

2009

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Fabio Roberto Castilho

Rodrigo Frota Silveira

Recommended Citation

Fabio Roberto Castilho & Rodrigo Frota Silveira, *Brazilian States Tax War Explained by the Property Right Theories of Law and Economics - Fake Redistributive Policies Leading to Underdevelopment*, 15 LAW & BUS. REV. AM. 353 (2009)
<https://scholar.smu.edu/lbra/vol15/iss2/6>

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BRAZILIAN STATES TAX WAR EXPLAINED BY THE PROPERTY RIGHT THEORIES OF LAW AND ECONOMICS— FAKE REDISTRIBUTIVE POLICIES LEADING TO UNDERDEVELOPMENT

*Fábio Roberto Castilho and Rodrigo Frota Silveira**

ABSTRACT

The most important tax in Brazil is the ICMS, a kind of value-added tax (VAT), rendered by the Brazilian State. In the last decades, Brazilian states engaged in a ferocious competition process of concession of illegal ICMS benefits. In such process, local authorities provide local firms with fake ICMS tax receipts that are used to reduce the ICMS paid in other states of the Brazilian Federation. Such actions are frequently justified as attempts to promote economic development in states of the Brazilian Federation where economic development is most needed. This paper's central objective is to prove that the ICMS Tax War [hereinafter Tax War] policies are aggressions to property rights motivated by an attempt of local governments to increase their own levels of taxation. The paper also attempts to demonstrate, as the secondary objective, that the kind of investment attracted by the Tax War is opportunistic and has low specific assets, generating poor or no local positive economic externalities. If the paper's central objective is true, the tax system currently implemented in Brazil contributes to generating underdevelopment, given that, in the Tax War environment, productive investments demanding high specific assets tend not to prevail in the competition with players that take opportunistic advantage of illegal tax privileges granted by Brazilian states. The conclusions on the illicit use of tax competition transcend the Brazilian experience, being also useful for countries that intend to sign international agreements on taxation (such as in the income tax field) or engage in the formation of Free Trade Areas and Economic Communities.

* The authors would like to thank Professors Decio Zylberstajn and José Maurício Conti of the University of São Paulo for the support and incentive in academic research. We would also like to thank Ernesto Ricca and Henrique Shiguemi Nakagaki of São Paulo State Treasury for the chance to test and apply academic knowledge in real world cases.

I. INTRODUCTION

THIS paper focuses on the Brazilian tax system and, more specifically, illegal state competition for tax revenues as an underdevelopment factor. Our field of analysis is the ICMS, a state-rendered VAT that is the most important tax in Brazil in terms of revenue.

Douglas North states that third-world countries are poor because their institutions do not encourage productive investments.¹ A tax system, given the importance of its interference on microeconomic decisions, is one of the most important institutions, leading to optimal or suboptimal economic performance. The Brazilian Constitution allows the ICMS paid in one state of the Brazilian Federation to be combined with the ICMS to be paid to other states.² The compensation system works based on reciprocity of credit acceptance.

In the last decades, Brazilian states engaged in a ferocious competition process of concession of illegal tax benefits. In such process, local authorities provide local firms with fake ICMS tax receipts to be used to reduce the ICMS to be paid in other states. Illicit local policies are often justified as redistributive actions that can bring economic development to the most needed states of the Brazilian Federation. This paper attempts to demystify Tax War policies.

This paper's central hypothesis is that the practice of illegal ICMS tax benefits is actually motivated by an attempt of local governments to increase their own collected ICMS. Regional development may be a secondary or irrelevant issue in such decisions. This hypothesis will be tested by evaluating the kind of ICMS tax benefits provided by Brazilian state governments and by analyzing the per capita income levels of citizens of the states that are engaged in the promotion of the Tax War. To do so, the paper presents two case studies. The first case is the awkward concentration of medicine distributors in the Brazilian Federal District and in the states of Goiás and Espírito Santo, far from the industry and the consumers. The second case is the important alteration of distribution of the ICMS collected on imports of raw material for beer manufacturing (e.g., malt), caused by the collection of ICMS benefits in the state of Santa Catarina, in dissociation with any increase on the level of local productive investments, employment, or even activity in seaports.

The secondary hypothesis, used to support the central one, is that activities attracted by illegal tax benefits tend to be, and actually are, low specific asset investments, incapable of generating substantial and permanent positive externalities for the regions in which they are established. Such characteristic of investments attracted by the Tax War is related to the lack of certainty of the permanence of competitive advantages provided

1. Douglass C. North, *Institutions, Institutional Change and Economic Performance* (James Alt ed., Cambridge Univ. Press 1998).
2. Constituição Federal do Brasil de 1988, artigo 155, § 2º

by illegal benefits. The secondary hypothesis is tested through the analysis of which kind of firms were attracted to the states of the Brazilian center-western region after the promulgation of the Brazilian 1988 Constitution, a landmark for the establishment of a never-ending, multiple player, and successive move game named the Tax War.

In proving this hypothesis, the paper refutes the commonly accepted association of the Tax War and the redistribution of riches and the justification of legal transgressions by the greater good of reduction of regional inequalities in the Brazilian Federation. This paper attracts attention to the fact that the Tax War can only be regarded as an aggression against property rights, a cause of instability, and a generator of poverty. The Tax War only provides tax privileges to opportunistic players and, in doing so, sacrifices the financial return expected by those who are willing to invest in firms that demand high specific assets and can promote long-term positive externalities for the communities in which they are established.

This paper also presents to the academic community an example of the application of legal and economic theories to federalist relationships and their potential use for the improvement of taxation systems. The lessons arising out of the analysis might be valuable, not only in terms of helping the decision-making process with respect to Brazilian tax system design, but also as a comparative example for countries that intend to sign international agreements on taxation (such as in the income tax field) or engage in the formation of free trade areas and economic communities.

This paper is divided into five parts: (i) Part one: corresponding to this introduction; (ii) Part two: a brief presentation of Barzel's and Eggertsson's legal and economic property rights theories and of North's theory on underdevelopment, on which this paper is based; (iii) Part three: an explanation of the Tax War according to Barzel and Eggertsson; (iv) Part four: Tax War case studies; and (v) Part five: conclusion, a North-based evaluation of the profile of firms attracted by the unlawful tax benefits and the impact of the Tax War on the national economy.

II. THEORETICAL FRAMEWORK—BARZEL'S AND EGGERTSON'S THEORY ON PROPERTY RIGHTS

The property rights theory according to law and economics distinguishes itself from the property rights theories studied in Brazilian law schools, establishing itself apart from the studies of the classic line of thoughts provided by Roman law and private law theories of continental Europe.³ According to Barzel, property rights may be classified into two basic types of rights: economic rights and legal property rights.⁴ Eco-

3. Legal studies in Brazil are highly influenced by Roman Law. The Brazilian legal system is remarkably influenced by Italian, French, German, and Portuguese theories on law and by the legal systems of those countries.

4. YORAM BARZEL, *ECONOMIC ANALYSIS OF PROPERTY RIGHTS* (James Alt & Douglass North eds., 1989) (1997).

conomic property rights are defined as the rights an individual has over goods, generating expectations of future profits or benefits, such as income, use, or consumption.⁵ Legal property rights, on the other hand, are tools to support the economic rights, guarantying that the economic rights will be respected by individuals and by the State. In such a concept, economic goals are the final goals reached through property, with the law being an instrument to achieve such goals.

Barzel also states that property rights and transaction costs are closely related: "I define transaction costs as the costs associated with the transfer, capture, and protection of rights."⁶ Once property rights are not perfectly delimited, an increase in transaction costs will be experienced. Each transaction will be accompanied by value dissipation. Given both the complexity of attributes of a given good and the costs incurred to precisely delimit property rights, in the real world, property rights will always be less than perfectly delimited. Thus, transaction costs will always be positive and recurrent, causing income and value dissipation.

Still, according to Barzel, the value of a good tends to decrease if the income or utilities to be generated to its owner can be altered by other individuals without the need of reparation.⁷ An efficient way to increase the value of a good is to impose that anyone that causes a decrease in the expected income or utility to be provided by the goods is forced to compensate the owner for the losses experienced. Given the rule imposing reparation, the owner will be the individual with the greatest power to alter the value of a good. Proper care and protection of the goods are stimulated by the owner responsible for such activities, for he will be the one facing the consequences of his own behavior. By stimulating individuals to maximize the value of the goods they own, a proper behavior towards the care for the goods owned can be expected. So, the rule that internalizes the consequences of proper behavior towards the goods owned also maximizes social welfare. That consequence will be experienced in several different spheres of human interaction, such as the market, families, firms, government, and any other organizations.

The State has a major role in delimiting property rights, under both legal and economic perspectives, as the State is entitled to set rules on property rights; to solve disputes between individuals; and to enforce laws and administrative and judicial decisions. Eggertsson states that when there are imperfections on the definition of property rights and insufficient enforcement of property rights, goods will become things without owners.⁸ Following this, people will dissipate resources in order to capture portions of the available good.⁹ This theoretical framework, along with North's explanation on poverty, is key to this paper and allows a

5. BARZEL. *supra* note 4.

6. BARZEL. *supra* note 4.

7. BARZEL. *supra* note 4.

8. Thrainn Eggertsson, *Economic Behavior and Institutions* 89 (Mark Perlman and E. Roy Weintraub eds., 1990).

9. *Id.* at 90-91.

different perspective of analysis of the tax competition of Brazilian states, known as the Tax War.

III. ICMS TAX WAR—LAW AND ECONOMICS PROPERTY RIGHTS THEORY APPLIED

A. A GENERAL VIEW ON ICMS

Brazil is a Federative State with twenty-six states and one Federal District. According to the Brazilian Federal Constitution of 1988, states (and the Federal District) are competent to institute and levy some tax, among which is the Tax on Circulation of Goods, Transportation, and Communication Services—ICMS. ICMS is the most important Brazilian tax in terms of revenue, corresponding to 21.8 percent of total Brazilian tax revenues (7.8 percent of Brazilian GDP) or 83.6 percent of the gross tax revenue of the states of the Brazilian Federation.¹⁰ ICMS is a kind of VAT, charged on every step of circulation of goods, both in intrastate and interstate transactions.¹¹ ICMS is due on sales and goods transferences and is calculated on the value of each sale performed by a taxpayer. In a simplified way, it can be stated that each distribution center, store, or industrial plant owned by a firm is considered an ICMS taxpayer in the state where it is located.

ICMS rates vary according to the kind of goods sold on intrastate transactions and range between 7 and 12 percent on interstate transactions between taxpayers.¹² The 7 percent rate is applicable only when a good is sold from a seller located in the states in the regions south and southeast of Brazil to a buyer located in the central-west, north, or north-east regions of Brazil.¹³

The ICMS due from a store or industrial plant to its state of location corresponds to the ICMS charged on sales performed, minus the ICMS

10. Ministerio da Fazenda—Receita Federal, <http://www.receita.fazenda.gov.br> (last visited July 11, 2007).

11. The ICMS is not the first Brazilian experience with a state-charged VAT. The former existent IVA was named ICM—Tax on Circulation of Goods, which was levied beginning in 1965. ICMS is a kind of VAT-C. Its advantages on the sales taxes levied only on sales to consumers are the fact that the value added on the production chain is concentrated in a few great contributors. IVA-C fiscalization is considered more efficient than that of the sale taxes. (Stiglitz, 2000, p.716). The degree of voluntary accomplishment is stimulated by the intrinsic mechanism of fiscalization, given that buyers need to register and keep documents relative to Sales in order to be able to use credits to reduce the taxes due on sales. facilitating (Sampaio, p.196). On the other hand, VAT-C has a series of fragilities, among which (a) fraudulent reduction on the registered Sales, reducing taxes to be paid (b) fraudulent increase in value or quantities of registered purchases, causing the increase of credits to be used for compensation (c) complexity of the tax system which has a variety of rates and tax benefits (Stiglitz, 2000, p.717; Sampaio, p.368).

12. Resolução do Senado Federal nº 22, de 19.05.1989.

13. The State of Espírito Santo equiparated to the States of the North, Northeast and Center West Regions for purpose of ICMS rate applicable on interstate transactions. The Brazilian 1988 Constitution rules that such rates are to be defined by Brazilian Senate Resolutions.

indicated in the purchase documents for the goods.¹⁴

The non-cumulative character of ICMS operates on a national basis. ICMS levied on the acquisition inputs can be compensated with the ICMS due on output sales, even when the ICMS due on inputs is charged by one state and the ICMS on outputs is to be charged by another state of the Brazilian Federation.¹⁵ To simplify, this paper refers to the acceptance of ICMS input-credits on an interstate basis as the “reciprocal credit acceptance rule.”¹⁶

National regulations set limits on state legislative competence on ICMS, imposing, among others, that (i) ICMS is not to be charged on export operations; (ii) rates on intrastate operations are not to be lower than the lowest rate on interstate operations (7 percent); (iii) ICMS is due on imports to the state of location of the importer; and (iv) any form of ICMS tax benefits or financial benefits based on ICMS need to be previously approved unanimously by every state and need to be implemented by a law approved with such specific purpose.

Because the ICMS due by each taxpayer is the result of the ICMS on outputs minus the ICMS on inputs, the total ICMS to be collected by each state will depend on the level of economic activity of sellers within the state as well as on the interstate trade performance. Interstate merchandise acquisitions decrease, while interstate sales increase, the ICMS collection for a given Brazilian state.

B. TAX WAR, STATE POWER, STATE TRANSGRESSIONS, AND ATTEMPTS TO CAPTURE ICMS POTENTIAL TAX COLLECTION.

Any tax is a burden on an economy and dissipates richness because it moves the demand and supply curves away from their ideal locations. So, any tax incentive is, in principle, something good for the economy. However, tax incentives are not always legal, not always provided for the good of competition, and not always adjusted to the interests of a national economy's development. The Tax War provides a good example of how vicious tax benefits might become when they represent a threat to property rather than an incentive to productive activities.¹⁷

14. “ICMS DUE” = “ICMS ON SALES” – “ICMS ON PURCHASES”

15. Some issues related to intergovernmental tax compensation are studied in the field of income taxation and supported by rules generally established on international agreements. Brazilian experience with ICMS, in its turn, involves multilateral interaction.

16. The reciprocal acceptance of ICMS credits is defined in Brazilian Constitution (article 155).

17. On Brazilian ICMS Tax War: Ângelo de Angelis, *A GUERRA FISCAL ENTRE OS ESTADOS BRASILEIROS*. Relatório CAT n° 59, março de 2006, São Paulo, 2006; Camargo, Araújo, 1999; Glauro ARBIX, *GUERRA FISCAL E COMPETIÇÃO INTERMUNICIPAL POR NOVOS INVESTIMENTOS NO SETOR AUTOMOTIVO BRASILEIRO*, Dados, Rio de Janeiro, v. 43, n. 1, 2000; Castilho ET AL., *A GUERRA FISCAL QUE NÃO INTERESSA A NINGUÉM*. Relatório CAT n° 48, abril de 2005, p 28 a 34, São Paulo, 2005; Gustavo Costa, *O CONFLITO DE COMPETÊNCIA EXONERATIVA EM MATÉRIA DE ICMS: UMA ABORDAGEM POLÍTICO- JURÍDICA SOBRE A “GUERRA*

Due to the design characteristics of the ICMS, there is a great economic incentive for a state to increase its own collected taxes by increasing the volume of operations charged by the ICMS within its territory. There are basically three ways to do it. One is to stimulate economic activity (“economic activity incentives”). Another way is to increase the level of imports, substituting the interstate acquisition of goods or allowing the importer to perform a later interstate operation charged locally by the ICMS (“import incentives”). A third way (which will work only for the states of Espírito Santo or any states of the north, northeast or central-west regions of Brazil) is to increase the level of activity of distribution centers that acquire goods from southern or southeastern taxpayers (at a rate of 7 percent) and sell such goods to southern or southeastern taxpayers (at a rate of 12 percent) (“local distributor benefits”).

The methods for implementing these policies are based on transgressions of the national rules on the ICMS. This involves abuse of power by the executive (state governors or state treasury secretaries) and, most frequently, fraudulent issuance of tax documents. The abuse of power corresponds to the violation of the constitutional rule demanding that a law, issued according to an interstate agreement, be approved in order to create an ICMS benefit.¹⁸ The problems related to the abuse of power are corruption and compensatory measures for fiscal equilibrium (increase of

FISCAL” NA FEDERAÇÃO BRASILEIRA, *Revista Tributária e de Finanças Públicas* nº42. Ano 10. São Paulo. Editora Revista dos Tribunais, 2002; Ferreira et al., *INTER-JURISDICTIONAL FISCAL COMPETITION: A REVIEW OF THE LITERATURE AND POLICY RECOMMENDATIONS*, 25 *Brazilian Journal of Political Economy*, nº 3 (99), 295-313 (2005); Sérgio Guimarães Ferreira, *GUERRA FISCAL: COMPETIÇÃO TRIBUTÁRIA OU CORRIDA AO FUNDO DO TACHO?* BNDES, Informe-Se, Nº 4, Rio de Janeiro, Janeiro, 2000; MARCOS LIMA FRANCO & JORGE NETO, *Texto para Discussão N.º 226, INCENTIVOS, EQUILÍBRIO ORÇAMENTÁRIO E BEM-ESTAR: OS EFEITOS DA GUERRA FISCAL*. Pós-graduação em Economia – CAEN, Universidade Federal do Ceará, Julho de 2001; Andréa Lemgruber, *A COMPETIÇÃO TRIBUTÁRIA EM ECONOMIAS FEDERATIVAS: ASPECTOS TEÓRICOS, CONSTATAÇÕES EMPÍRICAS E UMA ANÁLISE DO CASO BRASILEIRO*, UNB, Mestrado, Brasília, March 1999; Hugo de Brito Machado, *Os PRINCÍPIOS JURÍDICOS DA TRIBUTAÇÃO NA CONSTITUIÇÃO DE 1988*. São Paulo/SP, Dialética (4th ed. 2001); Henrique Shiguemi Nakagaki, *A GUERRA FISCAL E O CONTRIBUINTE PAULISTA*. Valor Econômico, São Paulo, January 2005; R. NELSON, *STATE COMPETITION FOR FOREIGN DIRECT INVESTMENT IN BRAZIL: THE CASE OF DELL COMPUTER*, *Brown Journal of World Affairs*, 2002; Régis Oliveira, *FEDERALISMO FISCAL E PACTO FEDERATIVO*, *Revista Tributária e de Finanças Públicas*, nº 61, RT, 2005; Marcelo PIANCASTELLI & Fernando Perobelli, *ICMS: EVOLUÇÃO RECENTE E GUERRA FISCAL. TEXTO PARA DISCUSSÃO 402*. IPEA, 1996; Sérgio Prado & Carlos Eduardo G. CACALCANTE, *A GUERRA FISCAL NO BRASIL*. IPEA, FAPESP, Edições FUNDAP, 2000; Rodrigo Frota Silveira, *ICMS: FRAGILIDADES, FRAUDES, BENEFÍCIOS E GUERRA FISCAL*. 1º SEMINÁRIO DE ESTUDOS TRIBUTÁRIOS DA SEFAZ-SP. São Paulo (SP), agosto de 2006; Ricardo Varsano, *A GUERRA FISCAL DO ICMS: QUEM GANHA E QUEM PERDE*. IPEA, Texto para Discussão nº 500, Brasília, 1997.

18. According to Prado and Cavalcante, 2000, it is clear that the legal system provides a rigid mechanism for the approval of ICMS benefits, demanding unanimously approval of the States.

general levels of taxation to be supported by every firm, in order to favor one specific company).

Except for the import operations made to substitute interstate acquisitions of fixed assets of firms located in the state that provides the tax benefit, the fraudulent issuance of fiscal documents is essential for the efficacy of ICMS illegal benefits. Whenever a seller makes an interstate transaction, it will write several types of information on the fiscal documents used to register the transaction and transport the goods sold. According to national ICMS legislation, the buyer, physical destination, nature of the good sold, nature of the transaction, value of the transaction, and ICMS charged should be indicated.¹⁹ By decreasing the amount of ICMS actually charged, but allowing a firm to indicate the charge in its issued fiscal documents as if it had really taken place, a state can attract to its territory commercial operations that would otherwise happen elsewhere, according to economic efficiency criteria.²⁰

Even though the Tax War is against the law, Brazilian legal instruments have little effect in preventing it from happening or punishing transgressors.²¹

Despite the difficulties in identifying the transactions to which illegal ICMS benefits were provided and the relative non-effectiveness of the institutional mechanisms available to repel the Tax War, once an illegal ICMS benefit is identified the consequences can be impugnation of the ICMS credits generated and the termination of the tax benefit.²² Therefore, it can be affirmed that an investment based on a Tax War benefit involves two types of risk: (i) risk of loss of the benefit itself, and (ii) risk of imposing losses to the buyers who might have their ICMS credits impugned by tax auditors.²³

19. Such rules are defined on Interstate Agreements, named "Convênios" Most of the rules on standardization of ICMS fiscal documents are provided by a Convênio celebrated in 1970.

20. The case studies will provide an illustration of this.

21. The enforcement inefficiency understanding demands specific knowledge of Brazilian Judiciary System and of the Brazilian Supreme Court's (STF) way of understanding the Tax War. It would be better explained by a specific study, but the causes of it can be anticipated as being slowness of Judiciary and the lack of specific sanctions to public agents which break the law to provide tax benefits. According to VIOL, 1998, ICMS Tax war is an internal competitive process taking place in Brazilian Federation and consistent of the illegal and disorientated providence of ICMS benefits, with the purpose of attracting private investments. The problem of Tax Competition in Brazil has its origin in the disconnection of theory and practice in institutional terms, resulting in the implementation of taxation models to which institutions are not ready to bare.

22. The termination of the benefit is generally determined by a judicial decision that declares the unconstitutionality of the law or decree that creates the tax benefit. The credits are impugned by administrative acts of the Tax Revenue Services of the State where the buyer is located.

23. The Tax Revenue Services actions towards illegally generated credits were intensified from 2005 on, especially in the state of São Paulo. Over 2 billion reais in tax fines were already applied due to the use of credits generated in the context of Tax War. (Source-São Paulo State Treasury)

C. APPLIED THEORY—HOW CAN BARZEL AND EGGERTSON
CONTRIBUTE TO THE EXPLANATION OF BRAZILIAN TAX WAR

Some authors try to justify the Tax War as a consequence of the regional inequalities of the Brazilian Federation. Under such perspective, the tax benefits, in spite of being illegal, are presented as tools to promote regional development.²⁴ Based on Barzel's writings, however, this paper presents the Tax War as a violation of property rights. One kind of property rights violation is the decrease of the total ICMS to be collected by other states of the Brazilian Federation, caused by the tax policies of states that provide illegal ICMS benefits. Another kind of property rights violation is the negative impact on the value of tangible and intangible assets of competitors who will have their profit expectations lowered by the market changes caused by a player acting within privileged conditions. A less visible kind of property violation will correspond to the compensatory measures taken by the affected states, generally the increase of taxation of goods less subject to the Tax War (e.g., electricity, fuel, and telecommunications).²⁵

The actual size of the aggression (or the potential harm to property consistent with an ICMS illegal benefit) is hard to estimate by the time an illegal benefit is created. First, the size is difficult to estimate because there is no necessary relationship between the volume of credits to be spread and the amount of private capital invested in the provider state. And second, the size is difficult to estimate because the benefit created does not represent a budget sacrifice for the provider state. Any extra operation attracted will positively affect the tax collection of the state that provides the benefit. Thus, there is little incentive for a provider state to control how many credits are spread to beneficiary firms.²⁶

In this Tax War environment, economic and legal aspects of property are jeopardized, as the value of assets tends to be externally influenced.

24. Some authors, among which Hugo de Brito Machado (2004), deny the institutional problems related to Tax War, affirming that it is a legitimate attempt of poorer Brazilian States to achieve economic development. According to the author, only the ICMS provided by rich States are against the Constitution, since the greater good of reduction of regional inequalities justifies legal transgressions.

25. Luis Carlos Vitali Bordin, *Carga Tributaria Brasileira em 2002*, BNDES, (2003), http://www.bndes.gov.br/clientes/federativo/bf_bancos/e0001919.pdf. Bordin observes that the collection of ICMS dropped until 1999, starting to recover after that year. Such facts jeopardize the prediction of ICMS fallacy due to the Fiscal War. The author states that the increase of collection from 1999 on occurs in the fields of fuel, electricity and telecommunications, economic activities of high growth in such period due to privatizations. Bordin estimates that around 40% of the total ICMS collection comes from those blue-chips.

26. Greater increases in the amount of operations (or even in the amounts indicated in fiscal documents) will provide extra tax revenues for the state of location of the document issuer. In such conditions there is little interest in controlling the actual volume of credits spread by a beneficiary firm. There is, inclusively, a great room for frauds, since any fraudulent increase in the amount of credits generated or exaggeration in the number of transactions will be beneficial for the state where the issuer is located. The authorities competent to audit the beneficiary will have little or no interest in controlling the volume of credits spread.

That will cause dissimulation of proper care by the owners.²⁷

By applying Eggertson's theories, both the possibility of increasing the ICMS revenue by attracting operations to a given state territory and the possibility of generating ICMS credits in amounts that overcome the taxes actually collected are potentially valuable goods with no predefined owners. After the existence of such goods (with no owners) is noticed, local governments and commercial and industrial firms tend to dissipate resources in order to capture property.

Local governments will concentrate efforts in creating and negotiating the concession of tax benefits, offering marginal reduction of taxation with the expectation of increasing the total ICMS taxable basis (total amount of transactions originated in their territory) and, thus, increasing the volume of ICMS collected. In such attempts, local governments may be successful in increasing their own tax collection²⁸ but always at the cost of negative externalities to be supported by other states.²⁹

Private players will dissipate resources in order to capture the potential of generating ICMS credits by allocating operations away from the point of maximum economic efficiency.³⁰ To obtain and keep illegal benefits, private players will incur higher bureaucracy and lobbying costs.

IV. CASE STUDIES

A. MEDICINE DISTRIBUTORS OF THE CENTER-WESTERN REGION—DRUGS AWAY FROM HOME

The analysis of the Brazilian medicine market shows a puzzling logistical arrangement.

The medicine production industry is concentrated in the states of the southeastern region of Brazil. São Paulo alone is responsible for approximately 40 percent of all industrial production of drugs for human use in Brazil.³¹ By looking at the data in Table 01—"Medicine Sales Performed by São Paulo Industrial Plants," one may observe that approximately 76 percent (41 percent + 35 percent) of the sales (in Reais) is made to clients located in other states of the Brazilian Federation. Such numbers are compatible with the relationship between the population of the state of São Paulo and that of Brazil.

27. At the same time, the Tax War will increase the transaction costs of Brazilian internal trade, given that a buyer, when estimating the value of the acquired good, will face the uncertainty of the quality of the ICMS credits generated by the seller.

28. According to CAMARGO, 2004, local governments can obtain gains from fiscal competition, but always causing harm to other states and to the nation.

29. Rodrigo Frota de Silveira & Fabio Roberto C. Castilho, *A Guerra Fiscal Que Nao Interessa a Ninguem*, Jus Navigandi, (2005), available at <http://jus2.uol.com.br/doutrina/texto.asp?id=8022>.

30. The effective reallocation of resources will occur only if the net value of the appropriation of the potential to generate ICMS credits is positive. This is key to the conclusions on the impact of Tax War on Brazilian economy and will be discussed in Part V.

31. Ministério do Desenvolvimento Industria e Comércio, available at www.mdic.gov.br.

TABLE 01 – DESTINATION OF MEDICINE SALES PERFORMED BY SÃO PAULO INDUSTRIAL PLANTS³²

Sales to Buyers Located in:	In Thousands of Reais	In %
São Paulo	3,700	23.5%
The Federal District, Goiás and Espírito Santo	6,500	41.5%
Other States	5,500	35.0%
Total	15,700	100.0%

But the awkward piece of data in Table 01 is that the sum of sales to Federal District, Goiás and Espírito Santo represent 41.5 percent of the sales of medicines performed by São Paulo plants, whereas the population of such states corresponds only to about 6 percent of Brazil's population.

On the other hand, data in Table 02 shows that the purchases of medicines by São Paulo distributors are also awkwardly allocated. Only 29 percent of purchases are made from suppliers located in the state of São Paulo, while 67 percent are made from suppliers located in other States. Another 4 percent are direct imports. Table 02 also shows that around 70 percent of São Paulo's interstate inflow of medicine corresponds to interstate transferences.

TABLE 02 – ORIGIN OF SÃO PAULO DISTRIBUTORS MEDICINE PURCHASES³³

Origin of São Paulo Distributors medicine purchases	In Thousands of Reais	In %
From São Paulo	3,067	28.8%
Purchases from the Federal District, Goiás and Espírito Santo	286	2.6%
Transfers from the Federal District, Goiás and Espírito Santo	5,030	47.0%
From Other States	1,821	17.0%
Direct Imports	490	4.6%
Total	10,694	100.0%

Considering only logistical issues, there is no reasonable explanation

32. São Paulo State Treasury, <http://www.fazenda.sp.gov.br/>. Transfers correspond to operations in which one distribution center sends merchandise to another distribution center of the same firm.

33. São Paulo State Treasury, <http://www.fazenda.sp.gov.br/>. Purchase value includes transfers (except in the case of Federal District, Goiás and Espírito Santo). Transfers correspond to operations in which one distribution center sends merchandise to another distribution center of the same firm.

for such characteristics of the considered market.³⁴ If logistical reasons reveal a potential inefficiency of distributors located in Goiás, Espírito Santo and in the Federal District, why do these channels of distribution have such a great participation in the Brazilian market? Even though a complete answer to this question would demand a detailed research of the considered market, followed by interviews with executives of manufacturers, the commercial Tax War—without a doubt—is the main reason why drugs are so far from their natural course of distribution. In fact, Comunicado CAT 36/2004 of the São Paulo State Treasury³⁵ states that Espírito Santo, Goiás and the Federal District provide illegal ICMS benefits for medicine distributors.³⁶

The Federal District³⁷ can be an example of how commercial ICMS benefits can affect markets. Whenever goods leave the states of the southern and southwestern regions (with the exception of Espírito Santo), the ICMS rate is 7 percent. Whenever they leave a state of the northern, northeastern, or center-western regions or Espírito Santo, the ICMS rate applicable will be 12 percent. So if a medicine goes from São Paulo to the Federal District, São Paulo will charge 7 percent ICMS. If the same medicine is sent from the Federal District to São Paulo, the Federal District will be entitled to charge 12 percent ICMS and will have to bear a 7 percent credit corresponding to the ICMS charged in favor of São Paulo. The ICMS of 12 percent indicated in the fiscal documents issued by a distributor located in the Federal District will be borne by São Paulo. São Paulo will be entitled to charge the ICMS on later sales of the medicine to consumers (the internal rate for medicines in São Paulo is 18 percent). Considering the costs of transportation, there is no reason for a medicine to travel this far.

The Tax War changes the perspective of how distributors' gains are obtained (ICMS credit generation becomes more important than the ability to buy and sell medicines efficiently). By engaging in the Tax War, the Federal District decides to provide its distributors with a discount of approximately 80 percent³⁸ on the ICMS to be paid locally, allowing the

34. The size of the consumer market in the States of Espírito Santo, Goiás and in the Federal District is relatively small (their population represent only 6% of Brazilian population - population is a good proxy for estimating the demand for medicines). There are no manufactures of drugs in the mentioned States. Geographically, such States are located away from the largest manufacturers and consumer markets (Southeastern and Southern regions) and they are not in the way connecting manufacturers and consumer markets.

35. Comunicado CAT is a kind of alert on the content of norms edited by the chief authority of a Brazilian State Revenue Services.

36. Rodrigo Frota de Silveira & Fabio Roberto C. Castilho, *A Guerra Fiscal Que Nao Interessa a Ninguem*, Jus Navigandi, (2005), available at <http://jus2.uol.com.br/doutrina/texto.asp?id=8022>.

37. The ICMS illegal benefits provided by Goiás and Espírito Santo are very similar to those of the Federal District.

38. That kind of commercial ICMS benefit described is that of Decree 20.322/99 and Decree 24371/2004. The benefits created by the mentioned Decrees are applicable for distributors of a series of merchandises, among which paper, foods, and electronics.

firms located in its territory to continue to indicate a 12 percent ICMS charge in fiscal documents as if the tax benefit did not exist.³⁹ By providing the illegal benefit, the Federal District is able to attract distributors' activity to its territory. In doing so, the Federal District increases the local taxable basis, obtaining revenues⁴⁰ that, otherwise, would belong to the state of São Paulo or to other states in which the medicines will be sold to consumers. The negative externality (5 percent loss to São Paulo) is five times greater than the gains obtained by the opportunist (1 percent gain to the Federal District).⁴¹ Distributors are able to obtain a fiscal advantage of about 4 percent, which seems to compensate for the higher logistical and bureaucratic costs, paying for the 3000km trip a drug makes before getting back to the state where it was manufactured.⁴²

The local investment made by distributors at the provider state territory tends to be low in terms of specific assets, as the assets needed for the "medicine trip" are a small office for issuance of fiscal documents and an area for transit of merchandise.⁴³

B. BEER MALT IMPORTS IN BRAZIL SANTA CATARINA'S BEERFEST⁴⁴

Santa Catarina is a state of the southern region of Brazil. Even though it is relatively small in terms of territory and population, it has the second best human development indices among Brazilian states.⁴⁵ Santa Catarina is famous for the German influence on its colonization and for its Beerfests⁴⁶, which, in spite of their notoriety, are not the greatest contribution of Santa Catarina to influence the Brazilian beer market.

Brazil imports malt for the manufacture of beverages, above all beer. In 2002-2004, the total quantity of malt imported into Brazil was respectively 634, 570, and 635 thousand tons. Firms located in eight states were responsible for approximately 90 percent of malt imports. The beer mar-

39. Such allowance is based on local laws and formalized in contracts celebrated between the local government and the distributors.

40. At the same time, São Paulo loses tax revenue corresponding to the difference between the ICMS charged (7%) and the ICMS to be bared as credit (12%).

41. These numbers are over simplifications, due to the fact that, in the model, we do not consider any value being added at the Federal District.

42. High value per kilogram of medicines might make the cost of transportation relatively small.

43. It is commonly reported that the medicines do not come to be unloaded from the transporting truck, making the trip only for the purpose of fiscal documents exchanged. A mere exchange of documents without the physical dislocation of merchandise from the State of São Paulo is also cogitated. From the standpoint of the provider State, the amount of tax collected will increase independently of the storage of the merchandise and of the actual physical circulation of goods. The "contracts" on ICMS commercial benefits usually do not set minimum the minimum amount of private investments needed for the allowance of the ICMS benefit.

44. The data used to construct the tables used in the Beerfest Case was obtained at "Aliceweb", a database administered by the International Trade Secretary (Secretaria de Comércio Exterior) of Brazilian Ministry of Industry, Commerce and Development (Ministério da Indústria, Comércio e Desenvolvimento).

45. Source—Human Development Reports—United Nations Development Programme.

46. Blumenau's Oktoberfest is the second largest festival in Brazil (Carnaval is the first).

ket in Brazil is mature, experiencing small variations in quantities produced, total volume of sales, and market share of the main brands.⁴⁷ No significant reallocation of the main manufacturer plants took place during the three-year period.

According to the data in Table 03, whereas the total imports of Brazil as a whole remained relatively stable from 2002 to 2004, Santa Catarina increased its malt imports by 2800 percent, or 135 thousand tons, becoming the second largest malt importer state in Brazil.

TABLE 3 – MALT IMPORTS IN BRAZIL BY STATE OF DESTINATION

Destination State for the imported malt	2002	2003	2004	Δ 2002 - 2004
SANTA CATARINA	5.323	41.900	141.183	135.860
ESPIRITO SANTO	76.752	190.484	181.278	104.526
PERNAMBUCO	95.911	117.448	130.921	35.010
MINAS GERAIS	39.473	31.584	22.339	-17.134
BAHIA	51.534	34.261	8.068	-43.466
PARANA	92.669	25.177	40.723	-51.946
RIO DE JANEIRO	75.015	14.690	21.224	-53.791
SAO PAULO	96.650	71.208	44.585	-52.065
Subtotal	533.327	526.752	590.321	56.994
Other	101.465	43.375	45.359	-56.106
BRAZIL	634.792	570.127	635.680	888

During the same period of time, imports by firms in São Paulo, Rio de Janeiro, and Paraná experienced a reduction in malt imports of approximately 158 thousand tons.

In a relatively stable market, how can the variation in the malt import chains be explained? The most important clue comes from an unusual source. In November of 2005, the state of Paraná filed a lawsuit⁴⁸ in the Brazilian Supreme Court, complaining about Santa Catarina's ICMS regulations. These regulations create ICMS benefits not previously approved by other states.⁴⁹ Paraná claims to be suffering from ICMS revenue losses due to the reduction of the volume of its imports.⁵⁰

In order to understand the relationship between the variation in quantities of malt imported in different states and ICMS regulations, one must

47. AC Nielsen estimates the beer market share in Brazil as follows in 2005: Schin-cariol 13, 1% AmBev, 68% and Molson 8, 4%. Source Journal O Estado de São Paulo, 16 of October of 2005, in "Cerveja paga imposto até última gota"

48. Ação Direta de Inconstitucionalidade number 3.607.

49. Nelson's studies on Dell's incentives do not mention the illegality of ICMS benefits not previously unanimously approved by Brazilian States. See Roy C. Nelson, *Dell's Dilemma in Brazil: Negotiating at the State Level*, Thunderbird Int'l Bus. Rev.601, Sept. 1, 2004.

50. The lawsuit has not yet been decided by the Brazilian Supreme Court.

comprehend how Brazilian imports take place and are tracked. The domicile of the importer to whom the merchandise will be destined determines the ability to charge ICMS on the import, not the point of Brazilian territory through which the merchandise passes customs.⁵¹

TABLE 04 – MALT IMPORTS TO SANTA CATARINA
BY ORIGIN

Malt imports bound for Santa Catarina by State of Origin	2002	2003	2004	Δ 2002 – 2004
SAO FRANCISCO DO SUL (Santa Catarina)	0	36.482	83.802	83.802
SANTANA DO LIVRAMENTO (Rio Grande do Sul) Roads	0	410	39.317	39.317
SANTANA DO LIVRAMENTO (Rio Grande do Sul) Railways	5.166	5.005	18.060	12.894
Other	156	3	4	-152
SANTA CATARINA	5.322	41.900	141.183	135.861

The first line of Table 04 shows the quantities of malt imported by traders located in the state of Santa Catarina, through the seaport of São Francisco do Sul, state of Santa Catarina. Such imports, inexistent in 2002, reached 83 thousand tons in 2004, dislocating a significant part (58 thousand tons) of Brazilian imports from the Port of Paranaguá (Table 05).

TABLE 05 – MALT IMPORTS AT THE PORT OF PARANAGUÁ –
PARANÁ, BY STATE OF DESTINATION

Malt Imports through Paranaguá by State of Destination	2002	2003	2004	Δ 2002 – 2004
GOIAS	5.307	0	0	-5.307
PARANA	83.928	13.980	30.596	-53.332
Paranaguá – Customs	89.235	13.980	30.596	-58.639

The second and third lines of Table 04 show the quantities of malt imported by traders located in the state of Santa Catarina through the customs of Santana do Livramento–Rio Grande do Sul (by railways and roads). The quantities imported through these channels increased from 5

51. According to article 155, § 2º, IX, “a” of Brazilian 1988 Constitution. The State of Espírito Santo is the Pioneer State in terms of ICMS Tax War on imports. There is a major tax benefit program named FUNDAP, by which trader firms located in Espírito Santo can be granted with a subsidized loan of around 8% of sales. Guia do Investidor.com, *Incentivos do Espírito Santo*, http://www.vitoria.es.gov.br/negocios/guia_investidor/incentivos_es.htm. The loan is to be paid in 25 years, with payments starting in the 6th year. *Id.* Interest rate is 1% yearly. *Id.* The benefited firms agree to make investments in the State of Espírito Santo. The financial operations are made through the Development Bank of Espírito Santo. *Id.* The problem of state competition for the taxation of imports was anticipated at “The Federalist Essays” as a potential economic inefficiency arising out of states’ taxation autonomy. The Federalist No. 12 (Alexander Hamilton).

to 57 thousand tons from 2002 to 2004. Importantly, the alteration of the profile of the imports is legal, not physical (Table 06).

TABELA 06 – MALT IMPORTS AT SANTANA DO LIVRAMENTO – RIO GRANDE DO SUL – BY STATES OF DESTINATION

Santana do Livramento imports, by States of destination	2002	2003	2004	Δ 2002 – 2004
SANTA CATARINA	5.166	5.415	57.377	52.211
PARANA	8.090	11.197	10.126	2.036
RIO GRANDE DO SUL	14.564	7.372	1.660	-12.904
RONDONIA	13.037	3.382	0	-13.037
SAO PAULO	43.010	24.643	2.705	-40.305
Others	0	0	2226	2.226
SANTANA DO LIVRAMENTO CUSTOMS – Railway – Roads	83.867	52.009	74.094	-9.773

Table 07 shows the quantities imported by firms located in the State of São Paulo by origin.

TABLE 07 – SÃO PAULO MALT IMPORTS BY ORIGIN

São Paulo imports by origin (Customs)	2002	2003	2004	Δ 2002 – 2004
Santos (seaport)	3,360	6,883	22,518	19,158
Sao Sebastiao (seaport)	45,429	39,266	19,361	-26,068
Outros	320	415	14	-306
Vitoria (seaport)	4,530	0	0	-4,530
Santana Do Livramento (railway)	43,010	19,210	0	-43,010
Santana Do Livramento (roads)	0	5,433	2,705	2,705
SÃO PAULO	96,649	71,207	44,598	-52,051

The comparison of the data in Tables 06 and 07 reveals that the most significant part of the increase on imports of malt in Santa Catarina (52 thousand tons of a total of 135 thousand tons) comes from the “legal alteration” of the profile of the imports occurring at Santana do Livramento customs and not from an actual alteration in the profile of malt import logistics. During the same period, without significant changes in physical aspects of malt market logistics, the state of São Paulo experienced a “legal decrease” in the volume of imports through the Santana do Livramento customs (approximately 41 thousand tons). The increase in investments in Santa Catarina is very small, as beneficiary firms tend only to have a small office for the issuance of fiscal documents in that state.

V. CONCLUSION-TAX WAR WINNERS-NORTH'S LESSONS ON ECONOMIC UNDERDEVELOPMENT

North explains poverty by stating that “[t]hird world countries are poor because the institutional constraints define a set of payoffs to political and economic activity that do not encourage productive activity.”⁵²

As shown in Table 08, the Federal District has the highest per capita income of the Brazilian Federation and already receives (and benefits from) a major amount of public investment (due to the allocation of the major structures of national public administration activities in its territory).⁵³ Santa Catarina has, by its own merits, previous to its engagement in the Tax War, achieved the highest longevity, education, and general HDI indexes among Brazilian states (Federal District excluded). The State of Goiás, as seen below, is also well positioned relative to other Brazilian states in terms of HDI.

Based on: (i) the information on the levels of development of the states successfully engaged in the Tax War; (ii) the profile of the investments attracted by the commercial Tax War of the center western region and (iii) the fact that Santa Catarina's engagement in the Tax War does not even aim for the actual increase of local economic activity (as show in the case studies); this paper has accomplished its central objective, demonstrating that the Tax War has nothing to do with reduction of regional inequalities of the Brazilian Federation.

The concrete examples of the Tax War presented in the case studies support the conclusion that the Tax War is a way of intensifying Brazilian regional inequalities. The explanation is that, as predicted by North,⁵⁴ the most developed organizations (in this case states that have better levels of development) benefit more from the flawed institutional framework, perpetuating their competitive advantages.

Despite the importance of the Tax War for intergovernmental relationships, the problems of enforcement of rules on concession of ICMS benefits⁵⁵ transcend conflicts among governments and directly affect the way property is valued in Brazil. Unlike the general bias of academic studies in Brazil, a tax benefit cannot be evaluated in isolation when it comes to its power to attract private investments.⁵⁶ Tax benefits providers com-

52. North, *supra* note 1 at 110.

53. Human Development Reports-United Nations Development Programme (2000), <http://hdr.undp.org/en/>.

54. North, *supra* note 1, at 3.

55. Here accepted due to the actual observed impact of Tax War in Brazilian economy and illustrated by the Medicine and Malt Cases and the lack of notice of punishment to transgressors in literature.

56. A methodological path that will lead to the conclusion that Tax War benefit are voluntary tax expenditures leading stimulating productive activity. The mistaken evaluation of the Tax War by the academic community is, in our opinion, a bias towards the research on the effects of tax competition on the allocation of industrial plants. Such bias comes from the preconceived (and wrong) notion that the Tax War is a way to achieve local economic development. Prado and Cavalcanti, 2000, evaluate the negative impact of the Tax War from the standpoint of public

TABLE 08 – BRAZILIAN STATES HDI.

Relative Position	State	HDI y 2000	Income HDI y 2000	Longevity HDI – y 2000	Education HDI – y 2000
1	Distrito Federal	0,84	0,84	0,76	0,94
2	Santa Catarina	0,82	0,75	0,81	0,91
3	São Paulo	0,82	0,79	0,77	0,90
4	Rio Grande do Sul	0,81	0,75	0,79	0,90
5	Rio de Janeiro	0,81	0,78	0,74	0,90
6	Paraná	0,79	0,74	0,75	0,88
7	Mato Grosso do Sul	0,78	0,72	0,75	0,86
8	Goiás	0,78	0,72	0,75	0,87
9	Mato Grosso	0,77	0,72	0,74	0,86
10	Minas Gerais	0,77	0,71	0,76	0,85
11	Espírito Santo	0,77	0,72	0,72	0,86
12	Amapá	0,75	0,67	0,71	0,88
13	Roraima	0,75	0,68	0,69	0,87
14	Rondônia	0,74	0,68	0,69	0,83
15	Pará	0,72	0,63	0,73	0,82
16	Amazonas	0,71	0,63	0,69	0,81
17	Tocantins	0,71	0,63	0,67	0,83
18	Pernambuco	0,71	0,64	0,71	0,77
19	Rio Grande do Norte	0,71	0,64	0,70	0,78
20	Ceará	0,70	0,62	0,71	0,77
21	Acre	0,70	0,64	0,69	0,76
22	Bahia	0,69	0,62	0,66	0,79
23	Sergipe	0,68	0,62	0,65	0,77
24	Paraíba	0,66	0,61	0,64	0,74
25	Piauí	0,66	0,58	0,65	0,73
26	Alagoas	0,65	0,60	0,65	0,70
27	Maranhão	0,64	0,56	0,61	0,74
—	Brazilian Averages	0,77	0,72	0,73	0,85

pete against each other (some kinds of tax benefits tend to prevail over others). Also, private firms must incur costs of acceptance of tax benefits.⁵⁷

Measurement of return of an investment in the Tax War environment is very complex, given that the market position to be achieved through the investment, apparently improved by a tax advantage provided, can be

finances, mentioning institutional problems such as corruption and the creation of monopolies. Sérgio Prado & Carlos Eduardo G. CACALCANTE, *A GUERRA FISCAL NO BRASIL*. IPEA, FAPESP, Edições FUNDAP, 2000.

57. The payment for acquiring the tax benefits will be higher transaction costs (measurement costs, lobbying and bureaucracy above others) and, maybe, some logistic and market inefficiencies.

suddenly modified by both the loss of the tax benefit⁵⁸ and the creation of other tax benefits that create better conditions for competing players.

As in any other environment, the objective of players will be to win the game, obtaining more return from their investments. The winning strategy for private firms in the Tax War environment is to capture most of the tax advantages with the lowest possible costs. Given the risks of illegality,⁵⁹ this strategy will be associated with investing for short-term returns based on low or no specific assets.

As observed in the first case study, the medicine distributors benefiting from the Tax War merely acquire (or rent) a storage room for the transit of merchandise. Such assets can have their destination changed with insignificant costs, and their acquisition does not change the fact that technology intensive investments in distribution centers will still be made close to the consumer markets.⁶⁰ The second case study presents a mere alteration in the legal profile of imports. Santa Catarina benefits only from the increase in ICMS collected, generating no actual increase of economic activity in its territory.⁶¹

The Tax War does not provide for medium-term or long-term capital-intensive investments (given that the value of specific assets can be undermined by the actions of others).⁶² It also increases the transaction costs for the entire Brazilian economy.

The organizations prevailing in the Tax War environment will be those with greater ability to associate with public agents, in order to achieve great returns by illegally undermining the value of assets of competitors and of other states. This advantageous association for the purpose of fraud determines the creation of privileges and monopolies, causing Brazilian institutional framework to repel productive investments, putting the country on a path toward underdevelopment maintenance and intensification.

58. In spite of the inefficiency of enforcement, in special due to the slowness of the reaction of the Judiciary, Tax War ICMS benefits have consistently been declared unconstitutional by Brazilian Supreme Court. Theoretically there is room for private legal disputes involving competing firms based on the legal acceptance of tax benefits. Brazilian administrative organs for the defense of concurrences rights have stated that illegal ICMS benefits are offenses to concorrenciais markets see Conselho Administrativo de Defesa Economica website (CADE) 38/1999), <http://www.cade.gov.br/>. No private demands based on illegal acceptance of illegal benefits actually took place in Brazil. No private demands based on illegal acceptance of illegal benefits actually took place in Brazil.

59. Including those consistent losses caused to the clients due to tax audits on illegally generated ICMS credits.

60. The amount of transferences of medicines to the state of São Paulo (line 4 of Table 02) supports the conclusion.

61. That is probably the case of Espírito Santo's FUNDAP, the original Tax Benefit program for imports. More complex bureaucratic activities, such as legal and accounting services do not have to be dislocated to Santa Catarina.

62. North, *supra* note 1, at 3. The property of those not directly involved in competition is also affected by the Tax War. Buyers will face higher transaction costs as they worry about the quality of ICMS credits indicated in acquisition documents. Individuals and organizations in general will face higher average levels of taxation in order to support public expenditures increase by the effects of tax benefits.

Even though the Tax War depends on the structure of ICMS regulations in what comes to interstate rates and credit acceptance, there are lessons arising out of it that transcend Brazilian tax system problems. In engaging in the formation of free trade areas or economic communities, countries tend to be more affected by the tax policies of others. The proper design and enforcement of rules concerning tax incentives must always be regarded as a major issue when evaluating the possible effects of any international agreement on trade areas; avoiding that integration, instead of promoting development, allows opportunistic behavior to jeopardize productive investments. International agreements on income taxation must also be preceded by the evaluation of rules and enforcement preventing opportunism, given that the issuance of fake tax receipts can be a strategy to benefit local players at the cost of other nations.

Thus, this paper's conclusions are: (i) the Tax War is an illegal form of opportunistic behavior which increases the tax collection of provider states by increasing the market participation of firms with low or no relevant specific assets; (ii) the externalities arising out of the Tax War are the loss of tax revenues for other states of the Brazilian Federation and, most importantly, the disincentive of productive investments and general increase of transaction costs in Brazilian economy; (iii) there is no evidence supporting the potential use of the Tax War as a tool to promote the reduction of inequalities for the Brazilian states; (iv) the experience provided by the consequences of deficient enforcement of rules on tax benefits transcends Brazilian experience, being important for countries intending to form or to increase the scope of free trade areas or international trade or taxation agreements.

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Comments and Casenotes

