"A simpler tax system, more legal certainty, and more growth"

A proposed reform calls for replacing Brazil's complex sales tax system with just a federal and a subnational VAT.

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THE COMPLEXITY OF THE CURRENT Brazilian sales tax system, which involves numerous special rules, incentives, and tax rates, makes it very difficult to improve its efficiency in any way other than scrapping it altogether. In June, the Tax Citizenship Center (CCIF), led by director and economist Bernard Appy, completed a proposal that does exactly that: instead of reforming taxes that already exist, replace them with just two new value-added taxes (VATs), one federal and the other subnational. The model was inspired by the best VAT practice of 160 countries, especially New Zealand, which has what is considered the world's most productive VAT, Appy says.

The proposed legislation replaces the federal Social Integration Program (PIS) and the social security financing tax on revenue (Cofins) with a general contribution on consumption (GCC),

and replaces the state tax on circulation goods and services (ICMS) and the tax on services (ISS) with a general consumption tax (GCT). The change would take place gradually, at first phasing in the GCC over two years. During this period, the new contribution would have a rate of 1%, and the PIS/Cofins rates would be reduced gradually so that the transition would be neutral in terms of the total tax burden. After this period, there would be a phased introduction of both GCC and GCT taxes over a period of 10 years and gradual elimination of all current sale taxes. "Today we have many built-in tax incentives, and it will take time for companies to adjust to the new system," Appy says, underscoring the need for states to negotiate possible losses of tax revenues. As the GCT would be fully charged in the destination state, it is necessary to compensate states that would eventually lose revenue, which, Appy says, will require new regional development instruments. He explains that though compensation to the states would be temporary, the transition would be long, extending for several decades.

The proposal provides autonomy for each state to set its tax rates as long as they are consistent and within predetermined limits. Municipalities, in addition to receiving a portion of the GCT revenue, would be allowed to introduce an additional tax on retail sales. With the extinction of current contributions and taxes, the reform proposal would eliminate differentiated treatment of sectors—only financial intermediation would continue to be exempt from VAT. "For operational reasons, in the entire world there is no VAT on financial intermediation because it is difficult to include interest in the credit and debit required for VAT calculation," Appy explains. The reform, Appy underscores, would open the way for a general clean-up of all the distortions caused by excessive special regimes and the cumulative incidence of taxes—it would both simplify the current tax system and ensure the same tax revenue as currently.

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"There will be some sectors that will pay more, others less," he says, so that one result will be a sectoral redistribution of the tax burden, "but all companies will save on tax compliance costs and management of tax disputes; the outcome for the country will be extremely positive as it will bring about an increase in investment and a significant improvement in productivity. This is a long-term gain." The main point, Appy says, is to focus on taxing consumption, applying the same tax rate regardless of how production is organized. "The company is the agent responsible for collecting the tax, and the tax paid by consumers will be exactly what will be collected along the production chain," he explains.

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Eliminating inefficiencies

The CCIF proposal explains the characteristics of the new taxes in detail. First, exports and investments are totally exempt from consumption taxes. "We propose that the accumulated tax credits be refunded within 60 days," said Appy, noting that today the state and federal tax authorities make it very difficult for businesses to get back tax refunds. The proposal also expands tax refunds to all purchases involving business activity; today refunds are limited to purchases of goods and services that are incorporated or consumed in the manufacturing process, as well as inputs and electricity. "For this we suggest using the same approach as the corporate income tax—whatever can be deducted as an expense in the income tax would accrue as a tax credit for the GCC and GCT," he says. That would significantly reduce the cost of tax compliance. Moreover, he explains, the persistence of the cumulative incidence of tax induces an artificial vertical integration of production, since the more value is added to the product the less tax is paid by the company. That generates severe inefficiencies.

The CCIF proposes to extend the GCC and GCT to agricultural activities, giving small farmers the choice to register as a taxpayer or not, depending on their interest in taking advantage of the tax credit. The same choice would be allowed for those included in the simplified tax regimes—Simple and Micro Entrepreneur Individual—who may choose to remain in the current system or register as payers of the new VAT taxes. Appy believes that "The new VAT system would matter most for companies in the middle of the production chain."

Appy recognizes that it will be difficult to carry out the CCIF tax reform proposal, especially in addressing state concerns of loss of tax revenues and the resistance of sectors that would pay more taxes or lose tax benefits. But he considers it to be the only possible way to achieve substantial changes in the tax system, reduce the cost of tax compliance, and reduce the inefficiencies resulting from tax distortions. "The project may face some resistance, but it would cause a significant change in the business environment in the country and promote productivity and investment. It would bring about a simpler tax system, more legal certainty and more growth," he concludes.