

Chapter 5

International experience in Federal countries- Brazil and Canada

1. GST/VAT has been adopted in more than 160 countries and has been found to be attractive because of simplicity, transparency, neutrality and ease of operation. There are many nations in the world having federal structure and have implemented GST system of taxation.

2. The mandate of the Empowered Committee also included studying model of GST existing in different countries before suggesting suitable model for our country. Any country desiring of implementing the GST would undoubtedly analyze similar system under similar conditions existing in other country and simulate the problems on the issues which are likely to arise in its implementation in their own country. Perhaps in the Indian context, it was advisable to analyze and understand the outcome of implementation of GST model in Brazil and Canada. The issues relating to GST in these countries is discussed in brief in the following paragraphs:

3. Brazilian Taxation System

3.1 Brazil is a Federative Republic composed of the Union, 26 states and the Federal District, with a total of 5,500 municipalities. The country is divided into five macro regions, each of which is composed of states with similar physical, human, economic and social characteristics. An overview of the Brazilian economy is marked by accentuated regional imbalances that require the State to assume a redistribution role, clearly one of the major characteristics of the current tax model. Brazil was one of the first countries in the world to have implemented a Value Added Tax in the context of the overhaul of the consumption taxes on goods and services at the time of the fiscal reform of 1965. This was an important step in the modernization of the Brazilian tax system. On the other hand, there

was also a need for a tax framework able to support the growth foreseen for the 1970's. Nevertheless, this tax reform was subject to the directives from the military government in place since 1964. The trend to economic and political centralization imposed a model where the federal government benefited from the revenues considered at that time as the most promising.²⁵

3.2 At the time of its implementation, the political and economic context was dominated by the need to ensure both local autonomy and centralization of the main powers in the hands of a central military government. Therefore, services were taken out of the scope of VAT and a Tax on Services -ST- was established at the municipality level. At the State level a tax on goods -GT- was created. In order to also allow the Federal Union to benefit from the excellent perspectives offered by consumption taxation, a wholesale tax was levied on industrial products. This system replaced the old cascading tax. In parallel, these changes reflected the political needs in a difficult context. This "fiscal federalism" was adapted to the demands of the new military government.

3.3 Once those reforms were implemented, the Brazilian Government was confronted by new international challenges caused by an increasing public debt needing for reforms of the tax system. Democracy in Brazil was restored in 1988 and the country adopted constitution in 1998. The major tax guidelines are defined by the Federal Constitution, which sets down general principles, the limits of taxing authority, jurisdictions and the question of sharing of tax revenues. National Tax System was instituted by the Constitution itself, which determines that the Union, States, Federal District and Municipalities can institute taxes, considering the power to tax as

²⁵ Celina Souza (2001)

one of the inherent qualities of the State. ²⁶Political-administrative autonomy, considered an essential characteristic of federative system, grants each level of government the right to institute taxes, fees (corresponding to utilization of public services and police power) and contributions targeted at improvements (resulting from public works).

3.4 According to the 1988 Constitution (with the alterations introduced by Constitutional Amendment no. 3, dated 03/17/93), the taxes under the specific jurisdiction of the Union, States and Federal District and Municipalities are as follows:

TAXES	JURISDICTION
Foreign Trade Taxes	
- Import Tax - II	Union
- Export Tax - IE	Union
Taxes on Assets and Income	
- Income Tax - IR	Union
- Rural Land Tax - ITR	Union
- Tax on Automotive Vehicles - IPVA	States
- Tax on Property Transmission <i>Causa Mortis</i> - ITCD	States
- Urban Building and Land Tax - IPTU	Municipalities
- Transmission Tax <i>Inter Vivos</i> - ITBI	Municipalities
Taxes on Production and Circulation:	
- Industrialized Products Tax - IPI	Union
- Tax on Credit Operations, Exchange and Insurance - IOF	Union
- Tax on the Circulation of Merchandise and Interstate and Intermunicipal Transportation Services and Communications - ICMS	States
- Tax on Services of Any Nature - ISS	Municipalities

²⁶ Secretariat of federal Revenue of Brazil

Note: The Federal District has both state and municipal taxing authority.

3.5 Aside from the taxes listed above, the Federal Constitution reserves exclusive authority to the Union to institute social contributions, contributions on intervention in the economic domain and those of interest to professional or economic categories. In the case of social contributions, one should stress that the States, Federal District and Municipalities may levy contributions on their civil servants in order to cover the costs of their Social Security and social assistance systems targeted to those workers. Direct taxes account for only 30 percent of all tax revenues, while indirect taxes (such as value-added taxes) account for the remaining 70 percent (Kee, 2003,p.15), that demonstrates that the Brazilian system is extremely regressive. These taxes are further categorized as: own-source, which are collected and spent by the same level of government, and shared, which are collected by one level and distributed to lower levels. For example, the major sources of revenue for the federal government are the personal income tax and industrialized income tax. Although, the federal government keeps 56 percent of the revenue from those two taxes and distributes 21.5 percent to the states and 22.5 percent to municipalities, with part of the distribution providing greater funding to poorer states and municipalities. The main source of own-source revenue for states is the tax on circulation of goods and services, which is a value -added tax at the state level, and that is retained in 75 percent by the states and shared 25 percent to municipalities.²⁷

3.6 Thus , GST of Brazil can be categorized into three major groups.

- i. **IP1 (*Imposto Sobre Produtos Industrializados*)**- Federal VAT on the manufacturing sector
- ii. **ICMS (*Imposto Sobre Operacoes Relativas A Circulacao*)**

²⁷ Maurin Almeida Falcao (2005)

De Mercadorias E Servicos) - State VAT on consumption covering agriculture, industry and a number of services.

iii. ISS (Imposto Sobre Servicos) - Municipal VAT - a tax on services which is not included in the ICMS. This consists of taxes which are mostly sector specific. One sector covers services under industrial, commercial and professional sectors with rates varying from 0.5 to 10.0% in different municipalities. The other indirect taxes under the second group consist mainly of (i) tax on financial transactions (IOF) (ii) tax on retail sale of fuels (IVVC) and (iii) tax on transmission of financial amounts and rights (IPMF). The third category comprises contributions to the social integration programme (PIS); the public employees financial reserve fund (PASEP); and various other social contributions.

The contribution of the ICMS varies from one state to another. Among the major states, Sao Paulo collected 38.2% of this tax as revenue in 1991 as against 9.95% in Minas Gerais, 10.3% in Rio de Janeiro, 7.67% in Rio Grande do Sul, 5.47% in Parana, 2.66% in Pernambuco and 1.88% in Ceara. Thus, almost 60% of the revenue was collected by three states and over 75% by seven states.

3.7 Federal VAT

(a) It is a tax restricted to the manufacturing sector only, and, levied on all transactions of taxable industrial products. The tax base consists of industrial value added defined as sales minus purchases, keeping capital goods outside the creditable base. The scope of IPI is restricted to the delivery of industrial products at the producer level and is levied on

- (i) importers of foreign products who subsequently sell them;
- (ii) industrial establishments performing any industrial process

from which a chargeable product results, even if it is actually exempt or subject to zero rate

- (iii) Establishments assimilated by the law to be industrial establishments.

The coverage for the taxable transactions under the IPI includes those industrial products that have been the objects of an industrial process *viz*, changing the nature, performance, completion, display or purpose of a product or improving its readiness for consumption. However, agricultural and mineral products are excluded from the purview of IPI. Also, retail and wholesale trade as well as services are excluded from its scope; it is restricted to a few select industrial activities only.

(b) Rate Structure : The IPI has a multiplicity of rates with considerable variations across commodities. This is attributable primarily to three factors:

- i) equity considerations
- ii) degree/ extent of processing of commodities
- iii) luxuries and sumptuary goods are taxed at high rates.

The rates are specified in a tariff list and are subject to frequent amendments. In general, IPI rates are: 330% on cigarettes, 200% on beer, 77% on perfumes, 40 to 50% on automobiles, 20% on wine, 8 to 10% on chemical inputs, 4 to 15% on paper, 4 to 10% on electrical machinery and equipment as well as nonmetal minerals, and 4 to 6% on metals.

IPI levied on raw materials, capital goods, intermediary products and packaging materials entering into industrial establishment's gets credit against the tax liability of the final goods provided these final goods are not exempt from tax. However, the credit is available with respect to exports and production of certain exempt articles specified

by law.

Imported goods are subject to IPI. However, under Law 9000 of 16th March 1995, the import of various equipment, tools and machinery is exempt.

(c) Exemptions under IPI: The major exemptions or exclusions are:

- (i) some specific inputs
- (ii) the outputs of firms installed in Manaus Free Zone - the ZFM (Zona Franca de Manaus) and approved by proper authority
- (iii) large number of specific products or projects. About 60 products are taxed at zero rates or exempted from the IPI. These include food items, pharmaceuticals, fertilizers, skins and leathers, and shoes. Exports are zero-rated.

(d) Collection

Most of the revenue of the IPI is generated from cars and other vehicles (16.2%), tobacco products (13.2%), beverages (10.1%), chemical products (8.1%), and the products of metal and mechanical industry (7.0%).

3.8 State VAT:

(a) ICMS replaced the sales turnover taxes in sixties. However, the coverage of ICMS is not all inclusive. First, the base of the specific taxes is explicitly excluded. Secondly, a large number of capital goods produced in Brazil are exempt. For example, agricultural machinery and equipment were exempted in 1969. This was followed by an exemption in 1971 for a wide range of equipment and machinery for the industrial sector intended for the northern and north-eastern regions. Exemptions also include intermediate imports, imports exempted from import tax, fertilizers and pesticides, many inputs for agricultural production, vegetables, eggs, and sale of agricultural

equipment in the north-eastern states. Except for these exemptions, the base of the ICMS includes the sale of goods at all stages of production-distribution process including retail trade as well as agriculture and cattle raising sectors. However, it excludes tax on services that is levied separately under ISS.

(b) Rates

There are seven rates applicable now:

- i) Sumptuary consumption items such as liquor, cigarettes, tobacco, electronic goods, video games, sports, communications, gas and alcohol are taxed at 25%;
- ii) Standard rate @ 18%
- iii) Electrical consumption between 50-200 kw. is taxed at 12%.
- iv) Food items @ 7% for rice, beans, bread, salt, meat and food items.
- v) Besides there are three more rates of 4%, 21%.

Industrial exports are zero-rated with some exceptions.

© International and Inter-regional Transactions:

ICMS being a state-VAT, the tax is levied on all intrastate sales, i.e., the sales made within the state. However, in a federal country any sale that involves the movement of goods from one state to another does not remain a purely intra-state transaction. Therefore, in treating inter-regional transactions, Brazil follows the "origin principle where the tax is levied by the exporting state. The importing state allows credit for the tax paid in the state of origin.

However, to neutralize the impact of varying levels of development in different states, the tax rate on inter-regional transactions varies according to destination. While the general rate on interstate transactions is 12%, the differential interstate rate is 7% for goods sent from south-east to north-east or to the central-west. Through

the levy of a higher rate of tax (17%) on sales and reimbursement at a lower rate (7%), these states raise 10% on imports. This adjustment operates as equalization mechanism even when the less developed states export to rich states, yielding a corresponding revenue loss to the rich states. For example, when the transaction takes place between a poor (exporting) state and rich (importing) state, the poor state collects 12%, which is reimbursed, by the rich state. Thus, the rich state raises only 5% (17% minus 12%) on imports consumed in the state.

This feature of "triangle trade" puts the exporting state to a definite revenue loss. However, these adjustments are intended to act as a regional equalization scheme through which southern states support the states in the north by reducing interstate tax rates selectively."

(d) Tax Harmonization.

Conselho de Politico Fazendaria (CONFAZ) (National Public Finance Council) plays an important role in harmonizing the interstate tax under ICMS. CONFAZ determines the exemptions or reductions in the rates of ICMS through meetings at regular intervals. However, the interstate rates are fixed by the enactment of the Senate. CONFAZ consists of all states' representatives with 27 councilors. The CONFAZ can change the rates but as there has to be unanimous approval of such a proposal, the changes are infrequent. Under the agreements of the CONFAZ, some specific products such as vegetables, eggs and domestic fish are exempt. Also, it has granted exemptions to sale of agricultural equipment to the north-east and to Para, Amapa, and Rondonia. Similarly, agricultural exports including specified vegetables and fruits are exempt. Small businesses are exempted on administrative considerations. Although CONFAZ harmonizes inter-state trade, some of the states try to grant concessions (such as grant of payment deferrals to attract industries) that are not permissible. Sales to ZFM area and industrial exports

are zero-rated. However, the credits earned by the exporters are rarely reimbursed in cash by the government. Thus, export credits are non-refundable and are an additional burden on the exporters.

Although, the Constitution grants immunity to exports, some semi-manufactured goods are taxable. However, the list of exempted items has been gradually enlarged and includes textiles, primary, intermediate and agricultural exports including frozen meat and fruit juice.

(e) Management of ICMS in Brazil

Administration of ICMS (the state-VAT) is a state subject. Hence, variations prevail among different states of the federation. CONFAZ provides overall supervision of the administrative aspects of the ICMS in different states. Various areas of activities undertaken in managing VAT are as under:

(i) Registration of Dealers

All the dealers are required to be registered with the department before the commencement of their business. Registration is essential also for (i) coordination with the federal income tax authorities and for (ii) obtaining license from the environmental department. To have proper identification of the bonafides of the dealer, he is required to produce documents related to his property and other credentials to show his financial status at the time of registration.

(ii) Classification of Dealers

ICMS is collected and paid to the government by the dealers according to their turnover. For this purpose, the dealers are classified into three categories: (i) micro enterprises, (ii) retailers, and (iii) large dealers. Micro enterprises are exempt from payment of tax upto certain turnover.

(iii) Payment of ICMS

Every registered dealer is not required to pay the tax. However, the procedure of payment of tax requires that the tax paying dealer submits a form (ICMS-2) before the 10th of every month along with its payment to a bank. The ICMS-2 contains all the details necessary to identify the category and features of the dealer such as the information on the code of economic activity, type of commodity purchased and sold, tax credit, exemptions granted, check posts through which goods enter, and other details of the payment. The ICMS-2 passes through four different channels, each one conducting some checks on the entries.

(iv) Submission of Return

All dealers having a turnover above the exemption limit are required to submit a monthly return in Form CEC. This return form requires the dealer to submit all the details about him including the economic activity, debits and credits of ICMS and authentication of the receiving officer. The Form CEC, a two-page document, is thus meant to provide the management of the ICMS with all the necessary information including the summary of all the transactions for control, cross checking, comparison and auditing of the dealer.

(v) Auditing of Dealers

The department analyse trend of the turnover and tax payments by the dealer and compares it with the sectoral trends to which the dealer belongs. In addition to special selections for auditing due to reasons of evasion, usually 1 percent of the dealers are selected. For this purpose, various methods are used.

(vi) Fiscal Frontiers (check-points)

ICMS administration also set up fiscal frontiers (*Postos Fiscais*

de Fronteira) at various important border points of the state to monitor inter state movement of goods., which acts as custom posts at the state borders. All the vehicles passing through these frontiers are stopped to obtain documents concerning the goods being carried by the vehicles. Thus, the frontiers control the inflow and outflow of the goods into and out of the state. The information so collected at the fiscal frontiers is sent to the concerned assessing authorities to cross-verify payment of tax on these transactions. Thus, the fiscal frontiers provide necessary information about the likely turnover of the dealer.

3.8 Problems of the current structure

Currently, the main problems that Brazilian tax system are :

- (i) GST exhibits concern in the relationship among states or among states and federal government
- (ii) Limited initiative and state action in its power to levy taxes (competence shared with the Senate and with the Confaz – National Council for Financial Policy)
- (iii) Discretionary treatment of national products
- (iv) Difference in the incidence of the ICMS on imported products, contribute to exacerbate the discretionary treatment of national products
- (v) ICMS tax have 27 different state regulations actually in force; and ICMS rates have about 44 different existing rates;
- (vi) Border frontiers created to check inflow and outflow acts as hindrances in the free flow of goods across the states give rise to corrupt practices at the frontiers and loss of manpower and truck time at the check posts

4. VAT in Canada

4.1 Goods and Services Tax (GST) at rate of 7% came into effect in Canada on January 1, 1991. It replaced earlier system of