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TAX EXEMPT PAPER: WE'RE BLAMING THE WRONG "CULPRIT"

Article 150 of the Federal Constitution of 1988 instituted tax exemption on all paper earmarked for cultural and educational purposes, with the objective, at the time, of promoting the arts, culture and education in the country. Hence, by force of law, **Tax-exempt paper** surfaced in the market.

Brazil's pulp and paper industry, mainly represented by IBÁ[1] and CNI[2], has been fighting since against the sale of this paper "deemed" tax-exempt, given that by deviating its purpose, it's used for other commercial ends, such as the production of business catalogs or advertisements, among other applications (which is prohibited by law).

With this prerogative, Brazil instituted a registration, supervision and control system regarding the production (whether produced in Brazil or imported), transport, sale and final use of tax-exempt paper. The system is called **Recopi** (*Recognition and Control System of Tax-Exempt Operations*).

At the front of the national industry's battle with the State is the price difference charged for the same paper (especially imported): for advertising purposes, it is necessary to add the II[3], IPI[4], PIS[5], COFINS[6] and ICMS[7] taxes to the end price of the product. In this case, the tax rate reaches an average of 36%, depending on which state. When used for the correct purpose, the imported paper receives the benefits of tax exemption.

Comparatively, studies conducted by CNI and several Industry Federations show that the taxes applicable to paper-based products in Brazil vary between 35% and 45% of the end price for consumers, which is considered a very high value.

As a result, the local industry that produces this type of paper armored itself through a protectionist system, where the biggest dispute occurs with paper produced abroad. Therefore, from an international trade perspective, this is a tariff barrier against the entry of imported products.

However, recent economic examples show that State interventions in the economy always end up causing market distortions, where the main party affected are end consumers, who usually end up paying expensive for the products they purchase.

As such, the "energy" of Brazil's industry should focus on the reason of the problem: **the high tax load on products sold in Brazil**. At the center of this point of view is the fact that the protectionist strategy adopted by governments in several countries around the world is bad for consumers and conveys a false idea of protecting the local industry.

Therefore, the focus of the country's pulp and paper industry on the tax-exempt paper market today is bad, both for consumers and the entire productive chain associated. If the villain is the high taxes charged in the domestic market, **the most evident alternative to increase competitiveness of the entire production chain would be the drastic and generalized reduction in tax load**.

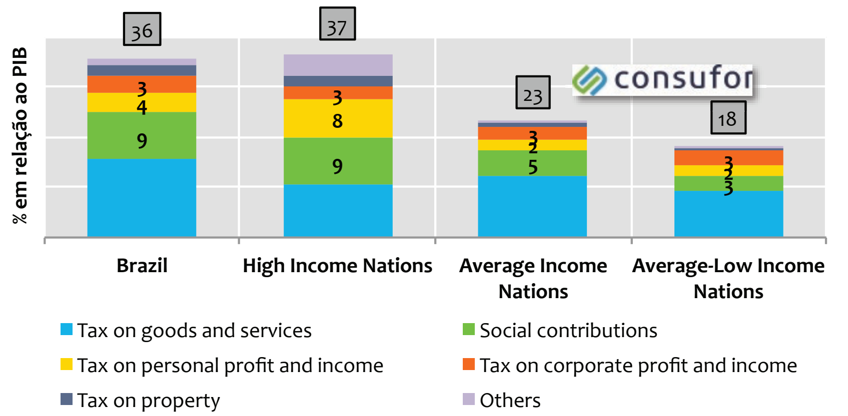
The tax load in Brazil eliminates the competitiveness of companies

Brazil has one of the highest tax loads in the world. A recent study conducted by the World Bank compared the competitiveness of several global economies, including countries in different stages of economic development. Unfortunately, Brazil stood out negatively in several aspects in this study.

According to the study, the country's tax load represents approximately 36% of GDP[8] (see Figure 1), which is equivalent to the tax load of the most economically developed countries in the world. Figure 1 also shows that most taxes fall on goods and services, that is, directly on the consumption of people and businesses (16% of Brazil's GDP, well above the average even of the richest nations).

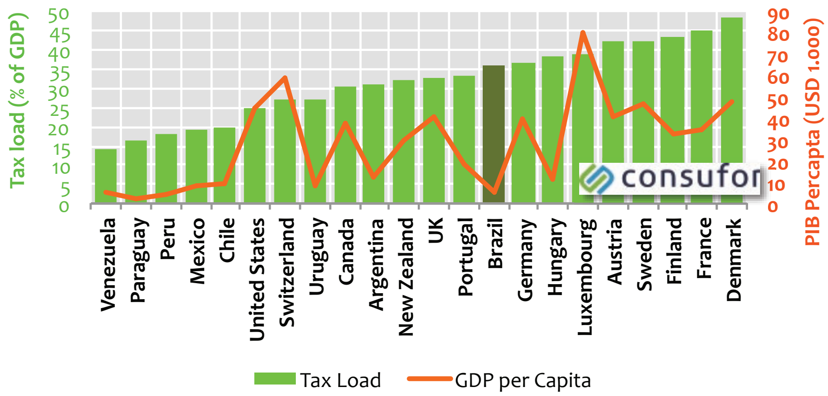
[1] Brazilian Tree Industry
[2] National Industry Confederation
[3] Import Tax
[4] Tax on Industrialized Products
[5] Social Integration Program
[6] Contribution for Social Security Financing
[7] Value-Added Tax on the Circulation of Goods and Rendering of Interstate/Intermunicipal Transport Services and Communication Services
[8] Gross Domestic Product

Figure 1 – Comparison of the Breakdown in Tax Load (% of taxes in relation to GDP)



Source: World Bank, compiled by CONSUFOR

Figure 2 – Comparison of tax load in relation to income per capita



Source: World Bank, compiled by CONSUFOR

In another comparison, Brazil stands out negatively when comparing tax load in relation to individual income of citizens. Figure 2 shows that Brazil simultaneously possesses the worst of the two indicators: high tax load and low income per capita.

The two comparisons presented show that the weight of taxes on Brazil's economy is too high. There is no other alternative to boost competitiveness of Brazilian companies other than to reduce this burden, that is, to reduce taxes.

Government's protectionist intervention harms end consumers

Over the last years, the IMF[9] and the OECD[10] having been working to harmonize tax systems of key global economies under a plausible reality. Brazil is a signatory of part of the conventions proposed, but since the country has historically opted for a highly protectionist strategy (against free market and economic liberalism), it is highly unlikely that it will assume tax regulations similar to the main liberal economies in the world. In summary, Brazil applies high taxes on imported goods and services with the idea of "protecting" the country's industry.

[9] International Monetary Fund
[10] Organization for Economic Cooperation and Development

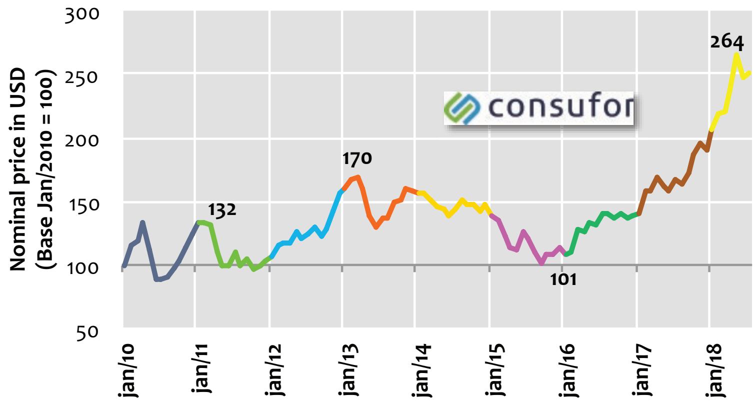
Such strategy conveys a false sensation of protecting our industry and, in reality, makes it less competitive in the international market. This problem is further worsened because the final consumer ends up paying for a more expensive service or product, whether it's a Brazilian-made product with a high tax load, or an imported product with all the protectionist taxes.

In a simplistic comparison of this protectionist strategy, a KTM 1290 Adventure motorcycle, top of the line model produced in Austria, has a selling price to end consumers in Europe of roughly €15 thousand (in a direct currency conversion, about R$ 69 thousand). Well, this same motorcycle (an imported good with no equivalent model in the domestic market) is sold in Brazil for roughly R$ 110 thousand (end price for consumers).

But this higher tax load is not a Brazilian exclusivity. In a recent protectionist wave, the United States launched a thorough review of trade agreements, imposing tariffs on products imported by the United States, like steel and aluminum (25% and 10%, respectively).

In response to this measure, the European Union announced an increase in import tariffs on several American products, such as motorcycles (the tax rate went from 6% to 31%). After these events,

Figure 3 – Nominal Evolution of Lumber Prices in the USA (Base Jan/2010 = 100)



Source: Nasdaq

one of the biggest icons of the U.S. motorcycle industry, Harley-Davidson, publicly announced that it will be transferring its production from the United States to Thailand, from where it will be able to produce and export to the EU without being subject to this new 31% tariff (the move will be concluded in 1.5 years).

In the company's justification, "fearing an increase in costs, if it were transferred to dealerships and end consumers, this would have an immediate and permanent negative impact on the business, reducing access to our products and negatively affecting the sustainability of dealerships".

The decision to change production location to optimize costs, maintain lower prices and ensure the company's profitability makes total economic sense. Additionally, it has a direct connection with the respect towards private property: it is the right of any private company (in a free and liberal society) to choose its location and, especially, its best production strategy.

Harley-Davidson has assembly lines in Brazil, India, Australia and Thailand. This provides the company two advantages:

On one hand, it allows the company to avoid import tariffs imposed by these protectionist countries with large consumer markets, and sell to these markets without being taxed on imports;

On the other hand, these same high import tariffs ensure the local company a big market reserve in these countries, since the local population cannot import motorcycles from its foreign competitors. This is an excellent arrangement for the company. And, once again, a State intervention in which the burden falls on the end consumer.

In another trade dispute, the US lumber production chain (particularly players on the West Coast) won a lawsuit for the country to impose a surtax on wood imported from Canada. And what was the result of this measure? An increase in the industry's competitiveness in the United States? No: What we saw was a strong increase in sawnlog prices in the US construction market, precisely at a moment in which the country is resuming housing construction.

Figure 3 shows the evolution in average sawnlog prices (in nominal terms) in the United States. In 2018 alone, the price increase has already amounted to 28%, this being in a country with a stable economy and single-digit inflation. And who pays for this additional cost: end consumers.

Hence, based on the justifications presented, Brazil's pulp and paper production chain should concentrate on significantly lowering the tax load of all products and services in the chain, through articulation and pressuring the State.

Recopi itself imposes on the system's participants the onus of supervising each one of the entities that sell tax-exempt paper (which by law is the State's responsibility), under the penalty of being subject to fines for not using tax-exempt paper for the purpose its intended, by an agent (manufacturer, transporter or consumer) involved in a given commercial activity.

As a result, maintaining supervision and good standing of tax-exempt paper in Brazil has been expensive, bureaucratic and, so far, very little efficient. IBÁ studies estimate that Brazil loses roughly $300 million annually in taxes due to the misuse of tax-exempt paper. However, what is not being calculated is how much the sector spends annually to remain "legal" under the bureaucracy of the Recopi system, nor how much more consumers pay in terms of taxes with the high tax load applied to the entire pulp and paper production chain.

The country is "buying" the wrong fight. We should be fighting the State's high interference on the economy, and our inability to compete pricewise due to high tax loads. ■