source:** Afonso and Varsano, 2003.

**State Tax**

The main tax in absolute terms is a state tax called the Value-Added, Communication and Transportation Tax (ICMS). A type of a value-add tax which, unlike many federations, is under the states’ jurisdiction and represents 23% of all taxes collected in the country. The ICMS has over 50 different rates given that each state is free to determine its rates. As a result, interstate trade is subject to many different and complex rules, stimulating tax evasion, despite high investments in the collection system. Constitutional amendment No. 42, issued in December 2003, limits the states’ prerogative to determine the rates of ICMS, but agreements on new, more uniform rates have not been achieved so far. In recent years, despite being the
highest tax in absolute terms, ICMS revenue has been in steady decline. One of the reasons is that the states have been using it to attract private investments, thus aggravating competition and giving raise to what became known as the fiscal war among the states. The fiscal war is a result of the concentration of economic activities in a few states and the lack of a federal industrial policy. Regardless of the relative importance of the ICMS, Brazil’s deep-rooted regional inequality affects the impact of ICMS on the states’ finance. For example, the capital of the state of São Paulo, Brazil’s wealthiest state, collects from a local service tax alone more revenue than 17 out of 26 states collect from ICMS.

**Federal Taxes**

On the side of the federal government, the bulk of the taxes come from income tax, both personal and corporate, representing 16% of total revenue and from several taxes paid by employers and employees including the Social Security Contribution (INSS), Social Integration Program/Assistance Plan for Public Servants (PIS/PASEP) and the Fund for the Guarantee if the Length of Service (FGTS) earmarked to finance the social security system. In relative terms, the greatest increase in federal taxes has been a tax paid by employers for financing the social security system over the company’s revenue known as the Contribution for the Financing of the Social Security System (COFINS) thus provoking businesses’ outcries which have not been heard by tax authorities. Other significant taxes are a tax on cheques, the Contribution on Financial Transactions (CPMF), and two taxes to compound workers’ fund, the INSS and the PIS-PASEP. Taxes destined to finance the social security system are administered mainly by federal institutions. Together these five federal taxes represent 13.8% of GDP and 49% of total public revenue. These taxes are not shared with sub-national governments and are levied mainly from businesses. As shown in Table 1, taxes have not stopped rising reaching 35.8% of GDP in 2003, despite mediocre or negative rates of economic growth registered in the last two decades. Data indicates that in 2003, 16.3% of all taxes levied by the three levels of government accrued from goods and services, 7% from payroll, 6.5% from income tax and 1% from property tax. Thus, the design of the tax system contributes to downplay efficiency and equity goals.

**Box 1: Distortions in Brazil’s Current Tax System**

Consensus, particularly among economists, of the main distortions of the tax system are:

- Taxation is cumulative; several taxes are levied on the same good or service.
- Excessive payroll taxation paid by employers stimulates informal contracts or payment of extra hours instead of hiring new employees.
- Taxation is too highly concentrated on businesses and too little on personal income and property. The middle class does not support this view.
- Complexity of the system stimulates tax evasion.
- High inequalities among states and municipalities result in pressure on sub-national levels to grant tax breaks or to lower the rate of some taxes to attract private businesses.
- Objectives of equity and efficiency take a back seat to current aims of the current tax system of achieving macroeconomic stability and tight fiscal control. Moreover, the distortions mentioned above contribute to reduced efficiency and equity.

**THE ROLE OF THE TAX SYSTEM IN CONSTRAINING EFFICIENCY AND EQUITY**

**Efficiency**

On the side of efficiency, Brazil has indeed modernized the tax collecting system, particularly the federal and state systems, with the aid of other countries and of multilateral organizations, including the Canadian International Development Agency (CIDA). Introduction of electronic auditing of large businesses, capacity building programs and better salaries for tax collectors, coupled with electronic access to tax forms are now widespread in federal, state and large municipalities tax bureaucracies. The collection of certain taxes, such as income tax and several taxes paid by large businesses, are easy to do and are widely used by taxpayers. Thus, efficiency is not a problem in collecting the bulk of taxes. The problems related to efficiency are linked to the amount of taxes paid by taxpayers, on the existence of varying rates of the same tax (e.g., the ICMS) and on the complexity of the legislation. These problems stimulate tax evasion, judicial actions against the government due to the complexity of the legislation, coupled with negative incentives for small businesses to legalize their
activities. Despite several measures adopted by the governments to fight tax evasion and to simplify tax collection for small businesses, tax evasion is still high. Specific issues are the ICMS and the number of small businesses operating illegally. Furthermore, judges have tended to interpret tax legislation more in favour of taxpayers rather than the government.

Another factor related to the efficiency of the tax system as a whole is the heavy tax burden posed on taxpayers, particularly businesses. The Brazilian business community argue that high taxes prevent them from being competitive abroad and contributing to the country’s efforts to expand exports of Brazilian goods, a policy now pursued by the federal government. They also claim that the high level of interest provides more incentive for investing profits in the financial market than in business expansion. Not surprisingly, every year there is a national campaign led by the Bar Association and other business organizations against the high level of taxation. It is estimated that Brazil needs to invest in infrastructure at a rate of US$ 20 billion a year in order to stimulate economic growth, a goal difficult to achieve without governmental financial support. Infrastructure deficits also play a role against business efficiency.

**Equity**

On the side of equity, the main problem is the fact that the bulk of taxes are indirect, therefore affecting the poor more heavily. Decreasing the rates of ICMS on basic food, for instance, finds resistance from the states in which food production is the main source of revenue. A second issue is the earmarking of several federal taxes to finance the social security system and to pay for workers’ benefits, which mainly targets individuals with formal jobs. A third problem relates to the concentration of resources at the federal level, which has increased over the years, preventing sub-national governments from implementing their own equity agendas. Equally important for equity concerns are the amount of taxes allocated to pay high interest rates and debt commitments. The high percentage of resources destined to debt payment prevents policy makers from formulating policies destined to minimize regional and social inequalities, and from increasing resources destined to the existing compensatory income distribution programs. Brazil is well known for its high level of social inequality, placing the country among the world’s fronrunners of income inequality, including among other Latin American countries. As for regional inequality, there are huge gaps among Brazilian regions. Table 2 displays the differences among Brazilian regions as regards GDP; very little has changed over the last few years.

**Table 2: Brazil: GDP by Region (%), 1998-2002**

<table>
<thead>
<tr>
<th>Region</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>North</td>
<td>4.48</td>
<td>4.45</td>
<td>4.60</td>
<td>4.76</td>
<td>5.04</td>
</tr>
<tr>
<td>Northeast</td>
<td>13.05</td>
<td>13.11</td>
<td>13.09</td>
<td>13.12</td>
<td>13.52</td>
</tr>
<tr>
<td>Southeast</td>
<td>58.16</td>
<td>58.25</td>
<td>57.79</td>
<td>57.12</td>
<td>56.34</td>
</tr>
<tr>
<td>South</td>
<td>17.48</td>
<td>17.75</td>
<td>17.57</td>
<td>17.80</td>
<td>17.66</td>
</tr>
<tr>
<td>Center-West</td>
<td>6.84</td>
<td>6.45</td>
<td>6.95</td>
<td>7.20</td>
<td>7.44</td>
</tr>
</tbody>
</table>

Adapted from www.ibge.gov.br.

The slight decrease in the Southeast’s GDP is more due to economic recession rather than to a deconcentration of economic activities to other regions, particularly the Northeast, the poorest region of Brazil in relative terms, both economically and socially. The GDP per capita in the Northeast is almost four times smaller than in the Southeast. Regional inequality was also increased by the opening up of the Brazilian economy, as it reinforced the differences between developed and less developed states, as per Graph 1.

**Graph 1: Regional Distribution of GDP and Population (%)**

In fact, Brazil’s regional inequalities mark the existence of three “Brazils”, composed of (a) an area constituting seven states in the south of the country which, together with the Federal District, share a high level of human development; (b) an area to the northwest of Minas Gerais which has a medium level of human development; and (c) an area composed of the states of the Northeast plus the states of Pará and Acre which is characterized by low levels of human development. This human development map differs markedly from the traditional geographical map which divides Brazil into five regions.

**Surplus and Debt Interest**

The payment of debt interest is responsible, together with payroll expenditure and social security benefits, for constraining policies to tackle poverty and to
decrease social inequality, as well as for minimizing infrastructural gaps that prevent the country from enhancing economic activities. Data indicates that since 1980 spending on interest has been much higher than on infrastructure and social investments. Database from the federal Treasury (www.stn.fazenda.gov.br/estatistica/index.asp) shows that from 1980 to 2003, taxes have increased threefold, interest payments have grown sevenfold, while investments have shrunk. By the end of October 2004, for instance, the federal government had spent only 17% of budget resources on investment. This is possible because in Brazil the budget is not mandatory, meaning that government officials are not legally required to spend legislatively approved funds. Federal officials argue, however, that although interest payments are high, these payments as well as payroll expenditure are under control. The real problem, they argue, lies on the payment of social benefits.

While investments are low, budget surpluses have been high for the last couple of years, even higher than what is agreed to with the IMF. It is estimated that in 2004 the surplus will reach 4.5% of GDP. Surplus is achieved by the three levels of government and by state companies. Public deficit, although very high for a developing country, has been declining lately, representing 53.7% of GDP in 2004.

Summing up, promoting equity goals is doubled constrained. On the one hand, the design of the tax system affects the poor more by collecting the lion share of revenue from indirect taxes. On the other hand, public resources are concentrated in a few functions which have no or little influence on addressing equity goals. If adapting the country to new economic paradigms has been preceded by a broad consensus, leading to several changes in the tax system, consensus has not yet been reached towards tackling regional and social inequality.

**POLITICAL AND ECONOMIC CHALLENGES TO REFORMING THE TAX SYSTEM**

As seen in the previous sections, the Brazilian tax system has been under constant change, and in the three political and economic periods mentioned earlier changes have been quite deep. Soon after the promulgation of the 1988 Constitution, federal and state governments, although for different reasons and with different agendas, as well as multilateral organizations and business groups have called for constitutional changes to adjust Brazil to a new economic paradigm not foreseen by the 1988 constitution makers. There were, and still are, calls for eliminating constitutional blockades preventing privatization, for changing the taxation and the social security systems, coupled with demands for writing off some workers’ rights. The first call was addressed during President Fernando Henrique Cardoso administration, the second by Cardoso’s and by President Lula da Silva, who took office in 2002, both sponsoring incremental reforms, and the third call has not yet been addressed.

**Arguments for Reforming the Tax System**

Although several constitutional amendments have been approved, claims for deeper constitutional change have not stopped. The argument is that there is still need to reform the Constitution and to reform recent constitutional amendments in order to increase the country’s ability to adapt to changes in the international environment and to decrease government spending in order to free the country from its dependence on foreign resources and also to redirect resources in the fight against poverty. Although the tax system has been subject to several constitutional amendments, these changes did not free taxpayers, including businesses, from what they claim is a heavy tax burden preventing them from competing abroad and from expanding their businesses. Furthermore, given the debt burden mentioned above, reforms have increased federal resources, not only to pay interest on its external and domestic debt, but also to achieve budget surpluses.

**Constitutional Amendments and NEW Legislations**

Adjusting the country to the new macroeconomic agenda has made the 1988 Constitution the most amended Brazilian constitution. As of November 2004, fifty amendments had been approved. The bulk of the proposed amendments have come from the federal Executive. Reforming the tax and the social security systems have been the most sensitive and difficult issues for negotiation. However, the federal government has been successful in approving the creation of new taxes and in increasing the rates of others, as well as introducing incremental reforms to the social security system, particularly in the pension...
benefits enjoyed by civil servants. In most cases, these reforms have increased resources at the federal and local levels. In the case of local governments, the most important changes were two constitutional amendments earmarking federal, state and local resources to be applied to health care and primary education, thereby increasing local revenues, while requiring them to be the main providers of these services.

On the side of distribution of resources in the federation, constitutional amendments and other federal laws were mainly designed to (a) impose limits on the sub-national freedom to spend resources, this being a requirement of the federal policy of fiscal control; (b) allocate specific resources to be spent on social programs such as health care and primary education; and (c) decrease the amount of resources to be freely transferred from the federal to the sub-national governments. Constitutional amendments have also either created new federal taxes or raised the rates of certain taxes not shared with the sub-national governments, mainly destined to keep the debt commitments.

An important change regarding fiscal control was the approval in 2000 of a fiscal responsibility law, inspired by the New Zealand’s experience, and a law imposing criminal and administrative charges on public sector financial managers that fail to meet the requirements of the fiscal responsibility law. These laws pull together and strengthen many existing limits on spending and add some new ones. It imposes limits on public sector debt and expenditure on payroll, prohibits the bailing out by the federal government of new debts contracted by sub-national governments and imposes punishment to public managers that varies from three months to four years imprisonment.

Despite the fact that the last constitutional amendment reforming the tax system was approved in December 2003, a new amendment is now being debated in Congress, aiming, among other measures to (a) reduce ICMS rates to five rates, to be approved by the Senate and applied nationwide by each state; (b) lower the rate to be levied on basic food, medication, low electricity bills, agricultural equipments and agricultural inputs; and (c) raise federal transfers to the municipalities in 1%. If approved, the proposed changes, although not addressing income redistribution in depth, would be positively felt particularly by lower income Brazilians.

The Role of Institutions in Overcoming Political Constraints to Reforming the Tax System

How have these changes been politically possible given the multiple systemic and political constraints? Three kinds of restrictions stand out: those posed by the rules for amending the Constitution, by the conflicting interests between the three levels of government and by pressures from the business community.

Although the number of votes required for a constitutional amendment is low in comparison to the number required in other countries—three-fifths of the members of Congress—amendments have to be approved by two rounds of roll-call voting in both houses: the House of Representatives and the Senate. This two-step process enables unsatisfied parliamentarians time to negotiate their interests after the results of the first round. The constraints imposed by conflicting interests between the three levels of government are also high. Tax system changes affect the federation's constituent units in different ways, particularly in countries like Brazil cutting across by regional cleavages and the financial disparities between constituent units. The political-partisan reality has also played a constraining role against changing the Constitution: since redemocratization, Brazilian governments have never been able to achieve a majority in Congress, having to rely on coalitions among several parties to pass new legislations. Despite these constraints, the federal Executive has successfully approved changes to the tax system, although negotiations are necessary to pacify discontentment, particularly from state governors and from mayors of the state capitals.

The Brazilian experience of reforming a highly constitutionalized tax system can be used to test some often-quoted assumptions in the literature that federalism and constitutionalized rules constrain change to the status quo.
pose certain obstacles to addressing solutions to fiscal problems, other significant variables play a role in opening the way for bargaining and negotiations toward changing the tax system. In the Brazilian case, these variables include:

(a) The way federal institutions are designed, particularly if mechanisms of intergovernmental relations are scarce, thus aggrandizing the role of the federal government;

(b) The dependence of sub-national governments on federal policy making and federal resources;

(c) The adoption of fiscal policies does not require changes in the state constitutions or legislations;

(d) The privileged position of federal financial bureaucracy within the government vis-à-vis other bureaucracies;

(e) The degree of consensus toward the introduction of a new economic agenda;

(f) The strategy adopted by Brazil's incumbent and current Presidents to phase out the reforms and to submit them to Congress incrementally (as opposed to the unsuccessful strategy of former President Collor de Melo, who sent only one package to Congress to reform several issues, including the tax and the social security systems); and

(g) The process of reform. Because reforms were phased out and incremental, each subject affected the interests of different veto players, thus neutralizing potential veto players while gaining the support of other players and facilitating its approval.

In certain federal countries such as Brazil, bargaining and negotiation among the actors of the three levels of government and of the business community towards changing the tax system and the making of fiscal policy has been possible, showing that the design of institutions and the path of reform is an important variable when it comes to changing the status quo. Furthermore, Brazil's dynamic political institutions have been constantly evolving to allow adjustments to new political and economic agendas.

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**BRAZILIAN AND CANADIAN FISCAL SYSTEMS: DIFFERENCES AND SIMILARITIES**

Brazilian and Canadian fiscal federalism and their tax systems present some similarities although their differences are profound in substance. The main common feature is that both countries have been reducing public spending to adjust to the new economic agenda. Second, the federal government of both countries is the most autonomous of the three levels of government and has the broadest power in terms of taxation, as pointed out by Wilkens (2004) for the Canadian case. Third, both Brazil and Canada have a strong, competent, professional bureaucracy formulating and implementing fiscal policies. In Canada, financial bureaucrats at federal and state levels tend to share similar professional and programmatic values (Simeon, 2001). Fourth, decentralizing forces remain strong, although the federal government still holds a leadership role.

**Brazilian and Canadian fiscal federalism and their tax systems present some similarities although their differences are profound in substance.**

Differences between these two federations can be found in the following issues. First, in Canada, unlike Brazil, there is an effective operating system of intergovernmental relations facilitating cooperative solutions to problems, and encouraging self, rather than imposed, discipline. Cooperation has been achieved in Canada through intergovernmental negotiation on a number of major issues–internal trade, social policy, and environmental regulation—where attempts at formal constitutional amendment have failed. Federal-provincial ministerial councils, which meet regularly, often under joint chairmanship, have been formed in a wide variety of policy areas. Some have performed very well; others less so. Such meetings can facilitate a common understanding of issues and help build trust relationships among officials of different governments, as Simeon explains in regard to Canada (2001). In contrast to Canada, the Brazilian experience went in an opposite direction. As mentioned above, the lack of mechanisms of intergovernmental relations might jeopardize the efficiency of the tax system as a whole by simulating competition between states, and could facilitate the approval of constitutional amendments given the prevalence of the federal Executive on fiscal matters.
Another quite different feature is the role played by the provinces in Canada compared to the Brazilian states. The states have been losing their importance with respect to the federal and local governments. Furthermore, the states’ role in policy making is also bound by two other issues. First, the 1988 Constitution incorporated municipalities as part of the federation together with the states, reflecting a tradition of municipal autonomy and little state control in municipal matters. Second, since the early 1990s the states’ participation in the national public resources has decreased vis-à-vis federal and local governments. The role of the states in the federation has always been a matter of tension with the federal Executive. This situation dates from the great political and financial autonomy granted when the first republican Constitution was promulgated in 1891. Constant disputes between and among regional oligarchies and between regional and federal Executive interests have characterized Brazilian politics and federalism until the mid-1950s. It is no coincidence that the country’s two authoritarian regimes in the 20th century decreased state resources to a larger extent than those at the municipal level.

Although Brazilian states are not losing resources in absolute terms, their share on the total amount of public resources levied by the two orders of government has decreased. There are several reasons for the states’ financial declining position vis-à-vis the other two levels of government. One reason is the successful reaction of the federal government to make up for its financial losses brought by the 1988 Constitution. A second reason results from the fiscal war between the states granting subsidies and tax breaks to attract private businesses. A third reason is the debt of the state that reached 42% of public sector debt in 1997. Although these debts have been negotiated with the federal government, the states’ capacity to fulfill their obligations to the federal government continues to be a matter of concern and subject to constant pressure from the governors to change the rules of the agreements. This means that the states’ investment capacity has been seriously influenced by their financial restructuring. Finally, the wave of decentralization on which Brazil has embarked means more autonomy and resources to local spheres and local communities, with little role to be played by the states.

Brazil can learn from two substantive Canadian experiences. The first lesson is Canada’s successful equalization system, despite a decline in the relative percentage of funding needs covered by federal transfers, which, according to Wilkens (2004) fell from 24.6% in 1983-1984 to 15% in 2000-2001. Most importantly, Brazilians can learn how to build a wide support for equalization, particularly in the wealthier states. The second lesson derives from Canada’s primacy, at least theoretically, of tackling inequality at the highest political level, as mentioned by Jubany and Meltzer (2004). Applying these lessons depends not only on changing fiscal policies or on minimizing the country’s debt burden, but primarily on addressing broader political conflicts, redefining policy priorities and improving economic performance.

CONCLUSION

Brazilian redemocratization and the 1988 Constitution have triggered high expectations towards addressing the country’s historical and long-lasting social and regional inequalities. Unresolved domestic economic problems, such as the incapacity to control high inflation rates and, most importantly, the emergence of an international and national consensus towards the adoption of a new macroeconomic paradigm have brought to the fore calls for reforming the Constitution soon after its promulgation. A new international environment has arisen, requiring tight fiscal control and budget surpluses, coupled with a national consensus towards making Brazil a global player. These realities have made deep changes to the original design of the 1988 Constitution. One of the most affected issues was the tax system. Its reform, far from being complete, shows the dilemmas of constitutional and policy changes in highly indebted countries with high levels of social and regional inequalities. Reforming the tax system has heightened tensions between fiscal controls and policies to address Brazil’s main social, regional and economic dilemmas.

Nevertheless, the Brazilian experience shows that reforming a highly constitutionalized tax system, as well as efforts to adjust highly indebted developing countries to global demands are possible given certain institutional conditions, made incrementally and supported by a wide consensus, however change can also trigger political dilemmas when major social, regional and economic constraints have not been addressed.


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The Canadian Foundation for the Americas (FOCAL) is an independent, non-governmental organization that fosters informed and timely debate and dialogue on issues of importance to decision-makers and opinion leaders in Canada and throughout the western hemisphere. Established in 1990, FOCAL’s mission is to develop a greater understanding of important hemispheric issues and help to build a stronger community of the Americas.

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