

Tax Reform in Brazil

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Brazilian government sent to the Congress a proposal of tax reform that should be voted in the beginning of this year. This reform proposes drastic changes in Brazil's Federal Constitution which contains most of the tax structure provisions. However, Brazil's constitutional system impose a few restrictions on changes in its structure. Therefore,. this research is to investigate if the proposal as presented would solve Brazil's tax system problems and analyze if the proposal comply with Brazil's constitutional law.

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1. INTRODUCTION

The Special Committee of Tax Reform of the Chamber of Deputies approved in 20/11/2008 the opinion and the amendment presented by the Deputy Sandro Mabel about the Constitution Amendment Proposal (therefore PEC) about the tax reform which has the objective to deeply change the national tax system.

Mr. Mabel, in his opinion, suggested the adoption of the PEC 233/2008, sent by the government of President Luiz Inácio Lula da Silva, and recommended the approval of all 09 Constitution Amendment Proposal on the same subject, which was being analyzed by the Chamber of Deputies in 2007, and also accepted more than 200 amendments proposed during the debates in the Commission.

The prolixity of the text presented appears to be a problem, which becomes complex in front of so many controversial themes, hindering its examination and approval without a full discussion with civil society.

Despite all the problems in Brazil's tax system and all the effort Brazil's government is putting to approve this proposal, it needs to be analysed more carefully because Brazil's legal system does not allow structure changes in the system simply by creating a new ordinary law.

In order to abolish and create new taxes, the provisions of the Brazilian Constitution must be observed and the way the changes are presented in the amendment may lead to major legal problems to the State.

This research is to investigate if the proposal presented would solve Brazil's tax system problems and analyze if it complies with Brazil's constitutional law.

1.1 Government Justification

Brazil government released a summary of the tax reform¹ where it states that it comes in a good time because Brazil is in a process of sustainable growth, characterized by a new round of economic growth: more robust and balanced. The basis for this growth is a major step forward in consolidating macroeconomic stability, characterized by a tax policy that ensures consistent reduction of public debt, low and stable inflation and the strength of the external accounts, the result of strong growth in exports and a record level of international reserves.

The document states that the most striking feature of the current moment is an economic policy moving towards accelerated growth and, especially, a policy of social inclusion and reducing inequalities that is the basis for all actions of the current government.

¹ Full text available on <http://www.fazenda.gov.br/portugues/documentos/2008/fevereiro/Cartilha-Reforma-Tributaria.pdf>

In addition, the summary states that the actual tax model requires high bureaucratic costs for businesses to establish and to pay their taxes, plus a huge dispute with the tax authorities. It is no coincidence that a World Bank study points out Brazil as the world record in time spent by companies to meet the tax obligations.

This is the context presented by the government in which the draft of the Tax Reform was made and sent to Congress, a result of extensive discussions over the last year with States, Municipalities, workers and entrepreneurs, whose main goal is to streamline our tax system and broaden the potential for growth of the country.

2. DOMESTIC LEGAL ISSUES

The text being debated in the plenary of the Chamber of Deputies really needs to be well analyzed, because its adoption will require a profound change of tax system legislation, going over the constitutional rules so called *Cláusulas Pétreas*².

The Law (on a objective sense) is a set of standards - so integrating the legal system - that are called rules of law. They form the positive law: The law that was made and can only be removed by who has the legal power to do so³.

Brazil's constitutional system has specific provisions regarding changes on its structure and the due process must be observed when proposing new laws.

One of the largest obstacles to the law makers in Brazil is that the Constitution has a lot of specific provisions regarding the law making process and if these provisions are not strictly followed the provisions of the new law will be declared unconstitutional by the Federal Supreme Court (STF) and all the work of years goes down the drain.

Since the enactment of the Federal Constitution in 1988 until last year, 3994 laws were questioned in the Federal Supreme Court. "A record number in any democracy," said the teacher and researcher of the Brazilian Judiciary, Maria Tereza Sadek. According to her calculations, from 1988 to 2002, 200 federal laws were invalidated by the Court, by means of injunctions or tests of merit. Since then, the situation described by the researcher has not changed. Figures of the Yearbook of Justice show that in 2007, from 128 state and federal rules considered by the Supreme, 103 were deemed unconstitutional.

In Mexico, from 1994 to 2002, only 21 federal laws were unconstitutional. During this period, 600 standards have been questioned. Throughout the history of the United

² Material limitations to reform the Constitution. In other words, cláusulas pétreas are provisions which prohibit the change through amendment to abolish specific constitutional provisions. They are clauses that cannot be changed, they are immutable.

³ ATALIBA, Geraldo. *Hipótese de Incidência Tributária*. Malheiros Editores. 6ª Edição. 2006. p. 25. (translated to english)

States, only 35 federal laws are no longer in force because of defects in their preparation, according to the researcher.⁴

This is the legal context of Brazil's law making process which shows that law makers are not prepared to comply with the Constitutional provisions, and are not able to make a good job for the society.

This is one of the factors that may explain the lack of trust in the government, however it is not a factor to explain the high wages earned by the politicians.

2.1 Tax Created - IVA-F

The Proposal for Amendment of the Constitution (PEC) sent by the government, as well the amendments approved by the Special Commission, would create the Federal Value Added Tax (therefore IVA-F), which would be levied on onerous operations on goods and services⁵.

The possibility that is being created for the Union is to levy a new tax on operations in which States and Municipalities already levy taxes through Tax on Circulation of Goods and Services (therefore ICMS) and Tax on Services (therefore ISS).

It should be noted that in this case, may arise a conflict of jurisdiction between the Union, States and Municipalities and then such conflicts must be solved by supplementary law⁶.

However, the trend observed over the years is that the Union will prevail their political strength in the face of other Federal Units, since Brazil is a Federative Republic established for a unitary State, where the other entities depend on the Union, mainly due to the indebtedness of States and major municipalities and are at the mercy of transfers of tax revenue⁷.

Creating this new tax the proposal is expanding the tax burden in a indirect way so the costs of taxation will fall on the price of goods and services paid by the people at the end of the production chain as far the new tax will be included on its tax base⁸ and may be charged "inside", further the burden will go to the most poor and less assisted people.

In theory, the Constitution is a system based on the principle of ability to pay, according to this principle taxes should be, whenever possible, calculated on the economic capacity of the taxpayer. The person who participates in most of the wealth produced by the country should contribute proportionately more. In another words, those who have more should pay more.

⁴ Brasil é recordista em número de leis inconstitucionais. Revista Consultor Jurídico. 13/06/2008 (translated to english). Article available in <http://www.conjur.com.br/static/text/67173,1>

⁵ Article 153, VIII, the amendment.

⁶ Article 146, I, of the Brazilian Constitution.

⁷ Article 159 of the Brazilian Constitution.

⁸ Article 153, VIII, Paragraph 6, IV of the text to be approved.

In practice, however, the framework of the tax system is extremely unfair, setting true reversal of the principle of ability to pay. Institute of Economic Research (IPEA) recently conducted a research which shows that the poorest 10% of the population suffer 32.8 % of total taxation of their income, while the richest 10% account for 22.7% of the taxation. Therefore, proportionally, poor people pay 44.5% more taxes than the rich people .

The main reason for this injustice is the fact that in Brazil there is higher taxation on consumption (indirect taxes) than on the income and wealth (direct taxes). As the poorest undertake most of the income consuming products essential to survival, they pay proportionately more taxes. Taken into account only the indirect taxes, the poorest 10% pay 29.1% of their total income and the rich, only 10.7%.

The increase on the taxation of consumption, as shown, requires the distortion of the principle of ability to pay, because it would be hardly possible to charge more for the consumption of those who can pay more.

2.2 Taxes Abolished

Besides the broad impact on goods and services, the proposal will abolish two contributions intended for Social Security (particularly the COFINS and PIS) provided for in Article 195, I and IV of the Brazilian Constitution and more two generic contributions. The first one is salary education, to ensure public education essential for children and adolescents⁹, which will be revoked by Articles 5 and 30, III of the amendment adopted by the Committee for Tax Reform and the contribution for intervention in economy for fuels (therefore CIDE Combustíveis) provided in Article 177, §4° of the Constitution.

The abolishment of the social contribution on net revenue (therefore CSSL) will not be considered as an abolishment because it will be incorporated by the corporate income tax.

Indeed, the creation of a new federal value added tax, that does not bind the collection of its revenue, as opposed to fees and contributions - directly reach the problematic health system, welfare and social assistance and basic public education, which were provided by the original constituent in Articles 194 and 195 of the Brazilian Constitution through the allocation of these specific contributions to be extinguished by the PEC.

It doesn't matter the amount of revenue passed from the collection of IVA-F to social security, welfare and the financing of basic education, because the proposal under discussion will abolish a source of revenue income that was specifically designed to these primary activities to the population, which constitute real social rights, as defined in Article 6 of the Constitution in force.

Certainly, social security contributions, whose disappearance is being proposed, were established by the original constituent as a mean of guaranteeing the cost of

⁹ Article 212, Paragraph 2 of the Brazilian Constitution.

social rights provided for in Article 6 of the Brazilian Constitution, relating to education, health, welfare, the protection of motherhood, the childhood, the assistance to the unemployed as the article stated.

In another words, contributions that would be abolished in the tax reform are related to individual guarantees, also including social rights, and therefore *Cláusulas Pétreas*, which shall not be changed by constitutional amendment¹⁰.

This is the reason its forbidden, under any circumstances, terminate these important social contributions, under the risk of penalizing the problematic social security system for the working class, the elderly, the sick and children.

As showed upon, Article 195 of the Federal Constitution provides that Social Security will be funded by the whole society, living here the spirit of solidarity, one of the goals and fundamental principles of the Federative Republic of Brazil, as Article 3 of the Constitution.

Its important to remember that when the Constitutional Amendment number 42/2003, established a collection of welfare contribution to idle servers, the Supreme Court, on the trial of ADI 3.105/DF, used the principle of solidarity as a ground for demanding the payment of that contribution.

Through the draft of the constitutional amendment in question there is a paradox, because when comes to collect taxes from the workers, they are required to contribute jointly with all the society, including employers. However, the other way around, the same principle is not applied, once the employer's contributions and the payroll contribution are being extinct, which shows the degree of inequality in the national tax system.

If adopted, the proposal to amend the contribution on the payroll, "the Social Security Institution (therefore INSS) will lose R\$ 4 billion a year" (\$1.5 billion). This is a tough attack on a social right which shall not be changed through amendment to the constitution. It is evident that the PEC, through a tax reform, attempts to abolish social rights, compromising revenues destined to retirement.

Therefore, employers shall not be discharged from payment of social contribution mentioned upon, considering the fact that they are subjected to the rule of universal contribution to the welfare system. If the cost falls only on the working class, it would violate other *Clausulas Pétreas* related to the fundamental principles of solidarity¹¹ and isonomy¹².

¹⁰ Article 60, §4º, IV of the Federal Constitution.

¹¹ Article 3, I of the Federal Constitution.

¹² Article 5. caput of the Federal Constitution.

2.3 VAT

With the reform, workers will, at the end, bear the costs of IVA-F, with wide implications on "transactions in goods and services" which will focus on everything, diminishing the power of purchase of wages, and that, also, will be detrimental to the productive sector, because it will decrease the purchases of products.

The proposed creation of IVA-F goes against the international financial crisis, because countries such as England are adopting measures to "reduce taxes for the middle class and increase the load on the elite and corporate profits". According to statement from the Prime Minister Gordon Brown published 25/11/2008 in the page 8 of the newspaper Tribune of Press, "This is the recipe of the British Government to save its economy and Christmas"

Besides, under the argument to abolish a "tax war", the proposal wants to take out the power of States to legislate, unifying the law of value added tax and strengthening the Council of Finance Administration (therefore CONFAZ) as the proposed wording of Article 155, II, Paragraph 2, Subparagraphs XIII and XV, presented in the amendment.

This shows that the new IVA-F does not correspond in any way to the dreamed value added tax value expected by a large portion of Brazilian doctrine. In the text presented in the Constitution Amendment Proposal (PEC) 233/2008 and the amendment approved in the Special Commission of Tax Reform, there are 3 taxes with the same possibility of incidence which lead to a major problem of the cohesion of the tax system.

2.4 Constitutional approach

The political and administrative organization adopted in Brazil by virtue of Articles 1 and 18 of the Federal Constitution has a federative nature and is formed by the indissoluble union of States, Municipalities and the Federal District, which, beside the Federal Union, are autonomous, which means absence of any hierarchy between them as part of its powers.

The basic postulates of the federation are settlers: a) the establishment of competencies of each of its members, b) the power of their members to legislate freely on their jurisdiction; c) the participation of members of the Senate, in the sphere of federal legislative decision; and d) the ability to be self-sustaining through the collection of revenue from its jurisdictions.

These postulates are aimed at preserving the autonomy of federal entities, which means that none of them is in a higher political position than any other. Incidentally, the Federal Constitution of 1988 preserved the federal system, which means that the federation shall not be terminated by any standard, including constitutional amendment¹³.

¹³ Article 60, § 4º, I of the Federal Constitution.

As a result of this, a constitutional amendment could not eliminate taxes provided in the Constitution 1988, as it has, for example, through the constitutional amendment number 03/93, which extinguished the Additional Income Tax (therefore AIRE), a State tax, and the tax on Fuel Retail Sales (therefore IVVC), a municipality tax.

The constitutional amendment 03/1993, when eliminated taxes, interfered with the power to tax of its Members, thereby reducing the power of raising revenue and weakening of the federative autonomy. Because of this consequences it was declared unconstitutional.

In addition, the PEC as presented, regarding the attempt to remove the States and the Federal District the power to legislate on a standalone basis on the ICMS, represents a threat to the Brazilian federation, reaching the autonomy of Member States.

Another serious threat of breach of the federal principle is the inclusion of the possibility of federal intervention in States, and in Municipalities¹⁴, to reorganize its finances, when a State "retains share of product from the collection of tax provided for in art. 155, II (ICMS), due to another State of the federation".

The intervention is a matter linked to the federal guarantee of order and, because of it, shall not be included or modified by amendment under Article 60, paragraph 4, I, of the Constitution.

Furthermore, the inclusion of Article 105, III, paragraph "d", presented in the amendment, which set to the Superior Court of Justice (STJ) the competence to judge matters relating to the ICMS. This provision actually seeks to remove from the Supreme Court of Justice (STF) the competencel, in final instance, to decide matters relating to the aforementioned tax, in evident violation of *Cláusula Pétrea*, provided in Article. 60, § 4, III of the Constitution, which prohibits constitutional amendment to legislate about the separation of powers.

It must be remembered that all the provisions and principles of the Constitution must be respected when creating or abolishing a law. The complexity of the Constitutional system will not be object of this study due to lack of time and space to do such analysis.

3. CONCLUSION

The amendment proposed by Mr. Sandro Mabel treated Constitutional Law as if it was similar to the ordinary tax legislation. In another words, he did not submit an abstract and general structure, as the Constitutional text must be.

Clearly and directly, the amendment's goal withdraw the competence of Member States and the Federal District to legislate independently on the ICMS, as provided in Article 155, Paragraph 2, XIII.

¹⁴ Article 34, V, "c", and 36, V to amendment.

In addition, contributions that would be abolished in the tax reform are related to individual guarantees, also including social rights, and therefore *Cláusulas Pétreas*, which shall not be changed by constitutional amendment.¹⁵ This is the reason its forbidden, under any circumstances, terminate these important social contributions, under the risk of penalizing the problematic social security system for the working class, the elderly, the sick and children.

Furthermore, employers shall not be discharged from payment of social contribution mentioned upon, considering the fact that they are subjected to the rule of universal contribution to the welfare system. If the cost falls only on the working class, it would violate other *Clausulas Pétreas* related to the fundamental principles of solidarity and isonomy.

Article 155 of the Constitution provides specifically that it is the States and Federal District which will establish the ICMS, namely: the constitutional text has given only to those entities the power to dispose of and treat this tax.

In this manner, only Member States and the Federal District (Legislative and Executive), following the general guidelines set by Complementary Law No. 87/96, can legislate on the ICMS, as well as implement its recovery.

The new IVA-F does not correspond in any way to the dreamed value added tax value expected by a large portion of brazilian doctrine. In the text presented there are 3 taxes with the same possibility of incidence which lead to a major problem of the cohesion of the tax system.

Moreover, brazilian taxpayers expected that IVA-F would be a single tax and abolished all other complex taxes imposed by the government, which would reduce the tax burden and cost of the tax administration. However, as presented, it will be just one more in tax, a scenario already complex tax, excessive and costly.

As stated above, if the reform is approved, workers will, at the end, bear the costs of IVA-F, with wide implications on "transactions in goods and services" which will focus on everything, diminishing the power of purchase of wages, and that, also, will be detrimental to the productive sector, because it will decrease the purchases of products.

It is imperative to remember that workers bearing the costs of the society is not news in Brazil. The original constituent provided a tax in Article 153, VII of the Federal Constitution, so called tax on large fortunes, which is conditioned to the enactment of supplementary law. It is not a surprise that the supplementary law was never even proposed by the government since 1988.

In theory, the Constitution is a system based on the principle of ability to pay, according this principle taxes should be, whenever possible, calculated on the economic capacity of the taxpayer. The person who participates in most of the wealth produced by the

¹⁵ Article 60, §4º, IV of the Federal Constitution.

country should contribute proportionately more. In another words, those who have more should pay more.

The increase on the taxation of consumption, as shown, requires the distortion of the principle of ability to pay, because it would be hardly possible to charge more for the consumption of those who can pay more.

The solution to this grave injustice would be the reduction of indirect taxes (consumption) and increase in direct taxes (income and equity), especially those that focus on the income of those who earn more.

The way this proposal was presented shows that it is not a result of extensive discussions over the last year with States, Municipalities, workers and entrepreneurs, as the government stated in its justification. There never was a public consultation to the society and the only sector which was heard was the entrepreneurs through its federations and associations.

In addition, all government policies created to try to reduce poverty are not showing any practical result. Thus, the poor become ever poorer and the rich even richer.

It is evident that Brazilian law makers are not prepared to comply with the Constitutional provisions. and are not able to make a good job for the society.

These factors may explain the lack of trust in the government, however it does not explain the high wages earned by the politicians. It is outrageous that the government is trying to increase its revenue without thinking about the impact that this increase will have in the life of the society, who really bears the cost of the government's adventure.

If this proposal is approved the big risk is to make the tax rules even more complex than they are today, further unbalancing the federal system and creating regional conflicts. If this occurs, the tax reform instead of withdrawing from businesses and taxpayers the huge weight brought by the major international financial crisis that has been killing the national economy with intensity, it will make problems even worst.

At this time of the crisis, when it is impossible to estimate the its duration, only a certain amount of effort from all parties involved can put the tax reform on track, namely to simplify the tax system. For now, the scenario is the usual one: just a game of pressure, where the most vulnerable part is the taxpayer.

For these reasons, the amendment proposed by Mr. Sandro Mabel shows to not be fair nor constitutional and should be rejected. The changes proposed will not solve Brazil's tax system problem and do not comply with the Federal Constitution provision. The reform is detrimental to the productive sector, workers and the institutions related to the Brazilian Constitution so called *Cláusulas Petreas*.

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