Fiscal Competition and Regional Imbalances

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By Diana Chebenova

In a classic tax war, different governments compete with each other to lower taxes in hopes that new businesses will move in and that investors will be persuaded to put more capital into existing local firms. But what happens when there is a tax war between richer and poorer states or provinces in a federal country? Can such tax wars be avoided? Those were the questions asked in a conference and a workshop in Belem, Brazil from August 31 to September 2. The events, entitled *Fiscal Competition and Regional Imbalances*, were organized by the Forum of Federations, the National Council on Fiscal Policy in Brazil (CONFAZ), and the Fiscal Forum of the Brazilian States.

Brazil is a federation of 26 states plus a federal district. A group of 11 Brazilian states, represented by their Secretariats of Finance, decided to create a permanent body, known as the Fiscal Forum of the Brazilian States (FFBS), with the aim of creating an adequate environment to study, analyze, and debate matters related to fiscal federalism. FFBS has a program of studies that involves a number of state officials with experience in different areas of public finances and taxation. These officials are brought together to rethink the problems that affect federal relations in Brazil. A long-term goal of the program is to reduce inequalities within the Brazilian federation by formulating suggestions to be applied later by decision makers. The program has a comparative character and includes analysis of the experiences of other federal systems.

The purpose of the workshop in Belem was, on one hand, to analyze the proposals presently being discussed in Congress with the objective of restraining competition between the states by unifying the rules of the ICMS, a state Value Added Tax. More broadly, the focus was on fiscal competition as an instrument of policy for regional development and also on alternatives for promoting such policy.

*Fiscal competition is the object of controversy in the international literature. While some emphasize its positive aspects, others stress the distortions it may cause. In Brazil, fiscal competition is strongly criticized. A rather difficult issue to be solved in the Brazilian tax reform is the one related to the ICMS, which is levied and regulated by the states. The ICMS is not unified, rather it has different rates and basis approved by the Senate but actually defined by the states. The Brazilian states have broadly used ICMS incentives to attract investments. Given that in Brazil taxable income is very concentrated, states do not want to accept to exchange their tax basis on goods and sales by another source of revenue, such as for example the income tax. The same rationale can be applied to property taxes. Current proposals to unify ICMS will hardly be implemented because of a number of reasons. Firstly, there are regional differences which create a division between rich and poor states, the former being mostly producers and the latter consumers. Secondly, Brazil's great territorial extension makes it quite

difficult to implement efficient mechanisms of control and this is also a reason for refusing the adoption of a zero-rate ICMS in interstate transactions. Thirdly, there is a lack of trust between the levels of government which impedes the use of a clearing house or such as a solution. In view of that, fiscal competition and VAT are inevitably closely related matters in the case of Brazil.
The use of fiscal instruments to promote investment and foster development of backward regions in large federations varies according to the particularities of their fiscal systems. It is understood that Australia and Canada are very distinctive cases with regard to the degree of fiscal decentralization and the principles governing the intergovernmental fiscal relations among its constituent units. The experts from Australia and Canada were asked to comment on these issues, namely to what extent these differences explain the way investment and regional fiscal policies have been designed and implemented and how these policies have been appraised. They were also asked to comment on whether the subnational governments play an active role or exert influence over policies implemented at the national level, and what are the main reasons behind decisions to adopt fiscal policies to attract investments and reduce regional inequalities in their federations.

Francois Vaillancourt summarized fiscal policies of the federal and provincial governments and emphasized the great freedom that Canadian provinces have in taxation - the only item that provinces cannot tax is trade. He defended the position that if a unit of a federation has a company that pays taxes, these tax revenues do not belong to the federated unit that houses the company, given that the taxes are paid also by the consumers of other provinces. He also said that it is necessary to take into consideration all the programs, spending, transfers, etc. in order to be able to identify correctly which province gains and which loses in the process of distribution of federal resources. The Expert Panel on Equalization convened to redefine the equalization mechanism in Canada was discussed, as well as a consideration to create a body similar to the Grants Commission in Australia. Professor Vaillancourt used the example of Quebec to illustrate how this province dealt with the question of attracting investment to promote regional development. Quebec used capital subsidies (raising taxes on labour and lowering them on capital) since the mobility of labour in Quebec is very low because it is mostly French-speaking only.

Roger Wilkins highlighted the level of centralization in Australia and mentioned that vertical fiscal imbalance in Australia is one of the highest in federal countries; about 80 to 90% of taxes are raised by the federal government. One of the intergovernmental mechanisms - the meeting of the Council of Australian Governments - is not focused anymore on equalization, but rather different public policy areas such as infrastructure or health care. The question in Australia is not about regional development, it is about providing adequate level of services to all citizens. The government should provide to its population a certain quality of life and in this sense, regional development is one of the means to achieve it, and not an objective in itself. Professor Wilkins expressed disbelief in the ability of the central government to promote regional development.
Tax policy in Australia is defined by the central government and this arrangement reduces fiscal competition between states. Fiscal benefits are not region or company specific.

Professor Wilkins spoke about the Grants Commission and its functions: a) define the methodology to be used for the distribution of resources between the states and b) apply this methodology. The methodology is very complex and there are only a few people who really understand it.
According to Professor Sergio Prado, academic coordinator of the workshop, in the case of Brazil, one of the main objectives of the Constitution of 1988 and its federal character was to fight regional inequalities; however, presently there is no national policy of regional development. A tax war is an autonomous policy of regional development carried out by the states which are obliged to adopt tax wars and induce development in their territories given that the Federal Government abandoned regional development policies. The principal mechanism used in a tax war is the ICMS that has a much higher weight than other instruments, such as government spending in infrastructure, provision of lands, etc. Professor Fernando Rezende mentioned that the debate in Brazil should be put in context of new economic reality where a tax war exists between different states, not just within states. Some Brazilian presenters objected to the term tax war, noting that what we are talking about are policies to attract investment or autonomous policies to stimulate productive activities.

The conclusion of the 2-day workshop drawn by Sergio Prado was that three main lines of thinking emerged from the discussions:

1. **System of fiscal transfers versus regional policies of development.**

The question of fiscal transfers in Brazil seems out of context since any development policy has always been linked to investments in Brazil. Also, intergovernmental fiscal transfers for the provision of public services is a mechanism that does not guarantee development. What should be the role of the state in promoting development? The state should minimally create basic conditions for development (such as infrastructure and similar) and economic development should be based on long-term, structural policies which are essential for development.

2. **National versus state development policies.**

Development policies have always been part of industrialization programs in Brazil but at one point these policies were abandoned. Regional development agencies such as SUDENE (development agency of the Northeastern Region) were replaced by sectoril development policies. During the era of F. H. Cardoso many regional development agencies were abolished. The government of President Lula has been trying to revive some of these agencies. Fiscal competition is legitimate in the sense that backward regions use the mechanism of fiscal benefits for their development; tax war can be translated into “defense of state interests” as opposed to national interests.

3. **Tax wars.**

Tax wars are seen in the following manner:

   a) They are negative and need to be eliminated
   b) They are not necessarily a negative phenomenon and might even be positive in certain cases (there is no other choice)

c) They are positive since they defend state interests

The alternatives for solving tax war are the following:

1. Implementing mechanisms of control by:

- central government (through imposition or negotiation)
- state institutions (replacing/renewing CONFAZ and establishing strict norms, policies and restrictions)

2. Tax reform through the state value added tax:

- adopt uniform legislation for the value added tax that would avoid a tax war (the model of Australia or Germany)
- adopt the destination principle for the VAT.

**Note by Fatima Guerreiro, Secretariat of Finance of Bahia*

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