Financial Aspects Of The Territorial Organization System In Brazil

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1. Contextualizing the Issue:

With the advent of the 1988 Federal Constitution and even previous thereto, the Brazilian State could finance itself through tax revenue and the contracting of domestic or foreign loans. And, as it was internally organized as a Federation, it became necessary to establish a form of financing for each sub-national unit, in order that all could enjoy autonomy, even in the raising of funds and allocation of expenses, which characterizes this form of territorial organization.

The purpose of this paper is to present the funding system of the sub-national units as adopted in Brazil through tax revenues, and the major problems faced during these fifteen years of experience under the auspices of the 1988 Constitution.

2. The Tax Financing System of Brazilian States:

2.1 With the advent of the 1988 Constitution, the Brazilian federalist framework was constituted including the Union, States, Federal District and Municipalities[1].

The Municipality is the smallest fraction of the federative units and usually includes urban units concentrated in an administrative seat. Brazil currently has over 5,500 municipalities, each a separate legal entity, which can enact laws that address their specific interests and have the prerogative to establish taxes. Each has Executive and Legislative Branches, with direct elections every four years[2].

States constitute another fraction of the National State and gather Municipalities within a certain uniformity in terms of socioeconomic regions and cultural identities. There are currently 26 States in Brazil, divided into five major regions. Each State has its own Executive and Legislative Branches whose members are elected every four years[3], and also a Judiciary Branch, responsible for judging all litigation of common law, except those involving the federal government's jurisdiction, as well as, evidently, cases that have to do with the National State.

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[1] List of certain works on Brazilian doctrine regarding federalism for possible consultation. Within the works on the general theory of federalism, I have included some that refer specifically to economic-tax federalism. This is not intended to be an exhaustive list but one that may be used as a reference for more thorough consultations: ARAÚJO, Luiz Alberto David. *O Federalismo brasileiro: suas características e a vedação material contida no art. 60, §4º, alínea I*. Cadernos de Direito Constitucional e Ciência Política, v. 5, n. 18, p.145-153, Jan./Mar. 1997; BARACHO, José Alfredo de Oliveira. *Teoria geral do federalismo*. Rio de Janeiro: Forense, 1986; BITAR, ORLANDO. *Organização Federal Brasileira*. *In:* Obras Completas de Orlando Bitar, 3 vol. Brasília, Conselho Federal de Cultura, 1978; BONAVIDES, Paulo. *A constituição aberta: temas políticos e constitucionais da atualidade, com ênfase no federalismo das regiões*. 2. ed. São Paulo: Malheiros, 1996; CAMARGO, Ricardo Antônio Lucas. *A LRF à luz do federalismo brasileiro: compilações doutrinárias sobre a Lei de responsabilidade fiscal*. L & C Revista de Direito e Administração Pública, v. 3, n. 30, 2000; CAVALCANTI, Amaro. *Regime federativo e república brasileira*. Brasília: Ed. Universidade de Brasília, 1983; CONTI, José Mauricio. *Federalismo Fiscal*. São Paulo: Manole, 2004 (also by this author: *Federalismo fiscal e fundos de participação*. São Paulo: Juarez de Oliveira, 2001); COSTA, Gustavo de Freitas Cavalcante. *Federalismo e ICMS: reflexos tributários*. Curitiba: Juruá, 1999; HERDEGEN, Matthias; VOGEL, Bernhard. *Federalismo e estado de direito*. São Paulo: Konrad-Adenauer Foundation, 1993; HOFMEISTER, Wilhelm e CARNEIRO, José Mário Brasiliense (org.). *Federalismo na Alemanha e no Brasil*. São Paulo: Konrad-Adenauer Foundation, 2001; HORTA, Raul Machado. *O federalismo no direito constitucional contemporâneo*. Revista do Tribunal de Contas do Estado de Minas Gerais, v. 41, n. 4, p.189-231, Oct./Dec. 2001 (also by this author and worthwhile reading: *Tendências do federalismo brasileiro*. Revista de Direito Publico. São Paulo, v. 3, n. 9, 1969); OLIVEIRA, Juarez de. *Federalismo: aspectos contemporâneos.* São Paulo: Juarez de Oliveira, 1999; PINTO FILHO, Francisco Bilac Moreira. *A Intervenção federal e o federalismo brasileiro.* Rio de Janeiro: Forense, 2002; REZENDE, Fernando e OLIVEIRA, Fabrício Augusto de. *Descentralização e federalismo fiscal no Brasil.* São Paulo: Konrad-Adenauer Foundation, 2003; SARAIVA, Paulo Lopo. *Federalismo regional.* São Paulo: Saraiva, 1982; SILVEIRA, Rosa Maria Godoy. *Republicanismo e federalismo: um estudo da implantação da Republica Brasileira 1889 - 1902*. Brasília: Senado Federal, 1978; SOUZA, Terezinha de Oliva. *Impasses do Federalismo Brasileiro*. São Paulo: Paz e Terra, 1985; ZIMMERMANN, Augusto. *Teoria geral do federalismo*. Rio de Janeiro:Lumen Juris, 1999 (also by this author: *Teoria Geral do federalismo democrático*. Rio de Janeiro: Lumen Juris, 2000).

[2] Only one subsequent reelection is permitted to the chief of the Executive Branch. There is no such restriction to the Legislative Branch.

[3] In the same sense, in the Municipalities, only one subsequent reelection is permitted to the chief of the Executive Branch. There are no restrictions regarding reelection to the Legislative Branch.

A single Federal District is similar to a State, with an Executive and a Legislative Branch, and where the Capital of Brazil, Brasilia, is located. The Judiciary Branch is maintained by the Federal District. It is not subdivided into Municipalities, with all of its operations performed by the district government.

The Union is the federal level of government. The Executive Branch is led by a President elected to a term of four years, and may be reelected once for a consecutive term. The parliament has two houses, with 513 Federal Deputies in the Chamber of Deputies, each serving a term of four years, and 78 senators that serve eight year terms, renewable each four years. The Judiciary Branch is autonomous.

The Union structure also represents the National State, with laws it enacts valid throughout the Nation (complementary laws) or only within the federal sphere of government (ordinary laws).

2.2 The 1988 Constitution established a tax system with cause-related and non cause-related taxes.

Cause-related taxes are (a) those taxes that arise from the exercise of enforcement authority or rendering of specific and divisible public services rendered to taxpayers or placed at their disposal; (b) *enhancement contributions*, that arise from building of public works that increases real estate value; and (c) *general contributions*, which can be subdivided into (c. 1) *social security contributions*, enacted to support costs of the public social security system, which can be collected from workers in private initiative or civil servants; (c. 2) *social contributions*, which are enacted for the purpose of performing specific social activities; (c. 3*)* *contributions of intervention in economic domain*, which can be enacted to render performance of the National State in the economy of a certain segment feasible; and (c. 4) *contributions in the interest of professional or economic groups*, enacted as an instrument for the National State to perform in benefit of these groups. Cause-related taxes also include (d) *compulsory loans*, the collection of which is linked to specific causes that led to their enactment.

The only non cause-related tribute is the "*taxa*", the collection of which arises exclusively from the imperative power of the State. This is the main reason for which the *jurisdiction to impose* taxes is described in the Constitution itself for each federative unit, as, otherwise, taxes could be established over any and all economic or other type of act.

2.3 Therefore, the Brazilian Constitution grants all federative units (Union, States, Federal District and Municipalities) the right to establish and to collect fees.

- enhancement contributions
- social security contributions from its civil servants to form their separate social security schemes.

2.4 Only the Union may establish:

- social contributions
- contributions of intervention in economic domain
- contributions in the interest of professional or economic groups
- social security contributions to be paid by workers of private initiative to cost the public social security system
- compulsory loans

2.5 Jurisdiction to establish taxes is divided as follows:

The ***Union*** has jurisdiction to institute taxes on:

Foreign Trade:

- tax on importation of foreign products (II);
- tax on exportation, abroad, of national or nationalized products (IExp);

Income:

- tax on income and revenue of any sort, including both individuals (IRPF) and companies (IRPJ);

Circulation/Production of Goods and Merchandise

- tax on industrialized products (IPI);
- tax on credit, exchange and insurance transactions, or related to bonds or securities (IOF);

Property:

- tax on rural land property (ITR);
- tax on large fortunes, under the terms of a complementary law (to date not implemented) (IGF).

The ***States and the Federal District*** have jurisdiction to establish taxes on:

Circulation of Merchandise:

- tax on transactions related to circulation of merchandise and rendering of interstate and intermunicipal transportation and communication (ICMS);

Property:

- tax on *causa mortis* and donation transfer of any goods or rights (ITCM);

- tax on automotive vehicle property (IPVA).

The ***Municipalities*** have jurisdiction to establish taxes on:

Rendering of Services:

- tax on services of any sort (ISS);

Property:

- tax on urban land and building property (IPTU);

- tax on "inter vivos" transfer in any wise, by an onerous act, of property, by nature or physical reception, and of property rights over real estate, except those of guarantee, as well as assignment of rights to acquisition of the same (ITBI).

2.6 The Union also has exclusive jurisdiction for two other types of taxes it can enact, which are:

a) ***residual jurisdiction***, which allows it to establish other taxes as long as they are non-cumulative and are caused by no other act or calculation base of those described in the Constitution. Once established, the Union must share 20% of the revenue from these with the States;

b) in the imminence or in case of foreign war, **extraordinary taxes**, which may or may not be within its tax jurisdiction, which may be cut gradually once the causes for their establishment have been resolved.

08. Even though each federative unit has its own jurisdiction, the sub-national units are not at complete liberty to establish taxes, as the Federal Constitution, in article 146 establishes the need for a Complementary Law in several situations, always seeking to render the collection of these tributes compatible with each other[4] The law in question is the National Tax Code.[5]

[4] "Art. 146. Complementary law is responsible to: I – make provisions regarding jurisdiction conflicts, in tax matters, between the Union, the States, the Federal District and the Municipalities; II – regulate constitutional constraints to the power of taxation; III – establish general rules on matters of tax law, especially on: a) definition of taxes and classifications thereof, as well as, in relation to taxes described in this Constitution, to the acts that generate taxes and the calculation bases and taxpayers; b) obligation, entry, credit, statute of limitations and nonpayment of taxes; c) proper tax treatment to corporate business practiced by incorporated companies. d) definition of differentiated and preferential tax treatment to small and medium-sized companies, including special or simplified tax regimes in the case of taxes described in art. 155, II, of contributions described in art. 195, I and §§ 12 and 13, and of the contribution referred to in art. 239. Sole paragraph. The complementary law

In addition to general determinations, the Constitution itself established that the ICMS[6] (tax on merchandise circulation), a state tax, would require a specific complementary law to set forth a number of parameters for its collection[7].

Likewise the ISS (Tax on Services Rendered), a municipal tax, requires a complementary law to render it compatible[8], in light of the innumerable possibilities of differences among the over 5,500 Brazilian municipalities[9].

3. The funding transfer financial system among Brazilian States: Participatory Federalism

3.1 The collection of some of the abovementioned taxes is not fully appropriated by the federative unit that collects them, as they are shared with the other federative units, characterizing what is known as ***participatory*** or ***cooperative federalism.*** There are two types of fund transfers:

A – Direct Transfer, through which what was directly received by one federative unit is redistributed to another:

1. The Union transfers 50% of ITR (rural property tax) to the Municipalities where the properties are located.

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referred to in section III, d, may also institute a unified tax and contribution collection regime for the Union, States, Federal District and Municipalities, as long as: I – it shall be optional to the taxpayer; II – conditions may be established for different classifications by State; III – collection will be unified and centralized and the transfer of the percentages pertaining to the respective units of the federation maintained, any withholding or conditioning of the same forbidden. IV – collection, surveillance and collection may be shared by federative units, adopting a national and unified register of taxpayers."

[5] Law 5.172/66 voted into ordinary law within the scope of the 1946 Constitution, with alterations, did not provide for Complementary Laws to address these matters, but recognized by the Federal Supreme Court to have the status of a Complementary Law since the 1967 Constitution.

[6] Federal Constitution, art. 155, 2nd paragraph., section XII – "Complementary law is responsible to: a) define its taxpayers; b) decide on tax substitution; c) govern the tax compensation regime; d) set for effects of its collection and definition of establishment responsible for collection, the place of operation related to circulation of goods and rendering of services; e) exclude payment of taxes on exports abroad, services and other products in addition to those mentioned in section X, "a"; f) determine cases where credit is maintained regarding transfers to another State or export abroad, of goods and services; g) regulate the manner in which, through decisions of the States and the Federal District, tax exemptions, incentives and benefits are granted and revoked. h) define which fuels and lubricants will be taxed only once, whether according to purpose, in which case provisions in section X, *b* shall not apply; i) set the calculation base and the manner tax amounts are calculated, also in importing any good, merchandise or service from abroad."

[7] Complementary Law 81/96, which regulates ICMS.

[8] Federal Constitution, art. 156, paragraph 3;. "§ 3 Regarding the tax described in section III do of the head paragraph of this article, the complementary law is responsible to: I – set the minimum and maximum tax brackets; II – exclude exports of services abroad from taxation. III – regulate the manner and conditions in which tax benefits, exemptions and incentives will be granted and revoked."

[9] Complementary Law 116/03, which regulates ISS.

2. The Union transfers the following IOF (financial transaction tax) on gold when used as a financial asset or exchange instrument: 70% to the Municipality where the metal originated from and 30% to the State where that Municipality is located.

3. The States transfer 50% of IPVA (vehicle property tax) collected to the Municipalities where the vehicles are licensed.

B – Indirect Transfer, through which taxes received from other federative units are redistributed, through a system known as Participation Funds:

1. The Union transfers the following from IPI (industrialized products tax) collected: 21.5% to the States, 22.5% to the Municipalities and 10% to the exporter States proportionate to the value of their exports.

2. The Union transfers the following from IR (income tax) collected: 21.5% to the States and 22.5% to the Municipalities.

3. States transfer 25% of ICMS (tax on merchandise circulation) to the Municipalities, with 75% of this amount distributed according to added value and the remaining 25% pursuant to state law.

4. The Union transfers the following from collection of the Contribution on Economic Domain – CIDE, on exploration and sale of oil derivatives: 29%[10] to the States, which transfer 25% to the Municipalities that receive them.

This system of Participation Funds, a central point in Participatory Federalism, is defined by a set of complementary laws that seek to promote a socioeconomic balance between States and Municipalities, and are based on the relation between the population and wealth of each federative unit, seeking to redistribute revenue collected. The Federal Court of Accounts is responsible for performing the calculation of the amount to be distributed to each federative unit through a system of quotas.

[10] The percentage in CA 42 was 25%, but AC 44, of 30-JUN-2004 increased this percentage to 29%.

4. Dilemmas of the System

4.1) Federal funding through contributions and deviation of funding in Participatory Federalism.

One of the initial dilemmas currently facing the Brazilian Participatory Federalism system is that the Union, which centralizes collection of several taxes that must be transferred by force of the Constitution, has no interest in increasing the same, and instead creates and increases other tributes that are not transferred. It therefore enjoys the capability to establish so-called *contributions*, and through these the Union increases it own collection revenue and not Income Tax or even Tax on Industrialized Products.

This procedure creates several distortions, as, since it is a cause-related tribute, the *contribution* must be utilized for the purpose for which it was created, and this has not been fully complied with. In practice, what happens is a replacement of what was heretofore supported through *taxes* to then be supported through *contributions*. Thus it (a) increases collection revenue of the Union with no transfer to States and Municipalities, and (b) the new revenue collected does not increase amounts allocated to the stated activities, as the amount that was previously allocated is deviated to other purposes.

This is the reason behind the sharp increase in revenue collection from so-called contributions (whether social or of intervention in economic domain[11]) as they are not transferred to the other federative units.

The chart below demonstrates the increase in collection of tributes in Brazil from 1995-2002, where one can see how much was collected by the Union, the States and the Municipalities, and the increases in the area of social contributions (highlighted) [12].

OVERALL TAX COLLECTION (in millions of R$)							
TRIBUTES	**1995**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
FEDERAL							

[11] In effect since December 2003, CIDE – contribution for intervention in economic domain, created as a tax on fuels, by Constitutional Amendment 42, is shared among member-States, which in turn share with the Municipalities.

[12] Chart prepared by Gilberto Luiz do Amaral and João Eloi Olenike, from the Brazilian Institute of Tax Planning – IBPT.

IR	28,969	36,524	45,818	51,516	56,397	64,908	85,802
IPI	13,635	16,833	16,306	16,503	18,839	19,456	19,798
COFINS[13]	***15,226***	***19,118***	***18,745***	***32,184***	***39,903***	***46,364***	***52,266***
INSS[14]	***40,690***	***45,890***	***46,740***	***52,424***	***55,715***	***62,492***	***76,082***
PIS/PASEP[15]	***6,122***	***7,590***	***7,547***	***9,835***	***10,043***	***11,396***	***12,870***
CSSL[16]	***5,852***	***7,698***	***7,704***	***7,303***	***9,278***	***9,366***	***13,363***
IPMF/CPMF[17]	***162***	***6,909***	***8,118***	***7,956***	***14,545***	***17,197***	***20,368***
IOF	3,223	3,785	3,541	4,877	3,127	3,585	4,023
IMPORT TAX	4,911	5,138	6,544	7,916	8,510	9,087	7,970
OTHERS	5,905	9,081	20,765	20,176	33,945	34,748	48,465
TOTAL 1	**124,695**	**158,566**	**181,828**	**210,691**	**250,302**	**278,599**	**341,007**
STATE							
ICMS	49,052	62,150	60,503	67,038	82,275	94,267	105,649
OTHERS	4,087	7,170	11,567	12,116	13,108	13,995	10,161

[13] Social Contribution for Social Purposes, taxed on income of companies.

[14] Social security contribution collected by the Union to support the general social security system, coordinated by INSS – the National Social Security Institute, and that is usually withheld from corporate payrolls.

[15] Social Contributions taxed on private company income (PIS- Social Integration Program) or state-run companies (PASEP – Public Servant Support Program).

[16] Social Contribution on Net Profit, taxed on corporate profits.

[17] IPMF (Provisional Tax on Financial Transactions) that was later modified to be a provisional social contribution on financial transactions (CPMF). This is the most perfect example of violation of participatory federalism, because as a *tax* the Union had to share it with the States and as a *contribution* this obligation to transfer a portion thereof no longer exists.

TOTAL 2	**53,139**	**69,320**	**72,070**	**79,154**	**95,383**	**108,262**	**115,810**
MUNICIPAL	9,024	11,305	14,219	15,096	16,011	16,884	19,754
TOTAL 3	**9,024**	**11,305**	**14,219**	**15,096**	**16,011**	**16,884**	**19,754**
GENERAL TOTAL	**186,858**	**239,191**	**268,117**	**304,941**	**361,696**	**403,745**	**476,571**

In other words, tax collection in Brazil has increased overall, and the taxes that the Union does transfer to the States and Municipalities (notably IPI) have not increased in the same proportion. The establishment and increase of social contributions used exclusively by the Union has the effect of weakening the system of *participatory federalism*.

Three contributions alone - CPMF, Social Contribution on Net Profit (CSLL) and Cofins – enabled the government to increase the tax burden by 2% of GDP, representing an additional revenue of R$ 18 billion in 1998. The ma jor changed adopted at the end of that year, and that have been in effect since then, were: (a) extension of the CPMF that had not been proposed by the Federal Government out of negligence but had been compensated by increasing IOF in 0.38% in different transactions; (b) increasing Cofins from 2% to 3% on company income; (c) increasing Social Contributions from 8% to 12% (beginning May 1, 1999) and (d) the fact that the government began collecting Social Contribution on Net Profits (CSLL) on financial expenses from loans and financing and interest on a company's own capital. Moreover (e) the National Social Security Institute (INSS) established that 11% of the gross value paid to service rendering companies be withheld.

The chart below shows the percentage of collection of each tribute in relation to GDP. One sees that a little over 7.5% of Brazilian GDP in 2002 was collected through *social contributions*, which was deviated from the Participatory Federalism system. If one adds *social security* to the *social* contributions, this percentage surpasses 13% of GDP.

TRIBUTES IN RELATION TO GDP – IN $ BILLIONS				
TRIBUTES	**2001**	**% OVER/GDP**	**2002**	**% OVER/GDP**

IR	64.91	5.70%	85.80	6.56%
IPI	19.46	1.71%	19.80	1.51%
COFINS	*46.36*	*4.07%*	*52.27*	*4.00%*
PIS/PASEP	*11.40*	*1.00%*	*12.87*	*0.98%*
SOCIAL CONTRIBUTIONS	*9.37*	*0.82%*	*13.36*	*1.02%*
CPMF	*17.20*	*1.51%*	*20.37*	*1.56%*
IOF	3.59	0.31%	4.02	0.31%
IMPORT TAX	9.09	0.80%	7.97	0.61%
OTHER FED. TAXES	15.60	1.37%	26.55	2.03%
INSS	*62.49*	*5.49%*	*76.08*	*5.82%*
FGTS	19.15	1.68%	21.92	1.68%
ICMS	94.27	8.28%	105.65	8.08%
OTHER STATE TAXES	14.00	1.23%	10.16	0.78%
MUNICIPAL TAXES	16.88	1.48%	19.75	1.51%
% OVER/GDP		35.48%		36.45%
TOTAL TRIB./GDP	403.74	1,138.10	476.57	1,307.40

The chart below shows the increased collection from contributions between 2001 and 2002, which indicates a systematic sidestepping of transferred means of tribute collection:

INCREAS IN TRIBUTES LINKED TO SOCIAL SECURITY AND WELFARE

			IN R$ MILLIONS
TRIBUTES	**2001**	**2002**	**% INCREASE**
COFINS	**46,364**	**52,266**	**12.73%**
CSSL	**9,366**	**13,363**	**42.68%**
PIS	**11,396**	**12,870**	**12.93%**
CPMF	**17,197**	**20,368**	**18.44%**
INSS	**62,492**	**76,082**	**21.75%**
TOTALS	**146,815**	**174,949**	**19.16%**

Collection of contributions linked to Social Security rose 19.16% in 2002 in comparison to 2001. The largest increase was in CSSL (Social Contribution on Net Profit), which rose from R$ 9.36 billion in 2001 to R$ 13.36 billion in 2002, a difference of 42.68%.

Brazilian taxation is heavily concentrated in indirect tributes, which burden production, and more specifically on contributions that burden revenue of companies or payrolls of salaried workers, transferring their prices to consumer goods and services[18]. This in detriment to the Participatory Federalism system.

4.2) The Law of Fiscal Responsibility and the Federative Pact

4.2.1 On the other hand, from an inspiration of international organizations, and in an attempt to achieve financial equilibrium in the States and Municipalities, which, generally speaking, spent more than they collected, the Law of Fiscal Responsibility (Complementary Law 101 dated May 5, 2000) was enacted, which established caps on federative units' indebtedness, taking as a rule the current net revenue[19], as follows (article 19):

I - Union: 50% (fifty percent);

II - States: 60% (sixty percent);

[18] From 1986 to 2002, Brazilian tax burden increased 530% while GDP rose 287% in the same period, according to Gilberto Luiz do Amaral and João Eloi Olenike in a study conducted by the Brazilian Institute of Tax Planning – IBPT. Go to www.ibpt.com.br to access the complete study.

[19] Understood as the "sum of all revenues from taxes, contributions, industrial and agricultural/ranching assets, services, current transfers and other revenues also current, deducting: a) in the Union, amounts transferred to the States and Municipalities by constitutional or court order, and contributions mentioned in line *a* of section I and in section II of art. 195, and in art. 239 of the Constitution; b) in the States, the amounts released to the Municipalities by order of the constitution; c) in the Union, in the States and in the Municipalities, the contribution of public servants to support the social security and welfare systems and revenues from financial compensation mentioned in § 9 of art. 201 of the Constitution." (art. 2, IV, LC 101/00)

III - Municipalities: 60% (sixty percent);

This procedure has caused a great amount of difficulty for some states to adapt and innumerable Municipalities have not managed to get their finances in order, as they find it difficult to obtain credit from both the national as well as international financial system, in the latter case with the Union as guarantor. The abovementioned debt burden caps were established beginning with this Complementary Law.

So, instead of attempting to decrease unnecessary and superfluous spending by the State and Municipalities, a mechanism was established that cut off any possibility of beneficial and healthy indebtedness that would be used to implement development and reduce socioeconomic inequalities.

4.2.2 Moreover, article 20 of the Law of Fiscal Responsibility describes percentages of revenue sharing within the power structure of each federative unit, as follows:

I – To the Union:

a) 2.5% (two point five percent) to the Legislative Branch, including the Federal Court of Accounts[20];

b) 6% (six percent) to the Judiciary Branch;

c) 40.9% (forty point nine percent) to the Executive Branch;

d) 0.6% (zero point six percent) to the Federal Public Prosecutors Office (*Ministério Público da União*);

II – Within each State:

a) 3% (three percent) to the Legislative Branch, including the State Court of Accounts;

b) 6% (six percent) to the Judiciary Branch;

c) 49% (forty nine percent) to the Executive Branch;

d) 2% (two percent) to the State Public Prosecutors Office (*Ministério Público Estadual*);

III – Within the Municipalities:

a) 6% (six percent) to the Legislative Branch, including the Municipal Court of Accounts, if it exists;

b) 54% (fifty-four percent) to the Executive Branch.

[20] It is worth mentioning that despite being called a "Court" it is an auxiliary agency of the Legislative Branch to examine accounts of other Branches of government.

The sub-national units allege that, under the Law of Fiscal Responsibility, they have suffered a reduction in their constitutionally assured autonomy in violation of the Federative Pact.

4.2.3 Two aspects of this law were argued before the Federal Supreme Court as unconstitutional because of concentrated constitutional control,

The first precept argued as unconstitutional is the possibility of States becoming indebted to state-run banks (state or federal)[21].

The second precept argued as unconstitutional is regarding the obligation of States and Municipalities to inform the Federal Executive Branch of its accounts, so that the same may consolidate and make them available, under threat of halting voluntary transfers and new credit transactions[22].

The allegation was that this violates the federative pact, which is the guiding clause in our Constitution, *verbis*:

"Article 60 - ...

§ 4 – No proposal of an amendment will be deliberated upon that tends to abolish:

I – the federative form of the State;"

If not even a Constitutional Amendment can be put before Congress that tends to abolish the federative form of the State, a Complementary Law, such as the Law of Fiscal Responsibility (nr. 101/2000), can certainly not do so. The allegation is that these two obligations were in violation of the federative pact, as it would be the Union creating obligations and prohibitions to be performed by the States and Municipalities, which is a blatant violation of their autonomy.

[21] "Art. 35. It is forbidden to conduct any credit operation between a unit of the Federation, either directly or indirectly through fund, independent agency, foundation of dependent state-run company and any other party, including entities of indirect administration, even under form of novation, refinancing or postponement of debts previously contracted. §1 - Operations between state financial institutions and other entities of the Federation are excluded from the prohibition described in the head paragraph, including its entities of indirect administration, which are not for the following purposes: I – directly or indirectly finance current expenses; II – refinance debts not contracted from the lending institution itself. §2 – The provision in the head paragraph does not hinder States and Municipalities from purchasing debt securities from the Union as investment of available funds."

[22] "Art. 51. The Executive Branch of the Union shall promote, on or before the thirtieth of June, the national consolidation per level of government, of accounts of units of the federation related to the previous year and disclosure of the same, even through electronic means of public access. §1 – The States and Municipalities shall render their accounts to the Executive Branch of the Union within the following deadlines: I – Municipalities, with a copy to the Executive Branch of their respective States, on or before April thirtieth; II – States, on or before May first. §2 – Noncompliance to the deadlines described in this article shall impede, until compliance be performed, that the unit of the Federation receives voluntary transfers and contracts credit transactions, except those allocated to refinancing of the adjusted principle of furnishings debt"

The Federal Supreme Court (STF), called upon to decide the question through a Direct Action of Unconstitutionality – ADI nr. 2250[23], the rapporteur for which was Minister Ilmar Galvão, thus considered in his full decision:

“Direct Action of Unconstitutionality. Preliminary Injunction. Articles 35 and 51 of Complementary Law nr. 101/2000. Credit transactions between federative units by means of transfer funds. Consolidation of accounts of the Union, States, Municipalities and the Federal District. Alleged violation of the Federative Principle.

Article 35 of the Law of Fiscal Responsibility, in disciplining credit transactions effected through transfer funds, is in compliance with section II of § 9 of art. 165[24] of the Federal Constitution, thus not in violation to the Federation.

The sanction, however, imposed upon federative units that fail to provide data for consolidation described in art. 51 of CL 101/2000 likewise does not breach the federative principle, insofar as credit transactions are described in said constitutional rule and the law being challenged refers exclusively to voluntary transfers. Preliminary Injunction denied”.

The merits of the case have yet to be examined, only the petition for a preliminary injunction, which was denied. There are two other legal actions pending before the Federal Supreme Court challenging the constitutionality of several precepts of the Law of Fiscal Responsibility[25], yet, neither of these, to date, have been decided.

Thus, according to a preliminary decision by the Federal Supreme Court - STF, the federative pact has not been violated through the establishment of prohibitions on credit transactions effected by States and Municipalities, nor by the establishment of the obligation of the States and Municipalities to inform the Union on the status of their internal accounts, under penalty of forfeiting certain rights.

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[23] In this case the State Government of Minas Gerais sought an Injunction to suspend the effects of articles of Complementary Law 101/00. The proceedings to hear the petition for injunction began on 20-Mar-03 and were suspended and later, terminated on 02-Apr-2003. Court Gazette, 01-Aug-2003. This decision can be consulted on the site www.stf.gov.br The merit of the suit still awaits judgment.

[24] The text of this article states: “§ 9- Complementary law is responsible to: II – establish rules of asset and financial management for indirect and direct administration as well as conditions for the institution and operation of funds.”

[25] Survey conducted by Minister Nélson Jobim of the STF on 15-Sep-2000, some 04 months after enactment of the Law of Fiscal Responsibility (CL 101, of 04-May-2000), demonstrated the existence of at least the following: ADI's 2238, 2241, 2250, 2256 and 2261, all pending judgment (see single decision by Minister Nélson Jobim, in MS 23.679/DF, on 11-Sep-2000, at the site www.stf.gov.br).

4.3 The possibility of the Federal Government withholding State funds

4.3.1 The Brazilian Federative Pact furthermore admits the possibility of the Union withholding funds from Direct Transfer Funds that belong to the States and Municipalities, in the case of debts of the latter two with the former.

The formula created to implement this possibility of withholding funds is most curious.

The head paragraph of article 160 forbids the withholding or any other restriction on the release of funds from Direct Transfer to States, the Federal District and to Municipalities, including any additional amounts related to said funds.

Since the time it was written, the 1988 Constitution contained a loophole in a sole paragraph, enabling the Union to condition release of funds to payment of credits.

Later, Constitutional Amendment nr. 3, dated 17-Mar-1993 expanded this understanding by mentioning that the provision in the head paragraph did not hinder the Union nor the States (the latter obviously in their relations with the Municipalities) from conditioning release of funds to payment of credits, including to independent government agencies.

The situation gained even greater detail through Constitutional Amendment 29 of 13-Sep-00, which established a new exception to the prohibition in the head paragraph, in mentioning that release of funds could also be conditioned to compliance with a minimum amount of funding in health activities.

In other words, the Brazilian model of Participatory Federalism allows a type of financial wardship by the Union over the States and Municipalities, as if it were a sort of *older son* taking care of the finances and commitments of its *younger brethren*. The same can be said of the States in their relations with the Municipalities.

4.4 The “tax war” among Brazilian States

4.4.1 The expression “tax war” denotes a situation where different States compete among themselves granting tax breaks so that companies or projects will set up within their territories. This can occur internationally among nations or internally among units of the same country.

In the case of Brazil, what is commonly known as “tax war” occurs when a State offers benefits to companies that intend to establish or expand their businesses. In practice, what takes place is a veritable auction of benefits, a tender in reverse. Said benefits may of different natures, the most common being total or partial ICMS exemption, suspension[26], extension[27] or deferment[28] in payment of the tax, reduction of the calculation base, total or partial return, directly or indirectly to the taxpayer or other intermediary, of the amount collected; presumed credit[29]; installment payments, etc. In Brazil this *war* is heightened by the fact that the ICMS collection system is hybrid, that is, a larger share of the tax is charged at the point of origin and a smaller portion at the destination. This, in a country with large socioeconomic disparities from on State to another, results in increasing existing inequalities instead of reducing them, thus heating up the tax war.

Within the abovementioned context, States (and nations, internationally) face the following dilemma: *Is it better to collect more taxes today or accelerate development with a view to increasing collection in the future?*

If the option of future development is chosen, within the tax war policy mentioned above, present collection would be forfeited in order to attract investments to selected priority areas. This means abdicating public funding in the present for health, education, security, in favor of reducing tax burden for industry.

On the other hand, opting to maintain current collection levels and even trying to increase them, without granting tax benefits, when there is a tax war underway, is to abandon any possibility of attracting new investments. It means to not create jobs, not provide new sources of revenue, destroy any attempt at distributing income and to relinquish the use of any existing natural resources. In other words, future collection is a problematic option. The economic benefits one State fails to offer may be offered in another and so the tendency will be for capital to call at the port that offers the highest yield and best combination between profitability and safety.

Attracting private investment in detriment to current tax collection results in increased public needs (schools, hospitals, sanitation) that public authorities are unable to address due to a lack of current revenue, during the period in which the benefit is granted. And, as a result of the market, the companies themselves will not have budget resources to pay for this type of public expenditure, even if they were inclined to do so, which is rarely the case.

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[26] Suspend results in nonpayment of the amount of the tax or part thereof due to amnesty or waiving.

[27] Extending deadline for payment. This procedure results in allowing the taxpayer to have more time to pay, and the deadline may be extended several months after occurrence of the act that generated the tax.

[28] *Deferment* results in postponing payment of a tax on an intermediate stage of production or commercialization until the end of the productive chain.

[29] Granting *presumed credit* means to provide the taxpayer a hypothetical credit to be used to compensate a tax in the following stage of commercialization.

Thus, the neoliberal policy of tax incentives with competition between States is extremely harmful to society as, on the one hand, future revenue generation is compromised in detriment to future generation, and on the other, the opposite occurs. Moreover, the market is not a good guide for public policies, which are not governed by profit, rather by the reduction of inequalities, be they economic, social, cultural or otherwise. Finding the optimal balance between these two extreme situations can be difficult if not impossible.

The tendency is for public finances to wane after a certain period, whether current (for those who opt to grant indiscriminant tax benefits) or in the future (for those who do not at present follow the market rule). Possibly, something in between these two situations, in the period within the granting of the benefits and increase in public needs generated.

Therefore the existence of the economic dilemma between attracting future industrialization or collecting more at present is one of the most difficult questions currently faced by society and only democratic mechanisms can determine what the real will of the people is in choosing between these two options. The simple existence of a tax war that obliges the States to adopt economic policies wherein this dilemma is present makes it imperative that society be involved in the discussion.

4.4.2 In 1975, CONFAZ – National Council of Tax Policies – was established for the purpose of averting tax wars among States. In it, States, under the coordination of the Finance Ministry, would stipulate tax benefits that States could grant with relation to ICMS, as long as the States were *unanimous* regarding the decision.[30]

The fact is that in the mid-1990s, when this type of indiscriminate dispute for investments among States took hold, the system completely fell apart, as many States began granting tax incentives directly to companies without even notifying CONFAZ and without any legal measure in place that was effective against this type of procedure.

Other States, seeking to unbridle themselves from financial and tax constraints, adopted compensation policies, usually in the credit sector, in order to reduce the weight of ICMS on commercialization of goods. The most common example is of one State in the Brazilian Federation that, in seeking to attract companies into its territory, invented the following system: the ICMS was determined and collected fully; nevertheless, the State Bank granted the company credit in the same amount, to be paid without interest or adjustment for inflation, over several months and with a long grace period. In other words, the benefit was

[30]Complementary Law 24/75

not considered a *tax* break, rather a *financial* benefit, and therefore did not require the consent of CONFAZ.

This type of subterfuge regarding legal determinations spread throughout the country through a wide variety of instruments.

The fact is that through these and other clever devices, CONFAZ's power to avoid tax wars among States has been completely relegated to a place of second or even third importance[31].

The STF, called upon to hear questions brought before it through direct legal actions of unconstitutionality filed by the Federal Public Prosecutors Office (MPF), usually decides by declaring the state law granting the benefits is unconstitutional, and that the tax benefits granted in noncompliance with CONFAZ rules is invalid.[32]

What occurs in practice is that the States insist in violating CONFAZ rules as, once a certain state law "x" granting tax breaks to attract and maintain companies in its territory is declared unconstitutional, another law is immediately brought before the state legislature, voted on and passed, which maintains the same procedure, under a different legal packaging. This continues until this new law is also declared unconstitutional and the entire process begins anew.

Basically this is due to the fact that it is of no use declaring law "x" or "y" unconstitutional in one State or another, as long as a single state maintains the procedure, since, while it grants tax benefits, it will attract new businesses to its territory and the businessmen themselves will conduct the reverse auction, inciting States to grant more and better benefits.

4.4.3 The Law of Fiscal Responsibility also strove to reduce the granting of this type of unilateral tax benefit, requiring an estimate on the financial-budgetary impacts of said waiving of revenue and penalizing unsound procedures[33].

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[31] This does not mean to maintain the CONFAZ system, rather to demonstrate its unfeasibility.
[32] See ADIn's 1.296-PE, 1247/MC-PA, 2352/MC-ES, 84-MG, 128/MC-AL, 1296/MC-PI, 1179/MC-RJ, 2021/MC-SP, and others.
[33]Complementary Law 101/00: Art. 14. **"**The granting or expansion of tax-related benefits or incentives that result in waiving revenues must be accompanied by an estimate on the financial-budgetary impact it will have on the year it enters into effect and on the two following years, in compliance with provisions in budget guideline legislation and under at least one of the following conditions: I – demonstration by the proponent that the waiving of revenue was considered in the estimate on revenue in budgetary legislation, under the terms of art. 12, and that this will not affect the goals of fiscal results in the attachment to the law of budgetary guidelines; II – it be accompanied by compensation measures, in the period mentioned in the head paragraph, by means of an increase in revenue from raising tax brackets, expanding calculation base, increasing or creating tributes or contributions. §1 Waiving of taxes includes amnesty, remission, subsidies, presumed credit, granting exemption

It so happens that this was likewise fruitless, due to the argument that it was not addressing a "waiving of *effective* revenue" but rather a “waiving of *future* revenue”, since the tax benefits were not for companies already established in the state but rather those that would come and set themselves up, as well as those already there expanding their production. Thus, they were not renouncing an existing revenue, rather renouncing a hypothetical revenue, that would not even exist had it not been for the tax reduction granted.

Therefore the Law of Fiscal Responsibility also had its effective authority restricted.

4.4.4 The most recent attempt to constrain the *tax war* came through a modification in the Constitution brought by Amendment 42, dated 19-Dec-2003, through which article 146-A was included, providing that: “Complementary Laws may establish special tax criteria for the purpose of preventing competition inequalities without prejudice to the jurisdiction of the Union to, by law, establish rules for the same purpose”.

One may classify both the antidumping compensation rules to be proposed by the Union, which seek to reduce the effects of the *international tax war*, while, through a complementary law, try and avert the tax war among the States. To this date, said complementary law has not even been proposed before the Congress.

4.4.5 It is imperative that a mechanism to completely halt the *tax war* in all of the States must emerge, which, while preventing any new initiative in this sense, and that a public policy be implemented to reduce regional and intra-regional inequalities in order to render this procedure unnecessary, as it produces huge inequalities within the Federation.

5. Conclusion

5.1 In light of the aforementioned, one may state that power in the Brazilian federation is heavily concentrated in the Union, which plays the role of a ward to the States and Municipalities in financial terms, overseeing their accounts and limiting their capacity to allocate their revenues. This ends up creating important political implications, as States and Municipalities become dependent on *voluntary* transfers from the Union, far from the balance described in the fiscal federalism policy implemented by the Constitution.

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in a non-general manner, alteration of tax bracket or calculation base, which results in a specified reduction of taxes or contributions, and other benefits that correspond to differentiated treatment. §2 If the act of granting or expanding incentives or benefits mentioned in the head paragraph of this article arise from a condition listed in section II, the benefit will only enter into effect when the measures described in said section be performed.”

The possibility of moving from shared forms of tax collection to other sources of non-shared revenue and the tax war have ended up rendering the decentralization intended from the onset of our Republic unfeasible, which, according to Orlando Bitar[34], was the result of federalist ideals.

A new federative pact needs to be discussed in Brazil in order to more clearly define the obligations of each political unit and sources of revenue that each may have at its disposal, with no room for loopholes or reallocation of public funds to purposes other than those established in the Constitution and budgetary legislation.

[34] Orlando Bitar. Op. cit., *passim*.