



Reform of the Brazilian Goods and Services Taxation Model

Centro de Cidadania Fiscal

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Centro de Cidadania Fiscal is an independent think tank that aims to contribute to the simplification of the Brazilian taxation system and to the improvement of the country's tax management model.

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Introduction

This note aims to present the contribution of Centro de Cidadania Fiscal (CCiF) to the construction of the Brazilian goods and services taxation model. It represents the result of more than three years of discussions on different alternatives to simplify the Brazilian system of taxation on consumption and to correct distortions that negatively impact the country's productivity, investment and business environment.

CCiF understands that it is incumbent upon the political system to decide on possible changes in the Brazilian taxation system, but it also understands that such decisions should be made based on consistent technical analysis and on the evaluation of the costs and benefits of different alternatives.

CCiF's work uses the following characteristics as its references, desirable for a good taxation system, according to the consolidated literature: simplicity, neutrality, transparency, equality and collection capacity.

The following sections present: (1) a description of the distortions resulting from the current goods and services taxation model in Brazil, (2) the difficulties in correcting these distortions, and, finally and primarily, (3) the reform proposal developed by CCiF.¹

1 Distortions in the taxation of goods and services in Brazil

Before presenting the proposals developed by CCiF, it is important to understand why it is necessary (and urgent) to reform the Brazilian goods and services taxation model. The problems with this model become clear when we refer to the standard adopted by most countries in the world, which is that of value added tax (VAT).

1.1 How does the VAT work?

VAT is a non-cumulative tax charged at all stages of the manufacture and trade process, guaranteeing, at each stage, the credit corresponding to the tax paid in the previous stage. This characteristic of the VAT makes it a neutral tax - the imposition of which does not depend on the way production and circulation is organized, so that the tax paid by the consumer in the final stage of sale corresponds precisely to what was collected over the entire manufacture and trade

¹ Since this is a note that summarizes the content detailed in specific technical notes, we have chosen not to include the bibliographic references used in this note, which will be included in the specific notes. The specific technical notes, already available, can be accessed at the website www.ccf.com.br.

chain (see Table 1).

Table 1. Example of VAT imposition

	Value of the Sale (A)	Rate (B)	Debit (C= A*B)	Credit (D)	Due Tax (C-D)
Stage 1	100	10%	10		10
Stage 2	200	10%	20	10	10
Final Product	400	10%	40	20	20
Total Taxation					40

Note. The credit corresponds to the debit from the previous stage. Proprietary elaboration.

In a well-structured VAT, fixed assets generate full and immediate credit and accumulated credits are returned in the case of exports, while imports are taxed in a manner equivalent to domestic production. This makes VAT to effectively be a tax levied on consumption, even though it is charged along the production and circulation chain.

Other characteristics of a good VAT are its imposition on a broad base - which reaches all goods and services - and the adoption of the destination principle, whereby in transactions between countries (or between states, in a federation) the tax belongs entirely to the country (state) of destination. Taxation at destination is essential for VAT to be a tax on consumption and not on production.

In most countries in the world there is only one VAT, with few rates. In most modern VATs (created in the last 20 years) there is only one positive rate.

1.2 Problems of the Brazilian model

Unlike most countries, which have only one VAT, based on a broad imposition and non-cumulative, Brazil has five taxes on goods and services (ICMS, IPI, ISS, PIS and Cofins), which evidence several problems:

- incidence base highly fragmented by sector (see Chart 1);
- extremely complex legislation, characterized by a profusion of rates, exclusions from the calculation base, tax benefits and special regimes;

- serious problems of accumulation, which result from the existence of purely cumulative taxes (ISS and part of PIS/Cofins) and restrictions on the use of credits in non-cumulative taxes (ICMS, IPI and part of PIS/Cofins);
- strong restrictions on the refunding of tax credits accumulated by the companies;
- collection of ICMS in the State of origin in interstate transactions, which makes room for fiscal war between the States and impairs the exporting companies.

Chart 1. Standard of tax imposition by sector

	IPI	ICMS	ISS	PIS/Cofins	
				Non-Accumulated	Accumulated
Industry					
Trade					
Services					
Farming					
Civil Construction					

The highlighted areas indicate the most common type of imposition for a typical company in the sector. Proprietary elaboration.

There are several consequences of this distorting model. First, unlike the VAT, which is a tax levied only on consumption, Brazilian taxes burden production, exports and investments, impairing the country's competitiveness and long-term growth.

Second, the complexity of Brazilian taxes levied on goods and services results in an extremely high cost for complying with ancillary obligations. That is the reason why, for the World Bank, Brazil is the world champion in hours spent by a medium-sized company to pay taxes.

Third, due to the complexity of the taxation system, the degree of litigation between taxpayers and the tax authorities is very high, which not only raises costs for companies, but also creates a strong legal uncertainty environment, jeopardizing investments. Although there is no comprehensive comparison with other countries, there are several indications that the degree of litigation on tax matters in Brazil is one of the highest (if not the highest) in the world.

Fourth, the diversity of forms of incidence and the multiplicity of rates, exclusion from the calculation bases, benefits and special regimes make it impossible to know for sure the amount of taxes charged along the production and trade chain of any good or service. While a good VAT is transparent (that is, the tax charged on sales to the final consumer corresponds exactly to what was charged in the production and trade chain), in Brazil the amount charged depends on the way that production is organized and on the existence of tax benefits, special regimes or cumulative imposition at any stage of the chain.

Finally, and mainly, the distortions in the taxation of goods and services cause the Brazilian productive structure to be organized in an extremely inefficient manner. This happens because - unlike the VAT model, in which the imposition is the same, irrespective of the way by which production is organized - the Brazilian model allows the cost of taxes to vary widely depending on the way in which production is organized. To reduce the tax cost, Brazilian companies elect forms of organization (in terms of sectors, geography, size and internalization or outsourcing of activities) which are inefficient from an economic point of view. In other words, if it were not for the tax distortions, Brazil could produce more goods and services with the same amount of labor and capital currently allocated.

In short, Brazilian taxes on goods and services have none of the desirable characteristics of a good taxation system: they are not simple, neither transparent, nor neutral, nor isonomic. The consequences thereof are: great loss of productivity, reduced investments, loss of competitiveness of national production and an absolute lack of transparency of the tax cost for the citizen.

Considering these problems, it is obviously necessary to reform the Brazilian goods and services taxation model and bring its characteristics closer to those of a good VAT. The question is how to do it?

2 Difficulty in migrating from the current model to VAT

If it is clear that it is necessary to correct the distortions of Brazilian taxes levied on goods and services, it is less clear how to do so. An alternative would be to make specific changes to existing taxes, seeking to correct their defects and bring them closer to the standard of a good VAT. This is a possible strategy, but with limited effects and difficulties in implementation.

First, an important part of the problems with the Brazilian goods and services taxation model is structural in nature. This is the case, for example, of the existence of purely accumulated taxes, such as the ISS and a portion of the

PIS/Cofins. This is also the case with the fragmentation of the taxation base between several taxes, which prevents the efficient operation of the non-accumulated debit and credit regime (for example, ISS debts do not generate ICMS credits and vice versa).

These are serious problems, which prevent the adoption of a model similar to that of a good VAT, and which cannot be solved through specific changes. In addition, attempts to unify the current tax bases - such as to unite the ICMS with the ISS - tend to generate strong resistance due to their impact on federative autonomy and the sharing of revenue between States and Municipalities.

Second, modifying the characteristics of current taxes to bring them closer to those of a good VAT can create serious transition problems. An example thereof would be the migration of ICMS collection to the destination State (through the reduction of interstate tax rates), bringing its characteristics closer to those of a good VAT. Such a change would have many positive effects, including the reduction of the fiscal war, but it could also generate several problems, such as a significant increase in the tax burden and the accumulation of tax credits in interstate transactions.²

Another example would be the adoption of a mechanism for timely refunding of accumulated tax credits. It is very difficult to adopt a fast credit return regime without this causing a significant loss of revenue for the States and the Federal Government, due to the huge stock of accumulated credits that would need to be refunded. This is an especially relevant problem in the current moment of fiscal crisis.

Finally, it is necessary to assess the relation between the political cost and the benefits of specific changes. In the case of an eventual reform of the PIS/Cofins, for example, there would be an improvement in the quality of these taxes, but this improvement would solve only a small part of the problems of goods and services taxation in Brazil.³ On the other hand, the political cost of the PIS/Cofins reform

² The increase in the tax burden happens because the tax that is not collected in the state of origin due to the tax benefits is charged in the state of destination. As for the accumulation of credits, it tends to take place in the case of companies that purchase inputs internally to the state (at high rates) and sell a relevant part of their production to other states (with zero or low taxation). Such companies would accumulate credits but would not generate debits that would allow them to use those credits.

³ The reform of the PIS/Cofins has been discussed at the Ministry of Finance since 2015 (see, for example: <http://idg.receita.fazenda.gov.br/noticias/ascom/2015/dezembro/fazenda-conclui-reforma-que-simplifica-a-contribuição-para-o-pis>). In its full version, such reform would include three main changes: a) the adoption of the non-accumulation regime for all sectors and companies (except those with revenue below the billing limit of the SIMPLES); b) the adoption of the "tax vs. tax" regime, whereby the PIS and Cofins debits would be broken down in the tax documents and would generate equivalent credit; and c) the adoption of the

may be high, also because many of the service sector and the civil construction sector operators have already opposed the proposal. In this scenario, the difficulties in approving the PIS/Cofins change (at least from the point of view of its impact in the sector) would probably not be much less than those faced in a comprehensive reform.

A similar situation concerns an eventual effort by the Federal Senate to approve the Resolution, reducing the interstate ICMS rates. It is important to assess whether the political cost of this change (which tends to be high) outweighs its benefits, since the ICMS, even with the reduction of interstate rates, would continue to be a very poor-quality tax.

In short, although specific changes in Brazilian taxes levied on goods and services are possible, their effects tend to be limited (considering the structural nature of the distortions), the transition problems are relevant, and their political cost may not be much less than the cost of a comprehensive change, which would have much greater positive effects on the economy.

3 The proposal of Centro de Cidadania Fiscal

Given the limits and difficulties in making changes to the current system, CCiF is proposing a comprehensive reform, based on the progressive replacement of the five taxes currently levied on goods and services (PIS, Cofins, IPI, ICMS and ISS) by a tax, VAT type, called **Tax on Goods and Services (IBS)**, the revenue of which would be shared between the Federal Government, the states and the municipalities.⁴ The model would be complemented by a selective tax, levied on goods and services that generate negative externalities, such as tobacco and alcoholic beverages.

The main characteristics of the proposed model are presented below, with emphasis on the transition system from current taxes to the new tax and the transition system for the federative distribution of the revenue. The purpose of the note herein is to present only the main characteristics of the proposal, which will be detailed in specific technical notes.

"financial credit" regime, whereby the possibility of companies' appropriation of tax credits would be expanded.

⁴ In this text, any reference to "states" also includes the Federal District.

3.1 Basic characteristics of the IBS

The IBS would be a non-accumulated tax, with all the characteristics of a good VAT.

The **taxable event** for the IBS would include charged operations with tangible and intangible assets, including leases, licensing and assignment of rights, and services.

The IBS **calculation base** does not include its own amount, and also, during the transition, the value of the five taxes that are being replaced ("**outside**" **imposition**).

Taxpayers would be all those who carry out the taxable event, be they legal entities or individuals. There would be a billing limit below which the registration of small entrepreneurs to collect the tax would be optional.

The **calculation method** would be the debit and credit system, in which taxpayers periodically collect the amount corresponding to the difference between the tax charged on sales and the tax levied on their purchases. The bookkeeping of the debits and credits and the tax calculation would be done by facility, but the payment would be made in a consolidated and centralized manner by Tax ID - CNPJ (headquarters), offsetting credits and debits of all the facilities (headquarters and subsidiaries), even when they are located in several municipalities.

The credit regime would be that of **financial credit**, in which every tax levied on goods and services used in business activity generates credit. There would be restrictions only on the appropriation of credit related to goods and services acquired for the personal use of the company's shareholders or employees and not related to the business activity.

The term for **refunding of accumulated credits** would be up to 60 days from the date of the request made by the taxpayer. If there are indications of irregularities in the constitution of the credits, this term could be extended for another 120 days, during which interest would run (at the Selic rate) on the amount to be refunded. After the 180-day period elapses without the investigation process being concluded, the amount corresponding to the credits would become transferable to third parties, regardless of the tax authority's authorization.

Exports would be totally exempt, through the guarantee of maintenance and return of credits to the exporters.

The tax levied on the purchase of goods and services aimed for the expansion of property, plant and equipment would be fully and immediately credited, ensuring the complete exemption of the **investments**. The advantage of this model - in relation to the exemption of capital assets - is that it does not require the breaking down of the acquired goods and services between inputs and investments.

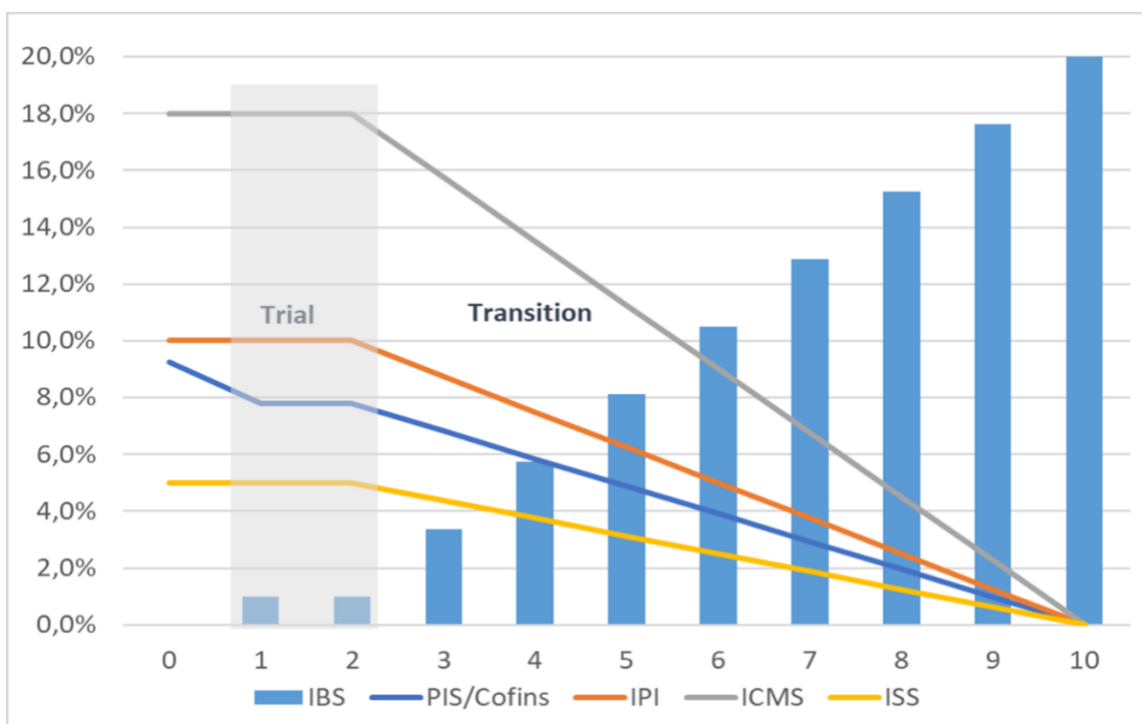
3.2 Transition for the companies

The transition to the new taxation model would be made gradually, over ten years, keeping the tax burden constant.

More precisely, the proposal is that the IBS be created with a low rate (of 1%), which would be maintained for a two-year trial period, reducing the Cofins rate by offsetting. The two-year trial period would serve not only to assess the functioning of the new tax, but also to accurately measure its revenue potential.

After this trial period, the transition would be completed in another eight years, through the progressive and linear increase of the IBS rate and the simultaneous reduction of the rates of the current five taxes, which, at the end of the process, would be extinguished (see simplified example in the following graph).

Graph 1. IBS transition



This model allows implementing the transition while keeping the tax burden constant. This is possible because the model allows to accurately measure the loss of revenue loss of the current taxes, which would be linear (12.5% in the first year of transition, 25% in the second and so on), as well as the revenue potential (per

percentage point of rate) of the IBS. In other words, in the first of the eight years of transition, the IBS rate would be increased by such a percentage that would result in an increase in revenue equivalent to 12.5% of the revenue of the current five taxes, and so on.

The long transition period proposed is justified for two reasons. The first is that the change in model affects relative prices, and consumers and companies need some time to adjust to the new reality, even renegotiating contracts, as needed. The second reason is that several companies currently enjoy tax benefits, which would cease to exist in the new model. Although most of these benefits are distorting, their sudden exclusion could generate turbulence, by making several productive units uncompetitive. In other words, the transition period needs to be long enough for companies to adapt to the change without major issues, but short enough for new investments to be made with reference to the new tax model and not the old one.

In particular, the transition model proposed would be an organized way of eliminating the ICMS tax war, since as the ICMS rates are reduced, the benefits will lose strength, being extinguished at the end of the transition period.

Finally, it is possible that, at the end of the transition, companies will have tax credits to recover from taxes that will be extinguished. As the proposed model does not include any form of communication between the five current taxes and the IBS, the suggestion is that the accumulated credit stock of ICMS, PIS/Cofins and IPI be securitized and translated into state and federal government debt securities (secured by the Federal Government).

3.3 Rates, exemptions and special regimes

CCiF understands that the IBS should have a uniform rate for all goods and services, for several reasons. Firstly, because it simplifies the collection process a lot. Second, because the adoption of a uniform rate eliminates the need to classify the goods and services in several categories, which inevitably generates distortions and litigation. Third, because the uniformity of the rate empowers the citizens, who is able to know exactly what is the government's share in the cost of the goods and services they are acquiring, and they are thereby able to compare this cost with the return obtained in the form of public services.

It is not without grounds that international literature strongly recommends adopting the VAT at a uniform rate, and the vast majority of VATs created in recent decades follow this pattern.

CCiF understands that the IBS should have a minimum of tax collection exemptions and special regimes. For technical reasons, they may be necessary in some situations, such as for very small taxpayers, or the adoption of a single-phase taxation regime for a few products, such as fuels and cigarettes.

CCiF recognizes that the transition to a uniform rate model is politically complex, in view of the large difference in sector imposition of the current tax regime, and that inevitably there will be pressure to adopt different rates for some goods or services. The mere fact that a particular sector is currently taxed at a lower rate is not, however, sufficient reason to maintain different treatment in the new model. Any discussion of reduced rates should be based on an assessment of whether there are justifiable reasons for different treatment and, mainly, of whether these reasons offset the cost of a more complex and less transparent taxation system.

Furthermore, it is crucial to understand that the granting of differentiated taxation for one sector, which results in a lower burden, means that all the other sectors will have to subject themselves to higher rates to maintain the revenue.

3.4 Extra-fiscal

Currently, Brazilian taxes on goods and services are widely used for extra-fiscal (non-tax) purposes of a social, sector or regional nature. This is the case, for example, of the tax exemption of the food staple basic basket, of the sector and regional benefits of the PIS/Cofins and of the ICMS (including the incentives of the tax war) and of the benefits for the Manaus Duty Free Zone.

CCiF believes that the IBS should not be used for extra-fiscal purposes. The purpose of this tax should be to collect revenue to finance government expenditure. The objectives of public policies are more efficiently achieved through other instruments.

This fact becomes clear, for example, when we consider the exemption of the good staple basic basket. Although poor families spend a larger share of their income on purchasing products of the food staple basic basket, wealthy families spend, in absolute terms, a higher value on purchasing those products.⁵ In this context, it is

⁵ According to the latest IBGE Family Budget Survey (2007/2008), families in the higher income range spend three times more on products of the food staple basic basket of PIS/Cofins than those in the lower income range.

more effective, from a distributive point of view, to collect the tax on products of the good staple basic basket and transfer the collected amount to the poorest families. Such a model can be implemented by raising the amount allocated to income transfer programs (such as *Bolsa Família*), or through a “personalized exemption” regime, in which the tax paid by low-income families on their consumption (identified through CPF registration in purchases) is returned to those families in the subsequent month, through the social programs cards, subject to a limit per family.

The same reasoning applies to the other extra-fiscal objectives of the current taxes on goods and services. This does not mean that objectives of public policies that are currently implemented via benefits under PIS/Cofins, ICMS, IPI or ISS should be abandoned. It just means that there are more efficient instruments than these taxes (and that the IBS) to promote such objectives - be they of industrial, regional or social policy.

A subject matter that deserves special attention concerns the granting of tax benefits under the ICMS. CCiF recognizes that the strong regional disparity in Brazil requires the adoption of measures aimed at the development of the poorest regions. However, ICMS benefits, especially those of the tax war, are not an efficient way to resolve regional inequalities, for two reasons. The first is that the fiscal war has become widespread and today all the states of the federation, even the wealthiest, grant incentives, which leads to a drastic reduction in the revenue of states with limited effects for the regional development. The second reason is that the benefits of the tax war are usually granted as an appeal for companies that, by vocation, would not install their facilities in the state, resulting in an irrational and inefficient regional distribution of production units.

In this context, CCiF understands that the gradual loss of the States’ power to grant incentives must be offset by an increase in the allocation of federal funds in regional development policy. But it also understands that it is important that these funds are used efficiently, through measures that explore regional vocations and that are aimed, for instance, at correcting infrastructure deficiencies and at qualifying workers, leading the poorest states in the country to become more competitive as productive hubs.

Finally, another problem with the use of general consumption taxes (such as IBS) for extra-fiscal purposes is that a complexity is created, which results in higher

operating costs and litigation.⁶

The best VATs in the world are not used for any extra-fiscal purpose. In several countries VAT is used for social purposes (through, for example, the tax exemption of some foods), given the strong political appeal of this type of measure, but only in rare cases is it used for other extra-fiscal purposes - sector, regional or environmental - and always in a much more moderate manner than as it is done in Brazil.

3.5 Responsibility of the States and Municipalities and Revenue Sharing

The proposal is that states and municipalities have autonomy in setting their IBS rates, that is, the tax rate would be uniform for all goods and services within each federative entity but could vary between states and between municipalities.

This option is justified by the need to maintain the federative autonomy of Brazilian states and municipalities, especially when considering that the ICMS accounts for most of the revenue of the Brazilian states and the ISS also evidences high relevance at the municipal level.

Since the IBS is a tax on consumption, the increase or reduction of the state or municipal rate implies greater or less burden on consumers in the state or municipality. In this model, an environment of political responsibility is created wherein there is clear opposition between the public authorities and citizens-consumers-voters of the states and municipalities.

In the transition to the IBS, a state reference rate would be defined, which is the one that replenishes the ICMS revenue of the group of states, as well as a municipal reference rate, which would replenish the total ISS revenue in the country (formation of the IBS rate is detailed below). The reference rate would be adopted automatically for all the states and municipalities, which would, however, have the possibility, by law, of establishing a rate higher or lower than the reference rate.

In interstate or intercity operations, for taxpayers or non-taxpayers, the rate of the state and municipality of destination of the good or service would be applied.⁷ The

⁶As an example, suppose that, aiming at a greater focus on the tax reduction of the food staple basic basket, a policy is adopted that reduces taxation on "second-rate" meat but not "first-rate" meat. The implementation of such a policy would certainly require the tax administration to start evaluating cuts of meat and would require complex control and specific inspection of butcher shops. The inevitable result would be an increase in the level of litigation at a cost to taxpayers and to the tax authority.

⁷As an example, in a sale transaction from São Paulo to Belo Horizonte, the rate applied in

collection would be centralized and jointly managed by the Federal Government, the states and the municipalities, as detailed below.

The sharing of the revenue between states and municipalities would be defined based on two parameters: a permanent criterion and a temporary adjustment, aimed to guarantee a smooth transition in the federative sharing of the collection, which would extend for fifty years.

The permanent criterion would be the sharing of revenue based on the principle of destination, whereby, in interstate and intercity operations, the revenue belongs entirely to the state and municipality of destination, wherein the consumer of the good or service is located.⁸

The temporary adjustment, on the other hand, would be made in such a way to offset the loss or gain of the state or municipality due to the change in the current sharing of the ICMS or ISS revenue to the distribution of the revenue of the state and municipal shares of the IBS based on the destination. This gain or loss would be calculated in each of the eight years of the transition from current taxes to IBS and adjusted for inflation. In the first twenty years, the adjustment would be entire, that is, in the sharing of revenue there would be a complementation/deduction corresponding to the real value of the losses/gains determined by each of the states and municipalities. Over the subsequent thirty years, this offsetting would be progressively reduced, until it is extinguished fifty years after the beginning of the transition.

In practice, this model means that state and municipal revenues would be little affected during the initial twenty-year period and affected very smoothly over the subsequent thirty years. In other words, while for taxpayers the transition to the new taxation model would last ten years, the transition in the federative sharing of the revenue would be longer, extending for 50 years. In addition, as the expected effect of the taxation system reform is an increase in potential GDP, the eventual negative impact of the change to the revenues of some states tends to be offset by the increase in tax revenues derived from the higher growth.

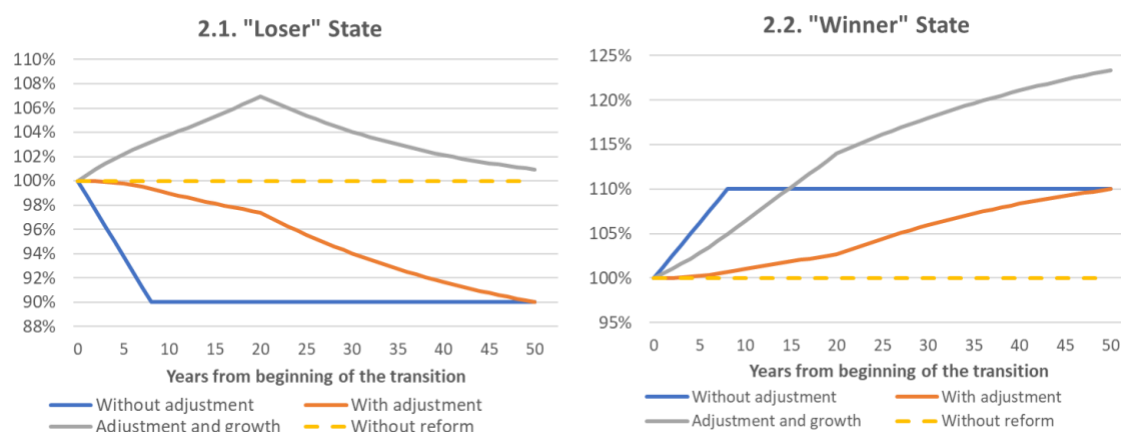
Graphs 2.1 and 2.2 depict the impact of the reform on the revenue of two

the operation would be the sum of the federal rate, with the Minas Gerais rate and the Belo Horizonte rate.

⁸ There are several ways to implement the principle of destination in interstate and intercity operations. In the proposal, the sharing of revenue to the state and municipality of destination is made using on the centralized collection of the tax, based on information from the electronic invoices. Such a model is only feasible due to the great advance observed in Brazil in the adoption of electronic tax documents.

hypothetical states: one that would lose 10% of the ICMS revenue with the transition to the destination and another that would gain 10% of the revenue. The dotted yellow line corresponds to what would be collected as ICMS if the IBS were not adopted. The blue line shows how the state revenue would evolve, if only the permanent sharing rule were applied. The orange line shows how the state revenue would evolve with the temporary adjustment rule. Finally, the gray line shows the evolution of the state's revenue, also incorporating a hypothesis of greater growth of the economy as a result of the reform.

Graph 2. State Revenue (% of the scenario, maintaining the ICMS)



Notes. Scenarios elaborated with the hypothesis of real growth of the economy (without the positive impact of the reform) of 2% per year. To construct the scenario that also considers the positive impact of the reform on growth (gray line) it was assumed that the reform would raise the growth rate of potential GDP by 0.5 percentage points per year, during the first 20 years and 0.05 percentage points per year for the subsequent 30 years. Proprietary elaboration.

As observed, the adoption of the temporary adjustment greatly minimizes the effect of the transition on state and municipal finances. In addition, when considering the positive effect of tax reform on growth, even a potentially "loser" state or municipality could benefit.

The temporary adjustment in the federal revenue sharing of the IBS would be made only for the portion of revenue corresponding to the reference rate. Possible increases or reductions in state or municipal rates in relation to the reference rate would be immediately shared according to the principle of destination, that is, they would only burden or benefit consumers in the states or municipalities that implemented the change.

The proposed model of adjustment in the federative sharing of revenue, characterized by a 50-year transition, has several advantages. The first is that it allows for a very gradual adjustment in state and municipal finances. The second is that, by allowing time for states and municipalities to adjust in a non-traumatic way to changes, it makes the offsetting of losses of state and municipal revenues by the federal government unnecessary - a topic that has always generated much controversy in previous debates on taxation reform.

Finally, it is worth mentioning that the reform of taxes levied on goods and services and the federative sharing of the revenue model opens room for revising the criteria applied for sharing of the state portion of the IBS transferred to the municipalities (corresponding to the current ICMS share, which is the 25% portion of the ICMS transferred to the municipalities). It is broadly agreed upon that the current criteria for sharing the ICMS quota-share (whereby three quarters of the total are proportionally shared to the value added in the municipality and a quarter by state law) generate many distortions, disproportionately benefiting small or medium-sized municipalities where large production units are installed.

The proposal is that the portion of the ICMS quota-share currently proportionally shared to the added value will be distributed proportionately to the population, when migrating to the IBS. Such a change would result in a sharing of revenue much more compatible with the municipalities' actual need for revenue.

3.6 Formation of the IBS rate

The current model of revenue sharing and constitutional tying of revenues that characterizes the Brazilian fiscal regime generates major budgetary rigidity.

An example of this rigidity is the allocation of ICMS revenue. Of each BRL 100.00 collected as ICMS, BRL 25.00 belong to the municipalities. And of the remaining portion, 25% (BRL 18.75) is linked to education and 12% (BRL 9.00) to health. This means that of the BRL 100.00 collected, only BRL 47.25 is available for free use by the state. In many states, there is even greater rigidity, due to the additional ties established in the state constitutions.

This system causes rational budget management to be very difficult. As an example, if a certain state wants to expand public security expenses by BRL 1 billion and finance this increase in expenses by increasing the ICMS rate, it will have to collect BRL 2.1 billion more and compulsorily allocate BRL 1.1 billion to other purposes.

The excess of revenue ties also contributes to the excess of tax benefits in the country. As the budget is very rigid, whenever possible, governments seek to achieve public policy objectives through benefits or changes in tax rules. This is a less transparent and usually less efficient way of implementing public policies compared to the use of budgetary resources, in addition to making tax legislation much more complex.

Maintaining the current rules for sharing and tying of revenues, the merger of several taxes into a single tax would further aggravate the problem of budgetary rigidity. In the case of IBS, for example, if the current allocations of the IPI, Cofins and PIS were converted into fixed allocations for the federal portion of the new tax, it would increase budgetary rigidity for the Federal Government.

The ideal scenario would be to solve the problem of rigidity by reducing ties as much as possible and delegating the allocation of resources to the budget. This is, however, a politically complex change. In this context, the proposal is that, in the creation of the IBS, a change be made to the sharing and tying regime of the five taxes absorbed by the new tax, which reduces budgetary rigidity, without, however, affecting the current allocations of resources, as subsequently explained.

The proposal is that each portion of the revenue from ICMS, ISS, PIS, Cofins and IPI which currently has a destination defined due to criteria of constitutional sharing or tying be incorporated in the new tax as a sub-rate of the IBS (called "singular rate"), which would be managed by the Federal Government, the states or the municipalities, in proportion to the revenue of each of the taxes replaced by the IBS. This model does not affect the taxpayers, for whom only the total rate is relevant, but it greatly reduces budgetary rigidity, by allowing each singular rate to be managed individually.

Table 2 depicts an example of how the IBS rate would be composed - in terms of singular rates - assuming that the total tax rate was 25% and based on the current criteria for sharing and tying revenue from each one of the taxes replaced by the IBS, defined in the Federal Constitution.

Table 2. Initial composition of the IBS rate

	Singular Rate	Current Tax		Singular Rate	Current Tax
Managed by the Federal Government	9.2%		Managed by the States	13.8%	
Federal Portion		PIS/Cofins and IPI	State Portion		ICMS
Free	2.90%	Cofins	Education	2.58%	
Social Security	4.63%		Health	1.24%	
FAT – Unemployment Insurance and Bonus	0.58%	PIS	Free	6.51%	
FAT – BNDES	0.39%		Municipal Portion		
Regional Funds	0.04%		Quota-Share	3.44%	
State Portion		IPI	Managed by the Municipalities	2.0%	
FPE	0.26%		Municipal Portion		ISS
FPEX	0.12%		Education	0.50%	
Municipal Portion			Health	0.30%	
FPM	0.30%		Free	1.21%	
			Total	25.0%	

Note. Estimated rates based on the collection in 2015 of taxes replaced by IBS, according to data from the Brazilian Federal Internal Revenue Service. The state and municipal portions corresponding to the current IPI incorporate both the allocation to the FPE and FPM and the offsetting for the export of manufactured goods (FPEX). The effect of the Untying of Federal Revenue (DRU), nor the federal tying of a portion of the IPI revenue for education and health has not been considered, since this tying has been suspended, under the terms of Constitutional Amendment no. 95, of 2016.

The singular rates could be changed by law of each of the entities and may even include other revenue ties defined in the state constitutions. To guarantee federative autonomy, the singular rates corresponding to the state and municipal portions managed by the Federal Government and those corresponding to the municipal portion managed by the states could not be reduced. The singular rates corresponding to the portion of the current taxes allocated for health and education actions could not be reduced either.

This model has several advantages. The first, already mentioned, is the lower budgetary rigidity. As an example, if a state wanted to increase public security expenses and finance this expansion by increasing the IBS state tax rate, it could do so by increasing only the singular rate corresponding to the free portion managed by the state, without affecting other revenues and expenses.

Another advantage is the greater transparency, since the breakdown of the rate would make the destination of the tax transparent for consumer-voters, thereby allowing for a democratic discussion of the costs and benefits of the policies being financed. The model would also avoid unclear forms of fiscal policy management, such as what occurred in the late 1990s, when the Federal Government raised the Cofins tax rate (and at the same time untied part of the revenue from social contributions) as a way of raising the Federal Government's primary surplus. In the proposed model this could be done directly and transparently by raising the singular rate corresponding to the free portion of the Federal Government.

Finally, federative tensions resulting from the Federal Government's reduction of the tax rate that have part of the revenue allocated to the states and municipalities would also be avoided, such as occurred in several situations in which the federal government reduced the IPI rate - a tax whereof more 50% of the revenue is allocated to subnational entities.

3.7 Interaction with SIMPLES Nacional

Although CCiF understands that SIMPLES Nacional needs to be reformulated to eliminate some distortions of the current model, this is a topic that deserves a specific discussion, to be carried out on a later instance. Anyway, there is no doubt that simplifying the goods and services taxation model is a necessary condition for an eventual review of SIMPLES.

In this context, CCiF initially proposes that companies adhering to SIMPLES can choose between two alternatives:

- a) To maintain SIMPLES in the current format, just replacing the reference to PIS, Cofins, ICMS, ISS and IPI with a reference to IBS, but maintaining the current allocation of revenue to states and municipalities. In this alternative, companies adhering to SIMPLES would not take credit from IBS or transfer tax credits.
- b) To adopt the normal IBS debit and credit regime, subject to the same conditions applied to the other companies. In this alternative, the SIMPLES rate levied on billing would be reduced by an amount equivalent to the portions currently allocated to PIS, Cofins, ICMS, ISS and IPI. The other SIMPLES levies on billing (corresponding to IRPJ, CSLL and employer's contribution to social security) would be maintained.

In general, the tendency is that companies adhering to SIMPLES that sell goods or render services to final consumers (which are the vast majority) opt for the first alternative, while companies adhering to SIMPLES that are in the middle of the production and trade chain (which are the minority) adopt the second option.

The transition for companies adhering to SIMPLES would be made gradually, over ten years, at the same pace as the transition from current taxes to IBS.

For companies adhering to presumed profit regime, there would be no differentiation, the normal IBS regime being adopted. In other words, the presumed profit regime, which belongs to the income tax sphere, would not affect the taxation of goods and services (contrary to what happens today in the case of PIS and Cofins).

3.8 Legislation

The creation of the IBS, as well as the progressive reduction and subsequent extinction of the five taxes replaced by the new tax and the transition in the federative sharing of revenue, require a constitutional amendment. CCiF understands that the constitutional text can be detailed regarding the transition of current taxes and the federative sharing of revenue, but it should be as lean as possible regarding the IBS.

There are several reasons why the constitutional text on the IBS (and, in general, on the taxation system) should be simple and objective. On the one hand, the way in which economic activity is organized is changing fast with the advancement of the digital economy, and it is important that legislation be flexible to keep up with these changes. On the other hand, the excess of details on tax matters in the Constitution opens room for divergences in interpretation (which could be resolved more quickly in infra-constitutional legislation), contributing to broaden tax litigation.

The detailing of the legislation on the IBS would have to be done by the complementary law, since it is a national tax, which is the responsibility of the Federal Government, the states and the municipalities. There would also be a single regulation, issued by the federal government based on parameters defined by mutual agreement among representatives of the three spheres of government.

3.9 Tax administration and litigation

The collection of the tax would be centralized and managed in a coordinated manner by the Federal Government, the states and the municipalities, in the manner that is already done today for SIMPLES Nacional. The sharing of the revenue collection among the different entities of the federation would be done automatically, according to the criteria already explained in this technical note.

The tax inspection would also be done in a coordinated and harmonized manner, with the participation of the tax authorities of the three spheres of government. As this is an important topic for the proper functioning of the tax, CCiF has started an agenda of discussions with representatives of the federal, state and federal tax

administration on what would be the best way to organize joint action in tax management and inspection.

The proposal is to have administrative litigation specific to the IBS, as this is a tax that is both federal, state and municipal. The way in which IBS administrative litigation would be structured is being discussed by a group of experts.

Finally, since it is a nation-wide tax, it is understood that judicial litigation must be processed by the Federal Justice.

3.10 Selective tax

As previously mentioned, according to CCiF's proposal, the IBS would be complemented by a federal selective tax, levied on goods and services that generate negative externalities, which consumption is to be discouraged. This is especially the case for tobacco products and alcoholic beverages.

The proposal is that the selective tax has a single-phase application, being due only in the production stage and in imports. The tax could be charged per unit of product (*ad rem*) or proportionally to the value of the taxed goods and services (*ad valorem*), or both, under the terms defined in ordinary legislation. The tax charged would be considered a cost to the purchaser and would not generate credit in the subsequent stages of trade.

Introduction of the selective tax would take place gradually, through the progressive increase of the rates. The proposal is that the increase in the rates of the selective tax occurs simultaneously with the increase in the IBS rates, over the eight-year transition period.

It is worth noting that, unlike the IBS, which is a tax with a collection purpose, the selective tax has a purely extra-fiscal (regulatory) purpose.

4 Final Comments

This technical note presents the outline of CCiF's proposal to reform the Brazilian goods and services taxation model. The core of the proposal is the replacement of five current taxes - PIS, Cofins, IPI, ICMS and ISS - with a single VAT type tax, called Tax on Goods and Services - IBS, whose characteristics reflect the best international practices.

The proposal to migrate the Brazilian goods and services taxation model to a VAT-type model, which seeks to bring Brazil closer to what is practiced in the rest of the world, is not at all original. This proposal has been defended by several experts at least since the mid-1980s.

The novelty of the proposal rests in the transition pattern, both for companies (progressive transition over ten years) and for the federative sharing of IBS revenue (transition in fifty years). Such a transition model, in addition to not changing the tax burden, enables minimizing many of the oppositions found in previous proposals for taxation reform, by both companies and federation entities. Another novelty is the proposal to replace the current model of constitutional sharing and tying of revenue with a model in which the tax rate is composed of several singular rates, not affecting the current sharing of revenues, but greatly reducing budgetary rigidity.

To a large extent, the innovations proposed in the transition model (especially concerning the federative sharing of revenue) are only possible because Brazil has advanced a lot in documents and tax obligations becoming digitally processed, especially through the electronic invoice (NF-e).

It is important to note that the proposed model is not a closed proposal, but rather a contribution to the debate on improvement of the country's taxation system, which can also be improved. CCiF itself continues to discuss some technical details of the proposal and will release technical notes as it progresses in these studies.

There are many benefits expected of the proposed changes. On the one hand, the great simplification of the goods and services taxation model would contribute to a significant reduction in the cost of taxation compliance (cost of compliance), as well as litigation on tax matters. In particular, the simplification could even allow the compulsory entry of the tax for smaller taxpayers, who would only be required to register purchases and sales through the electronic invoice system. In the aggregate, the change would represent a significant improvement in the country's business environment.

On the other hand, the proposed changes tend to contribute to the expansion of the investment rate in two ways: by reducing the cost of capital assets (resulting from elimination of cumulativeness); and by the increase in the legal certainty of companies, a consequence of the major simplification of the taxation system.

Finally, and mainly, the proposed changes tend to make the Brazilian taxation system much more neutral, eliminating allocation distortions that negatively affect productivity. Although it is almost impossible to make an accurate calculation of the impact of changes - as it would depend on the analysis of each of the existing sector distortions -, it is possible to estimate that there would be significant positive impact on productivity. A change in the taxation system in the proposed line would probably be the measure of the microeconomic reform agenda with the greatest impact on the country's productivity and potential GDP over a horizon of ten to twenty years.

The reform under the proposed terms does not affect the tax burden, but it significantly improves the quality of our taxation system, making it simpler, more transparent and neutral, and benefiting Brazil's long-term growth.