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PERSPECTIVES ON TAX HARMONIZATION FOR BRAZIL AND FOR THE SOUTHERN CONE COMMON MARKET - MERCOSUL

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INTRODUCTION

The most important characteristic of contemporary economics is the huge degree of interrelationships among countries. Never, in the world's history, has existed as many international transactions as we have today. Globalization is the word in fashion, an expression one can hear anytime and anywhere. In government offices, over private company's rooms, at the academic circles, in newspapers, radio and television, in the Internet, and all around, people are discussing the process, its consequences and preparing to fit themselves into the new environment. Even those few who are not aware of it are unable to elude the impact it exerts on their daily life.

The globalization process leads to, and is strengthened by, the association of countries in regional economic blocks. The leading regional economic blocks are the European Union, the North American Free Trade Agreement (NAFTA), and the Southern Cone Common Market (Mercosul). The future formalization of the so-called "Pacific Rim", an economic space shared by Japan and other southeastern Asian countries, is on perspective.

Economic integration can assume the form of a Free Trade Area, if Member States eliminate their border controls to allow the free circulation of goods among themselves. NAFTA is an example of such an agreement. Another possible form is a customs union, in which the Member States have free circulation of goods among themselves plus a common external tariff, to be applied to all imports originating from countries other than their partners. This is the present status of Mercosul. Finally, integration can take the shape of a single market. This is the most complex economic integration, where the features of a trade union are enforced by the coordination of Member States' economic policies. This is the stage that the European Union now finds itself.

An economic block is instituted with the goal of fostering members' economic development, but to achieve this goal the members have to pass through an almost endless list of self-adjustments. These self-adjustments give way to the emergence of long concealed struggles among vested interests, often related to the distribution of national wealth. One of the most critical (and painful) adjustments is tax harmonization.

This is what is happening now in Brazil, where there is a rising debate over reforming the tax system. Mercosul functions as an important determinant of the direction and depth of this reform. It has been said that a system like that of Brazil is an obstacle to further trade integration with other countries. This statement has been enforced by the federal government which, recently, presented a taxation reform proposal.

In short, the item of interest to this paper is to replace the ICMS with a federally collected value-added tax (VAT). It is being argued that setting the VAT is an essential phase in the process of economic integration.

The transfer of authority to tax commercial operations from the states to the federal government of the authority prompted some people in Brazil to call it "the break of the Federalist System". This statement is explained by the fact that state revenues come almost entirely from the ICMS. According to critics of this proposal, without the ICMS revenue, the states would be completely dependent on the federal government. Critics maintain that the alternative sources presented in the proposal are insufficient to keep the states revenues at the same level they are today.

The objective of this paper is to discuss the present situation of tax reform in Brazil, as well as the pace of Mercosul's tax harmonization process and its future perspectives.

In the first chapter the conceptual framework will be established. The main concepts regarding the value-added tax and the process of tax harmonization will be presented, in order to further discuss in the following sections. A slight analysis of Mercosul's Member States' tax system will also be presented here. Brazilian indirect taxes will be described in some detail.

The second chapter shows how tax harmonization is being conducted in the European Union. It will be easy to discover that European countries, in order to structure a common tax system, have gone through the same kind of problems that the South Americans are now facing. The findings of this chapter will subsidize the suggestions in the last chapter.

The situation of the tax harmonization process in Brazil and in Mercosul is the third chapter's subject. Also in this part the possible impact in state level public finance will be presented, if the proposed tax reform is to be implemented.

The fourth and final chapter offers considerations about which features a well-balanced VAT common system should display in order to enhance Mercosul integration.

CHAPTER 1

TAX HARMONIZATION and VALUE-ADDED TAX: CONCEPTUAL FRAMEWORK

Basic Concepts of Tax Harmonization

The fundamental legal document in the Mercosul institution is the so-called Treaty of Assuncion, signed by Brazil, Argentina, Paraguay and Uruguay in March 1991.

The Treaty states, in its first article, that Member States will join into a single market, this implies a free circulation of persons, goods, and capital within Mercosul's borders.

In their route toward the proposed economic integration, the Member States will have to endure many adjustments. Some of the adjustments are designed to enhance the profitable effects of economic integration, while others may be taken in order to avoid potential threats that always come along with it.

Among the necessary adjustments, one of vast importance and equally huge difficulty is the tax harmonization process.

Tax harmonization is the process of isolating and treating tax-related discrepancies, in order to prevent them from disturbing the economic integration.

The difficulty is understandable when one realizes that for decades (centuries, in some cases) taxes were tools designed to build barriers against invasion of foreign goods that could put threats to a national economy. Therefore, it is not a simple task to disassemble long-standing structures that were planned to protect closed economies.

Yet, tax harmonization is essential if real integration is to be achieved. After all, the fundamental objectives of tax harmonization are to ensure the neutrality of taxation in respect to trade within an international community, and the elimination of obstacles to the free movement of persons, goods, services, and capital.

It is necessary to emphasize that harmonization can be the establishing of legislation to which all countries shall conform, or can also take the form of a process of approximation among Member States' tax systems and tax features. In fact, not even the European Union - by far the most advanced and integrated economic block - has built a community law in a strict sense. As it will be explained in a specific chapter of this paper, European countries are in a process of approximation.

Harmonizing Indirect Taxes

In the European Union economic integration process, only the indirect taxes have been harmonized, so far. The direct taxes remain in the control of the national governments. The same is proposed to happen with Mercosul.

Direct taxation is essential to determine product cost and competitiveness, but is confined into domestic scope. If a Member State decides to raise the income tax rate, it will penalize only its own taxpayers. Instead, if the same country decides to raise the tax rate on the consumption of a particular good, the producers of this good will suffer, regardless where they are located, whether within the country or abroad.

That is why indirect taxation is the most suitable field in which a tax harmonization process may take place. This is due to the essential characteristics of indirect tax. Since this tax is straightly embodied in the product's final cost, it influences significantly the price formation process. Therefore, indirect taxation distortions among Member States may neutralize all the efforts done to extinguish intracommunity trade tariffs. This is the main reason why indirect taxes are the ultimate aim of tax harmonization.

General Characteristics of a Value-Added Tax System

Indirect tax appears commonly as the value-added tax, which main characteristics are following presented.

Since its onset in the 1950's, the VAT has been widely adopted by both developed and developing countries. More than 50 countries currently have VAT, including 20 of the 25 members of the Organization for Economic Cooperation and Development (OECD). Recently Canada and Japan introduced VAT into their national tax system. Argentina, Paraguay and Uruguay, three of the four Mercosul's members, adopted VAT as their indirect tax.

A value-added tax is collected in stages as goods and services are produced and sold. The tax at each stage is usually determined by the value added to the product by factors of production such as labor and capital. This is done without regard to whether the goods and services will ultimately be purchased by consumers. Thus, a VAT is levied on sales between businesses as well as on sales to consumers.

A VAT can be structured in a variety of ways that differ in terms of:

- a. what is taxed (tax base);
- b. how preferences are selectively granted (reduced rates, exemptions);
- c. overall rates;
- d. how the tax is calculated at each stage;
- e. in case of international trade, where the tax is to be collected, whether at the production or at the consumption point.

A value-added tax typically taxes a broad range of consumption goods and services, but it does not tax all consumption. Some goods are excluded from the VAT base because of administrative problems in valuing and taxing them. Others are excluded to promote economic and/or social policies. Additionally, reduced rates are used to promote production and consumption of certain products.

A broader base has two obvious advantages. First, it discriminates less among taxpayers based on their preferences for particular goods and services. Second, a lower tax rate on a broad base produces fewer impacts over the structure of relative prices.

Although total consumption is not a realistic tax base for a VAT, it provides a starting point from which practical tax bases can be defined. Excluding goods and services from the VAT base increases the tax rate that must be levied on remaining goods and services in order to keep total revenue at a given level. Narrowing the base and raising the tax rate distorts consumption choices by making taxed products more expensive than untaxed products.

Regarding the calculation method, usually the tax owed at each stage is calculated by way of a credit method. Under this method businesses charge the VAT on the value of their sales (debit), but receive a credit for the VAT

supposedly paid on purchases from their suppliers. The difference between debit and credit is what is owed to government. Therefore, the credit method refunds the tax on the value added in prior stages. Imposing the VAT at each stage by charging tax on the entire value of business sales enables the method to tax the value of different goods at different rates. The credit method requires a cumbersome system of invoices to ensure that the VAT charged on purchases is correctly credited.

The value-added tax has been widely praised both as a "pro-growth" tax that does not inhibit the accumulation of capital and as a "neutral" tax that does not distort the allocation of capital among its alternative uses. An ideal VAT, which taxes a broad consumption base at a uniform rate and grants no preferences, would be a neutral tax.

The inherent disadvantage of taxing consumption is the regressive feature of VAT. It means that the burden of the tax, considered as a share of a specific household total income, is greater for families having lower income. Strictly from this point of view, the income tax is considered fairer.

Mercosul's Member States Tax Systems

Despite the different sizes of their economies, Mercosul's Member States have some similarities in their national tax systems. These similarities provide a starting point for the tax harmonization process and are essentially related to the distribution of revenue among the various forms of taxes. Brazil and Argentina, the two largest Mercosul economies have similar figures as revealed by the analyses below. Regarding the structure of the tax system and the operational specificity of each tax, only Brazil presents significant disparities.

The economic importance of tax revenue is almost the same in Brazil and Argentina, as displayed in the Table I. It shows the weight of tax collection upon their Gross National Product.

Table I

Tax Collection as a Percentage of GNP - 1991

Country	Percentage
Argentina	17.1
Brazil	16.3
Paraguay	10.4
Uruguay	30.2

Source: Comissao de Aspectos Tributarios do Mercosul (Reports, s.d.)

The importance of income tax (business and personal) is alike among the countries, according to the data summarized in Table II.

Table II

Income Tax Collection as a Percentage Total Tax Collection - 1995

Country	Percentage
Argentina	12.8
Brazil	16.6
Paraguay	16.9

Uruguay	4.2
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Source: Bordin e Lagemenn (secondary data).

Parallelism is also to be found when one exams the percentage that indirect taxes represent over each country's total tax collection.

Table III

Indirect Tax Collection as a Percentage Total Tax Collection - 1995

Country	Percentage
Argentina	35.8
Brazil	41.7
Paraguay	53.3
Uruguay	43.5

Source: Bordin e Lagemenn (secondary data).

According to the tables above, it can be affirmed that the tax structures of all four Member States are rooted in indirect taxes. Consequently, the measures taken in tax harmonization process will affect all Member States approximately in the same way, and will focus particularly on indirect taxes. As it has been already mentioned, these similarities help the harmonization proceedings.

Major differences appear when it comes to analyzing the form those taxes assume in each country. Argentina, Paraguay and Uruguay charge commercial operations with federal VAT. Only Brazil has a different system.

Brazilian Indirect Taxes

The Brazilian system is intricate and sometimes obscure. As for indirect taxes, instead of VAT there are three taxes, at federal, state, and municipal levels. The IPI (24% of total indirect tax revenue) is a federal tax that falls over any industrial production. All merchandise transfer, plus the services of telecommunication, transportation, and electric power are taxed with ICMS (71%), which is collected by states. Any other sorts of services are taxed with ISS (5%), collected by municipalities.

According to the numbers above, ICMS is by far the most important indirect tax in Brazil. The Brazilian ICMS differ from neighbor's VAT in all of its basics features, such as calculating method, rates, and tax base. These differences could be minimized by an approximation of rates and procedures. However, the major difference between VAT and the Brazilian ICMS is not located in its operational structure, but in the competence to collect it. While the VAT in Argentina, Paraguay and Uruguay is collected by the country's central government, ICMS belongs to Brazilian states. This discrepancy is the main obstacle for the harmonization process.

CHAPTER 2

THE EUROPEAN EXPERIENCE

Brief Historical Background

European integration is an idea that has existed since long ago. After World War II, the idea reappeared stronger than ever. When, in 1957, the Treaty of Rome was signed, new hope spread over the continent.

From the beginning it was clear to everyone that the process of integration would be gradual, it would take a long time, and it would suffer periodic setbacks. Due to this perception, the integration was based on a strategy of achieving first the simplest goals, postponing to an undetermined future the projects of a single currency and, above all, political union.

The free circulation of goods, the single import tariff on goods and services from non-Community countries, and the definition of a Community trade policy are some of the goals first achieved. Later, the goals selected were the extension of free circulation to persons, capitals and services, the approximation of economic policies and the economic and monetary union. By now, the Community has partially succeeded in accomplishing these goals.

To arrive to the point it is now, the European Community had to use several tools. The fiscal tools were of extreme importance. Of special interest to this paper is the role of tax harmonization, as well as how it is being conducted.

Establishing the European Union as a common taxation area has been a politically difficult task. Though further progress is needed towards a common system of VAT, larger strides have been made in this decade than in any other.

Efforts towards tax harmonization started with the so-called "Neumark Report", in the late 1950's, made by the Fiscal and Finance Committee. The report stated that harmonization should focus on indirect taxes, and should be implemented in three phases. In the first phase, all Member States would have to institute the VAT within their legal framework, but they would be free to establish the elements of the tax. The second phase consists of determining exactly what economic operations (base of taxation) would be subjected to the VAT. In the third, phase all the remaining elements of VAT and all other taxes (e.g., the income tax) would be harmonized.

The first phase was to be complete by January 1st, 1970. But the difficulty that it represented to the majority of the Member States delayed the accomplishment of this phase until 1973. The first European country to adopt VAT was France, in 1954. Greece was the last, having adopted it only in 1987.

In 1977, the European Commission presented a proposal of approximation for VAT elements, starting the second phase. As with the first phase, it is taking a long time for all the Countries to introduce the proposal into their internal legal framework. All Member States have yet to establish a common elected base in which the tax can be applied.

In third phase, occurring in the 1990's, Member States will approximate slowly the VAT rates and mechanisms of inspection, as well as some measures related to the harmonization of other taxes.

The Present Value-Added Tax System in Europe

The ultimate objective of the harmonization process is the creation of a common system of VAT under which sales within the Community would be taxed from the point of origin, which assures the advantages mentioned previously. The view is that the taxation of goods and services in the Member State of origin would meet the needs of a common market, since an answer could be found to two political questions: the harmonization of rates and the allocation of revenues to the Member State of consumption.

The Fiscal and Finance Committee recognized in 1989 that moving to a unified system of taxation in the Member State of origin would take long. So, it was decided that a transactional system would exist for some time. The transactional system should preserve the principle of taxing transactions from the point of origin, while still allowing tax to be collected by the Member State of destination in the majority of situations.

Since 1993, when the present, so-called transactional VAT-system was put into place, substantial developments have taken place at the European Union level.

As it has been emphasized, the introduction of VAT by all Member States was one of the earliest achievements of the European Economic Community. So, the tax over sales was harmonized in terms of structure and main characteristics. However, the creation of a common system of VAT was not accompanied by a harmonization of the base of taxation nor of the rates of taxation. As exported goods were entitled to VAT refunds and imports were taxed to adjust for differences in tax rates, the fiscal controls could not be removed from Countries borders.

No ambition to create real free movement of people, goods and services could be fulfilled so long as Member States were operating border controls in order to collect taxes on imported goods. Since work first started on the introduction of a system of VAT in the Community, the question of abolishing tax frontiers has been discussed.

Fiscal controls were an extra cost on companies trying to do business across the EU's internal borders. They were abolished on July 1, 1993 when transitional arrangements came into force based on collecting VAT on goods and services at local rates in the country of destination. A work program was adopted for creating a genuine common VAT system based on the collection in the country of origin. It was argued that the inefficiencies and distortions that existed in the previous situation were imposing unacceptable costs on companies, besides leading to tax evasion.

At the heart of these considerations is the single market. Its aim was, and still is, to convert 15 separate national markets into a single European market, to open up new opportunities for industry, by giving immediate access to over 350 million consumers, and so strengthen competitiveness in the world.

Thus, the taxation of transactions and the actual collection of tax continued to be carried out in the Member State of destination, considered to be the country in which the goods or services sold would be consumed and to which the revenues generated by taxation should therefore accrue. The situation has changed little since the introduction of the transactional system. No progress has been made on approximating the Member States' laws, and the level of harmonization of VAT rates has remained modest.

The goal of eliminating fiscal checks at the Community internal borders – a condition to the single market – has been achieved through the transactional system. However, it became clear that both the process of harmonizing the Members States' laws regarding taxes, and the transition to a definitive system are still far off.

While it was a major step forward to substantially abolish the internal frontiers of the European Union, this only partly reflects the process of economic integration that has taken place. The level achieved is much more visible when it is recalled that the European Union is today in the process of introducing a single currency. It is not about having a common symbol on coins and bank notes, but about showing that the European Union has developed into a single economy.

Limitations Of The Present System

The present VAT system is designed in such a way that VAT revenues are collected directly by the state on whose territory the consumption of goods and services takes place. Complex rules were introduced in order to define the location of a transaction. Thus, there are 25 different rules for determining the place at which a transaction should be taxed, which led the economic agents to divide their turnover up between the various Member States which are competent to tax them, and this represents an unnecessary waste of energy.

In fact, VAT has lost the objectivity it should have, since the applicable tax system depends on a range of diverse factors that have to be taken into account by the seller of goods or services. Depending on the arrangement of these factors within an industry, it may be profitable for an economic agent to set the business in a way that is at a first glance economically illogical, but leads to greater post tax results.

Due to the form in which the common system was set - European Commission's directives that left too many powers and options to Member States - divergences in its application have existed since the beginning. The

impact of these divergences has been reinforced by the fact that economic agents are now affected to a greater degree by legislation and the way it is applied in Member States other than the one where they are established.

Increasingly denounced as being the most damaging barrier within the single market, the divergence in the application of the common system of VAT between Member States has a variety of origins.

The result is an extremely complex situation in which there is no legal certainty for most economic agents. This in itself constitutes another obstacle to transnational economic activities. Consequently, there are many obligations for firms, which have to be familiar with the details and practical implementation of legislation of all Member States in order to be able to operate in the Community.

In addition, economic agents exploit these divergences using smart tax accounting, which distorts any fairness of competition, that might otherwise exist in the single market.

On top of these difficulties in ensuring correct taxation, firms also face problems in obtaining the deduction or refund of VAT paid in Member States in which they are not established.

The present system is poorly suited for the development of some of the most energetic segments of a contemporary world economy, like remote commerce (Internet), multinational transfers, and international services that evade VAT on consumption. Likewise, current legislation is incapable of ensuring correct taxation in areas such as telecommunications in which rapid technological developments have occurred. Also, private firms are increasingly taking on activities which were previously the exclusive domain of public services, and the system still does not know how to deal with this.

The transactional system gives the Member States the illusion of having retained full sovereignty in determining their revenues and the overall operation of the VAT system. In reality, the system is too complex and subjective. This, plus the fact that it is not well suited to new economic challenges and the divergences regarding its application, have a detrimental effect on the competitiveness of business, without guaranteeing the Member States the certainty of being able to receive the revenues to which they are entitled.

Perspectives For The Common European VAT System

The common system of VAT must have the characteristics of a genuine Community tax area. This means that domestic and intracommunity transactions should afford equal treatment. This is the unavoidable consequence of the ultimate objective of tax harmonization, that is the creation of a common market within which there is healthy competition and whose characteristics are similar to those of a domestic market.

By assuming so, the European Commission continually emphasizes that the present system will necessarily have to change to one closer to its original propose. This means that the transactions will be taxed in the country of origin. The first steps are being done.

Taxing transactions in origin implies close collaboration among countries auditing services. This collaboration is very important in order to prevent fraud, as well to assure a fair share over the tax collection between country of origin and country of consumption.

The European Commission is launching a program designed to enhance the efforts of the European Union to prevent VAT fraud. The program, called Fiscalis will be established for the period of January 1998 to December 2002, and provides the necessary tools (communication and information exchange systems) for national officials to cooperate in preventing fraud. To stimulate this cooperation, the program also provides ways to bring national officials together in real fraud prevention work and to equip them with the necessary knowledge and skills.

The Commission is aware that it is necessary to incentive Member States to take the necessary policy and resource decisions at the national level, as well to make the fullest possible use of administrative cooperation to prevent fraud in the field of indirect taxation. The European Commission report on the operation of administrative cooperation in the VAT area (published in 1996) concluded that failure to make the fullest

possible use of administrative cooperation would pose an unacceptable threat to the integrity of the VAT system. The report made recommendations to the Member States to better integrate administrative cooperation into their day to day fraud prevention activities and to better fulfill their obligations to each other.

Administrative cooperation will be at the heart of the new common system of VAT, as set out in the Commission work program adopted in 1996. The cooperation program is the first of the proposals outlined in the work program to be adopted. It is being proposed now because it will require some years of implementation before bringing the improvements necessary to permit the new system to function properly when it enters into force.

As well as laying the ground for the new system, the Commission's initiatives will already benefit the current VAT system. These benefits will not, however, answer the inherent weaknesses of the current VAT system itself. This can only be matched by a meticulous reform of the system along the lines to which we already referred.

CHAPTER 3

PRESENT SITUATION OF TAX HARMONIZATION IN MERCOSUL and THE IMPACT OF FEDERAL PROPOSAL OVER STATES' FINANCES

Present Situation of Tax Harmonization in Mercosul

There is only one direct mention to the taxation question in all Mercosul's constitutive documents. The 7th article of the Assuncion Treaty states that:

7th Article

In the area of taxes, charges and other internal duties, products originating in the territory of one Member State shall enjoy, in the other Member States, the same treatment as domestically produced products.

It is clearly a general approach, which does not establish how its objectives are to be achieved. Its aim is not to address the tax question in itself but, rather, to ensure the free circulation of products within the community's borders.

However, as already stressed, the free circulation is jeopardized if the tax systems are not harmonic among themselves. Hence, it was necessary to create an institutional tool to start the process of tax harmonization, and the 10th Working Subgroup was created to fulfill this task. Brought into existence by the Assuncion Treaty, it was composed of thematic commissions, among them one called Tax Affairs Commission. In 1995 the 10th Working Subgroup was replaced by the Coordination of Macroeconomics, Fiscal and Monetary Policies, and the Trade Commission undertook the Tax Affairs Commission's assignments.

The principal results achieved so far concern the setting of a Common External Tariff and the abolishment of import duties on other Member States' products.

Regarding the harmonization of indirect taxes, the Tax Affairs Commission produced, in 1993, a report called "Report on General Consumption Taxation in Mercosul." Its main objective was to analyze indirect taxes and enroll the aspects that could present obstacles to free trade, also to suggest potential harmonization procedures.

The Commission concluded that the complex and exclusive Brazilian tax system represents the larger challenge to tax harmonization. The other Members States' indirect taxes are fairly equivalent, and little effort would be spent to harmonize them.

It was suggested that the rates do not have to be exactly the same in all countries, at the very first moment. To establish a narrow band would provide a beginning and fully approximated rates could be succeeded afterward.

Taxing operations at the location of consumption was preferred to taxing at the location of origin. The Commission explained its option by recalling that taxation at origin would ask for a degree of operational cooperation that is still too far. This option implies that border controls will stay in scene for some more years.

Recognizing that, due to political difficulties, the replacement of the Brazilian ICMS may take some time, the Commission proposed some modifications to its legislation. These modifications are intended to reduce the disparities between ICMS and VAT.

In fact, the Commission proposed a step-by-step process, very alike to what the European countries are enduring right now (it will be presented in the next chapter). The fundamental concept is to track a stable - still longer - road to harmonize the countries' tax structures.

Concluding its report, the Commission emphasized that the process of tax harmonization requires political decisions that are out of its scope. However, it enlightens the route to be followed.

Progress has been minimal since the conclusion of the report. Although some measures had been taken within each country, in order to prepare ground to approximation, major efforts seem to be pending until the "ICMS Question" is solved.

The Main Obstacle to Brazilian Tax Reform

In September 1997, the Brazilian federal government presented a tax reform proposition. Mercosul's necessities were among the reasons alleged to carry out the reform. Based in the Commission's conclusions as well as in its own studies, federal government proposed to replace ICMS with VAT.

According to federal technicians, VAT is a more modern, efficient, and simple system than the IPI-ICMS-ISS Brazilian array. Consequently, Brazil ought to replace it with a VAT system. Otherwise, tax harmonization is a goal that will not be fully accomplished. Moreover, federal proposal's supporters say that in a context of growing globalization a country can not afford the price of holding an autochthonous tax system.

Unhappily, things are not so easy. The federal government is the one that signs the international treaties and represents the country in Mercosul decisions, but the National Constitution forbids the federal government to maneuver the state's and city's tax systems. It is politically and operationally impossible to have state level personnel seating together with other Member States representatives. After all, Mercosul is a community of countries, and Argentina, Paraguay and Uruguay would not accept to discuss community affairs with Rio de Janeiro or Minas Gerais, because they want to dialogue with Brazilian central government.

The federal government is aware of this problem and the tax reform recently proposed is an attempt of dealing with it. Replacing IPI, ICMS and ISS with a federal VAT would solve the competence problem. State's revenue would be provided by a sales tax and by an excise tax to be applied to the consumption of cigarettes, oil, beverages, energy and telecommunications.

The creation or extinction of a tax requires a constitutional amendment. The states' deputies are afraid that the end of ICMS will ruin its finances, so the approval of such an amendment is a hard task. The following section presents an unrefined trial of understanding how the proposal, once accepted by Congress, would affect states finances.

Potential Impacts on States Finances

The financial impact of the tax reform can be defined as the difference between the amount a state collects within the current system and the amount it will collect if the system shift to the proposed new model.

Only Minas Gerais state finances will be examined. Furthermore, the exam will confine to one month, December 1997, and one tax, the ICMS. The option for Minas Gerais is due to the availability of data. The temporal limits are necessary to keep the simplicity of this essay. The restriction to ICMS can be explained by the fact that this

tax represents over 90 percent of every Brazilian state's revenues. Notwithstanding, the conclusions can be expanded to all other states, since they all have very resembling fiscal profiles.

Initially, it is useful to remember what are the alternative sources proposed for states' revenue. The states would have the competence to collect a sales tax and an excise tax.

The sales tax would charge only retail sales. Usually the sales tax rates ranges from 6 to 16 percent over the sale value.

The excise tax incidence would be the sale of tobacco, beverages, telecommunications services, electric power, and fuel. The typical average rate for this kind of tax ranges from 10 to 45 percent over the sale value.

In December 1997 Minas Gerais State collected around US\$ 530,000,000 of ICMS tax. This amount is distributed by economic sector as showed in the table above.

Table IV

Composition of ICMS Collection

Minas Gerais State, December 1997.

Economic Sector	Percentage of Total Collection	Value of Collection (US Dollars)
Industrial	63.6	337,080,000
Commercial	25.0	132,500,000
Services	11.2	59,360,000
Agricultural	00.2	1,060,000
Total	100.0	

Source: Minas Gerais Finance Secretariat

In order to simplify the reasoning lets consider that half of total commercial operations are retail sales. The average rate of ICMS for commercial operations is 6 percent, therefore the approximate total financial movement in the commercial sector was 2,200,000,000 dollars. Hence, there would be a retail sales amount of 1,100,000,000 dollars in December 1997. Assuming that sales tax for retail operations with a rate of 10 percent, the sales tax collection would be around 110,000,000 dollars.

The next table displays the collection on consumption of those products on which excise tax would fall.

Table V

Collection on Consumption of Selected Products

Minas Gerais State, December 1997.

Products	Percentage of Total Collection	Value of Collection (US Dollars)

Fuel	14,4	76,320,000
Electric Power	9,1	48,230,000
Tobacco	5,2	27,560,000
Telecommunications	6,5	34,450,000
Beverages	4,4	23,320,000
Total	39,6	

Source: Minas Gerais Finance Secretariat

The financial movement of products above was 1,300,000,000 dollars, according to the ICMS rates applicable to them in December 1997. Accepting an excise tax rate of 20 percent, the collection with this tax would be of 260,000,000 dollars.

The potential sales tax collection (110 million dollars) plus the potential excise tax collection (260 million dollars) results in 370 million dollars of potential total collection. Comparing it to the 530 million actually collected means that Minas Gerais State would receive 30 percent less if the proposed tax system were in use in the last month of 1997.

This loss is even more dramatic when the state's fiscal situation is recalled. With a total debt over 16 billion dollars and recurrent annual deficits, state's finances could not afford such a blow.

It is unnecessary to emphasize the precarious quality and inaccuracy of the calculations above. Nonetheless, it is useful to show that, under the unstable fiscal conditions that Brazilian states face presently, any serious transformation in the tax system may occur with a corresponding redistribution of duties within the national institutional picture.

CHAPTER 4

PERSPECTIVES OF TAX HARMONIZATION IN MERCOSUL

The importance of tax harmonization in shaping the formation of regional economic blocks was already stressed enough in this paper. Why the VAT is the tax that best matches the harmonization needs was also explained. Now it is time to discuss what should be the guidelines to a process of tax harmonization of the value-added tax within the Mercosul.

This proposal assumes that the Federal government can intervene in States tax system, hence passing the Tax Reform through Congress. As already stated, the bottom line of this reform is the abolishment of ICMS and its replacement with VAT.

Based in the European VAT experience, as well as in theoretical approaches, this chapter will enlist the main features that a Common Market tax system may have. These features shall also conform to the community legal framework already developed.

Concerning the unique characteristics of an economic integration process, the guidelines of a common VAT system should be:

1. to treat all transactions in the same way, whether domestic or within the Mercosul;
2. to maintain national tax receipts at least at current levels;
3. to fasten the system with greater legal certainty and effective control;

4. to establish simple rules to be applied uniformly.

In order to conform to these guidelines, it is necessary to take some measures. The most important measures are:

1. to ensure that commercial operations will be taxed only in the country of destination of the goods or services;
2. to guarantee the same level of tax receipts by reallocating revenues between Member States on the basis of their measured levels of consumption;
3. to have a single VAT rate for all Member States, although variations within a narrow band of percentages might be sufficient;
4. to ensure that VAT rules are applied uniformly;
5. to create a common system that is more modern than the existing national ones, with alterations in exemptions, adjustments to changes in the economy (e.g. privatization) and adaptations to new technologies and new products (especially in the field of telecommunications).

It is clear that it would be better to tax the operations in the place of origin but, as the European experience has shown, it is more feasible to tax in the place of destination, at least during the initial stage of customs union construction. To tax consumption based on destination is only practical after developing operational and cooperative multi-lateral inspection and compensation systems. In fact, to tax operations on its origins would present situations such as Brazilian tax inspectors auditing an Argentinean firm.

An approximation within a rather narrow band might be sufficient in the case of the standard rate. Nevertheless, the introduction of a single standard rate should not be set aside since this would be the only way of guaranteeing that the tax is entirely neutral and could bring significant anti-fraud benefits. The level of the standard rate must be settled by a political decision. This decision may consider the context of overall tax revenues and the Mercosul general objectives and fiscal strategy.

The simplicity of the VAT system, and therefore its vulnerability to fraud as well as its effects on business, depends directly on there being as small a number of rates as possible. Therefore, there should be only one reduced rate and its scope should be defined restrictively and according to coherent criteria. Hence, a reduced rate like this would ideally have to be compulsory in all Member States. This rate could then also be applied to the bulk of items, which are currently exempted, as exemptions necessarily hamper the neutrality of VAT.

The single market should function on the same conditions and in the same way as a domestic market, and this applies in the field of VAT. It must offer firms the opportunity to carry on business in all the Member States. The VAT system must therefore ensure that no activity is more difficult to exercise in one Member State than in another and that any purchase can be made on the same terms throughout Mercosul. In addition, a transaction involving several Member States should not be allowed to result in more obligations than one carried out within a single Member State. Any other approach implies costs that would penalize Mercosul business.

Eliminating the distinction between domestic and inter-Community transactions must enable operators to deal with only two possible situations related with trade: transactions involving a third country and transactions carried out within the Community. Thus, it will be possible to achieve a major simplification to the benefit of operators, consumers and administration.

The degree of harmonization of VAT rates which needs to be achieved must be considered in the light of what is judged necessary to avoid harmful distortions of competition for the Community as a whole.

Indeed, one of the essential characteristic of VAT is its neutrality vis-à-vis the conditions of competition. Consequently, maintaining the possibility of applying too many different rates from one Member State to

another would endanger this neutrality with the risk that business locations would be influenced, which would be inconsistent with the very principles of a single market.

Otherwise, the Member States cannot be expected to accept, from the outset, a system of taxation, which might damage their own operators if there is not a sufficient degree of harmonization of VAT rates.

The introduction of a single rate would provide a perfect solution avoiding any tax-related distortion of competition, and, above all, ensuring that the tax is applied simply and uniformly throughout the Mercosul. Nevertheless, an approximation within a band could prove sufficient.

As the operations are to be taxed in their destination, it is absolutely essential to enhance efficient border control. The records gathered at border bureaux are necessary to run the credit method, and to avoid fraud and omission on collecting taxes at destination.

Harmonization of many other aspects of the common system of VAT is necessary. The conditions to perform the right to deduct, the exemptions, the treatment of small firms, are some examples of topics that have to be examined. These aspects must be harmonized in order to ensure competition and uniform application of the tax and are related to the simplicity and effectiveness of the tax system.

It is necessary to recall that in the process of achieving economic integration, taxation policy must take account of constraints put on Member States with regard to the objective of reducing or stabilizing budgetary deficits. Taxation policy should contribute to reaching that objective by, at least, stabilizing tax revenue.

The best way to do this is to promote growth and employment thus increasing overall tax receipts, at the same time reducing expenditures. Another aspect could be to make tax collection more effective by simplifying the tax and thus making it easy to apply and by reducing the tax system's susceptibility to fraud.

The regressive feature of VAT must be taken in account. To minimize the problem, a reduced rate (or exemptions) should be applied to those products that are a burden for the budgets of lower income families. Basic consumption items as food and clothes may receive lighter tax rates. As each population has its own preferences, regarding food and clothes, each country should be allowed to have a list of exempted or low-rated products. It is important to mention that the smaller the number of reduced rates the simpler and more efficient the system.

The basic characteristics of a desirable tax system outlined above represent a blend of both macroeconomic and microeconomic considerations. In the former case, the tax system ought to be sensible to GDP growth, showing it in its revenue-generating capacity. However, since overall economic growth may be affected by the microeconomic allocative effects of a tax system the system's efficiency is critical.

The importance of an efficient tax system can be understood by accepting that taxes influence relative prices in the economy. Therefore, taxes have an impact on the pattern of production, consumption, and income. A desirable tax from the point of view of efficiency is one that minimizes its impact on relative prices, thus leaving the allocation of resources essentially undisturbed. Heavy tax on a particular commodity will tend to reduce its production and consumption and may, therefore, result in a loss of efficiency if resources are diverted from their most productive use. In practice, efficiency is achieved by levying taxes on as broad a tax base as possible and at fairly low and uniform rates. This also implies keeping tax exemptions to a minimum.

Finally, one shall remember that what was mentioned above about the high cost for a country to maintain an autochthonous tax system also applies to a regional market. It is important to have harmonized taxes not only within Mercosul but, also, to approximate the tax system as close as possible to the structures that exists in other economic blocks, like the European Union. A tax system that is immediately comprehensible by commercial external partners works in favor of strengthened multilateral exchange.

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