

Free Competition: How Tax Evasion and Tax Competition Distort Markets – The Brazilian Perspective

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The article discusses how tax evasion and tax competition jeopardize free competition between companies. Focusing on the Brazilian experience, it shows that the country is not a major player in international tax competition, but that there is a ferocious tax war between Brazilian States and Municipalities. The article describes the two main examples of this internal tax competition and presents some of the still unresolved juridical problems it causes. Then, the article puts light on the contradictory Brazilian approach to tax fraud (including piracy): hard financial and criminal penalties, but a permanent possibility of full amnesty through payment. The conclusion is that the principle of free and equal competition between companies will not be guaranteed in Brazil until discriminatory tax benefits are proscribed and until tax evasion ceases to be a relatively safe harbour.

1. INTRODUCTION

We feel intuitively that tax competition between countries or between political subdivisions of the same country, and tax evasion, must reflect negatively on the free market.

Effectively, a company that sets itself up in (or transfers to) a low pressure tax jurisdiction frequently seeks not only increases in its profits – through less disbursement with taxes – but also the possibility of passing on part of such saving to its prices, capturing some of the market from those of their competitors that are subject to ordinary taxing.

Identical motivations – increasing distributable profits and gaining advantage over the good taxpayers – inspire tax evasion, which justifies putting on a par, for the purposes of this study, two phenomena which are in principle so distinct, but which do have their points of contact, as will be seen.

2. INTERNATIONAL TAX COMPETITION

Technological evolution and the growing removal of restrictions in economies are responsible for our era being characterized by the free international circulation of capital, merchandise, services, and people.

This globalization, however, is still felt only very timidly in the field of taxation, where each country – even when taking into account the behaviour of the others – takes and implements its decisions in a practically isolated fashion, as if to remind itself at every moment of the strong bond existing between sovereignty and taxing.

In fact, bilateral tax treaties promote no more than a minimal harmonization, in the sense of preventing or remedying (at times, only in part) the cases of double taxation or of double non-taxation, but without imposing on States any limits as to the structuring of their own tax systems (the merely negative effect, not a positive one, of the double taxation conventions). In addition, their contractual nature and the usual tolerance of national Constitutions regarding their violation (treaty override) are sufficient to confirm the primacy of States unilateral decisions.

Even in the European Union – where the annulment of local tax laws that offend against any of the four fundamental liberties established in the founding treaties has already become normal – any new effort at tax harmonization depends on the unanimous agreement of the Member States.

It is in this hiatus between a world economic system and numbers of watertight tax systems that the seed of international tax competition is sown, defined as both:

- (a) the action of the taxpayers in comparing and choosing the jurisdiction that is more favourable to them; as also
- (b) the reaction of the States to such action:
 - (i) in either augmenting their own tax advantages and the protection of bank and business confidentiality;
 - (ii) or adopting steps tending to annul the tax effects of the shift of sources of income abroad (legislation of the Controlled Foreign Corporation (CFC) type, exit tax on non-realized capital gains, etc.).

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Such countermeasures are adopted when the shift of the source of income abroad is fictitious (false establishment of a paper company in a tax haven, manipulation of the transfer prices, etc.), or when it is a question of passive income (interest, dividends, and royalties), there being nothing that can be done, in the tax field, against the dismantling of a producing unit in a country, followed by the creation of a similar plant abroad.

Returning to the better-known face of tax competition, the inverted auction of tax advantages, here are the effects that the economists attribute to it:

- it provokes loss of economic efficiency – a company can be led to set up in a country where it produces less profits than it would generate in another one, provided that the difference in taxes compensates for the loss of earnings, leaving the investor, at the end, a higher net gain than the one he would have got if he had opted for the more productive country;
- it provokes an increase in the efficacy of public expenses (a positive effect that can be felt in the first moments, even though the final outcome is negative for all the States involved), as the tax revenues diminish (by virtue of the incentives), but the public necessities that have to be satisfied by them remain the same;
- it provokes fiscal injustice, because (a) the tax burden tends to shift from the more movable bases (capital) to the less movable ones (work and consumption), which violates the principle of the ability to pay; and that (b) public expenses tend to be concentrated in favour of the more movable taxpayers, with the intention of keeping them in the State territory, which undermines the redistributive function of tax.

The importance of tax competition should however be placed in perspective. A barometer prepared by Ernst & Young Law from research carried out with company directors of multinational companies points out reasons of a tax nature only in the 8th, 10th, 15th, and 17th positions in a list of seventeen factors of a country's attractiveness, coming behind variables such as proximity to the target market (1), transport, logistics, and telecommunications infrastructure (2 and 3), social (4), and monetary (5) stability, flexibility of labour laws (6), qualification of labour (7), and so forth.

If it were not enough to be few relevant compared to other factors, tax competition is also a game that, in the long run, affects all States adversely, by annihilating their tax revenues.

In spite of this, the differences in the level of countries' development, associated with the immediate gains that the mechanism produces for the more aggressive ones, makes it virtually impossible to achieve a consensus on

the establishment of minimum tax limits to be observed by all.

And because of this, countries continue, to different degrees, to avail themselves of this instrument, granting tax incentives to inbound investments and, at the same time, passing laws tending to annul the tax effects of shifts in the overseas direction.

In such a scenario, Brazil seems to be more reactive than proactive. Effectively, although having traditionally had low taxes on property and inheritance, the country is far from being able to be accused of maintaining a low tax burden (in general or on income) and does not customarily grant specific incentives for non-residents – on the contrary, in their tax collecting fury, the federal tax authorities violate treaties and go to the limits of protectionism, as in the case of the exigency of withholding income tax on payments of services rendered by non-residents that do not possess a permanent establishment in the country.

In addition, Brazil does not preserve bank confidentiality against the tax authorities nor business confidentiality, although confirmation of the right of direct access of the tax authorities to the taxpayer's bank details, without the need of judicial authorization, is still pending in the *Supremo Tribunal Federal*.¹

It is worthwhile mentioning that, in its reaction against the effects of international tax competition, Brazil at times goes too far, adopting much more rigorous measures than those necessary and making the just pay for the sinners. Just think of the rigours of our legislation on transfer pricing, that stray from Organization for Economic Cooperation and Development (OECD) guidelines, or the supposed Brazilian CFC legislation, that disregards the legal entity of associated or controlled companies even when they have actual business activities and are situated in countries of high fiscal pressure.

One Brazilian constitutional rule, however, can be considered an active international tax competition measure, either because it benefits the Brazilian exporter on the external scene, or because – precisely because of this – it can have the effect of attracting to Brazil exporting companies that intend to set up in the region. This is the immunity of export revenues from the so-called contributions for the intervention in the economic domain and from social security contributions.

Limiting ourselves to the last, it is certain that the immunity removes the PIS (Contribuição para o Plano de Integração Social) and the COFINS (Contribuição para o Financiamento da Seguridade Social), contributions for the funding of social security that are calculated on gross revenues, and now the *Supremo Tribunal Federal* seems to be moving towards an interpretation that also excludes the social contribution on net income, on the part where the profit is formed by export revenues.

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¹ The highest Court for constitutional issues.

As it cannot be said in either case that it is a question of indirect taxes on consumption, whose exemption and restitution in exports are accepted by the World Trade Organization (WTO), and as in both cases the benefit depends directly on the performance of the exporter, it seems certain that it fits into the concept of the Organization's prohibited subsidies, and may be questioned by other countries. If nevertheless maintained, it may provide opportunity for the imposition of countermeasures on the part of the countries disadvantaged.

Being an active claimant in the ambit of the WTO (involved in more than 10% of the litigation, in spite of accounting for merely 1% of international trade), Brazil certainly exposes itself to redoubled supervision from other countries.

3. INTERNAL TAX COMPETITION IN BRAZIL

If Brazil is definitely not one of the protagonists of international tax competition, it has however been watching for decades its federated units fight a ferocious and interminable fiscal war.

A brief – and incomplete – exposition of the Brazilian tax system is necessary for an understanding of the problem.

The Constitution attributes exclusive tax competencies to the federated entities, and the taxes are instituted by laws voted, according to the individual case, by the federal legislature, by the legislature of each of the twenty-seven Member States, or by the legislature of each of the more than 5,500 Municipalities. Each federated entity collects its taxes, through its own staff, and the revenue of some taxes is afterwards divided up according to complex constitutional criteria (from the Union to all States and Municipalities; from each State to its Municipalities).

Between the Constitution and the innumerable instituting laws, there is a national law binding on all the federated entities (including the Union) that institutes general standards of Tax Law, giving a systematic nature to what otherwise would be no more than a pile of disparate rules. Among the functions of such a law – in fact there are several laws – is the solution of conflicts of competency among the federated entities and the definition of the taxable event, of the calculation basis and of the contributors of each of the taxes envisaged in the Constitution.

Among the various types of taxes *lato sensu* contemplated by the Constitution (taxes *stricto sensu*, individual

public service charges and supervisory charges, contribution on improvements in real estate valuation arising out of public works, special contributions,² and compulsory loans)³ are the taxes *stricto sensu* that interest us directly as regards the theme being examined.⁴

The Constitution attributes them to the political entities, in a *numerus clausus* régime,⁵ by reference to the respective taxable events. Thus, the Union is responsible for import and export taxes; individual and corporate income tax; the tax on manufactured goods (Imposto sobre Produtos Industrializados (IPI)); the tax on financial operations; the tax on rural territorial property; and the tax on large fortunes (never instituted).

The States are responsible for the tax on inheritances and donations; the value-added tax on sale of merchandise and on interstate and intermunicipal transport services and on communication services (Imposto sobre Operações de Circulação de Mercadorias e sobre Prestações de Serviços de Transporte Interestadual e Intermunicipal e de Comunicação (ICMS)); and the tax on the ownership of automotive vehicles.

The Municipalities are responsible for the tax on the constructed and territorial urban property; the tax on onerous transmission *inter vivos* of immovable property; and the tax on services of any nature, provided that they are different from those subject to the ICMS and that they have been previously listed in the national law of general standards (Imposto sobre serviços (ISS)).

We shall not qualify as manifestations of fiscal warfare the innumerable conflicts of competency that, in spite of the national laws of general standards, break out between federated entities – or better, between two taxing bodies and one taxpayer, who finds himself forced to pay two different taxes on the same taxable event – in the still foggy frontiers of some of the taxes *stricto sensu* above mentioned: the urban or the rural property tax, when there is doubt about the exact qualification of the property; the tax on manufactured goods (IPI) or the general tax on services (ISS) on industrialization orders; the State value-added tax or the ISS on access providers to the internet (the discussion here is as to whether they provide communication services or not); ICMS or ISS on additional services provided by telephone companies (wake up calls and others – the doubt is the same), and so forth.

This is because, although the wrangling between federated bodies is evident, which surely places federalism at risk, the idea is lacking in such situations of deliberately reducing taxes with the intention of attracting investments

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² In their turn, subdivided into *social* (general and destined for the funding of social security), *of interest to the professional and economic categories* (i.e., for the payment of costs of the trades unions and of the supervisory bodies of the liberal professions) and *of intervention in the economic domain*.

³ The last two able to be instituted almost exclusively by the Union; the others, by all political bodies, in accordance with their competency.

⁴ The division of taxes *lato sensu* into different species is a major problem of Brazilian tax doctrine. The question is too complicated to be dealt with in the limits of this article, but taxes *stricto sensu* are generally defined as those that have as a taxable event an act of the taxpayer, and not an act of the State (as in the case of the individual public service charges, the supervisory charges, and the contribution on improvements in real estate valuation arising out of public works). Taxes *stricto sensu* are listed immediately below in the text.

⁵ The Union has a residual competency for the creation of new taxes, different from those contemplated in the Constitution.

(or of tax reaction to shifts resulting from such incentives), that we judge central to the concept of fiscal war.

Fiscal war definitely does exist in the torrent of tax incentives awarded and of regulatory and judicial counter-measures adopted by the Member States and the Municipalities concerning the ICMS and the ISS. We shall analyse each case separately, starting with the municipal tax.

In view of the possibility of a service provider acting in a place distinct from where he is installed, and to avoid the conflict of competencies that could arise in such a situation, the national general standards law for more than forty years has defined as competent for the collection of the ISS the Municipality where the establishment providing the service is situated (defined according to economic factors, whatever may be its juridical clothing), independently of where the activity was effectively carried out.

Under the protection of such a rule, Municipalities located around the big cities and towns started to reduce their ISS rates drastically, with the intention of attracting to their territory the service providers that acted in the latter. The benefit for the providers was clear: they could continue to provide their services in the metropolitan centres, but now paying much less ISS to the Municipality of their new establishments. The gain for the Municipalities that adhered to the fiscal war would consist, in addition to the small revenue generated by the ISS of the new taxpayers, in greater dynamism for their economies because of the establishment of these same companies (generation of direct and indirect employment, etc.).

In fact, however, many of these transfers were simulated: the economic unit continued where it always had been, and the establishment supposedly created in the Municipality of low fiscal pressure was nothing more than a shell, at the most possessing one telephone line and one secretary, and not infrequently shared with several other companies.

Such situations could have been fought as cases of tax evasion, and actually many assessments were made under this heading. However, not being prepared to tolerate any loss of revenue, the big cities and towns maintained in Court the thesis that – because of a supposed principle of territoriality of tax laws, that we do not recognize – the ISS should be paid to the Municipality where the service was effectively provided, and not to that where the rendering unit was established.

This interpretation came to prevail in the *Superior Tribunal de Justiça*,⁶ and this although it is manifestly contrary to the text of the law that the Court did not even bother to declare unconstitutional.

Even if clearly wrong in the merit and irregular in the form (since the annulment of the law is the only condition in which its application can be denied), the decision

had at least the advantage of extinguishing the municipal tax war, that was based on the possibility of performing the services in one Municipality and paying the ISS to another.

Later, betraying their ignorance of the recent evolution of the theme, the Brazilian Congress inserted in the Constitution a minimum limit of 2% for the rate of the ISS⁷ and prohibited the granting of tax incentives that would make the real percentage lower than this, steps that would only make sense under the rule of the rendering establishment.

The reaction against the disregarding of this rate floor will be stormy, in view of the fact that the *Supremo Tribunal Federal* does not receive direct unconstitutionality suits of municipal laws, which can be examined only through the incidental, American-type, control.

Finally, in 2003, a new national law of general standards was produced for the ISS, in which the criterion of the establishment providing the services was reiterated (although with more exceptions than there were in the previous law, of 1968). Pronouncement of the higher courts is awaited on its interpretation.

The question of tax incentives (exemptions, reductions in the calculation base, granting of notional credits, etc.) darkens the sky also over the State value-added tax (ICMS). According to the Constitution and a national law of general standards dating back from 1975, such benefits may only be granted or suppressed through the prior and formal consensus of the Governors of all the federated States, unanimously for granting and with 4/5 for revoking.

The reality, however, is quite other. In the first place because the States conceived, and the *Supremo Tribunal Federal* upheld, the subtle difference between *tax* incentives – that affect the calculation of the value due – and *financial* incentives – that come into play after such calculation, an example being a loan by a State bank, long term and with subsidized interest, of identical value to that calculated as tax. As the Constitution requires prior consensus only for the concession or the revoking of *fiscal* incentives (a word that the Court interpreted as referring only to tax, although a broader meaning could easily have been adopted), the door remains open for oblique tax subsidies, and for a fiscal war legitimized by the Supreme Court.

There does not always exist, however, such concern with etiquette. Unauthorized tax incentives are awarded all the time, by all States, in flagrant violation of the Constitution. When it has the chance to pronounce on them, the *Supremo Tribunal Federal* invariably annuls them. But such decisions are avoided by the contravening States by revoking the irregular incentives on the eve of judgment. As the Court does not invalidate revoked rules, the unconstitutionality

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⁶ The highest Court for legal issues.

⁷ Which should prevail until a nation law of general standards establishes another floor, which has not yet occurred.

suit loses its object and is extinguished without an examination of merit. And the unauthorized benefits are restored soon after

To gain an idea of the extent of the problem, it is sufficient to say that all the proposals of constitutional tax reform debated in Parliament over the last fifteen years envisage the retroactive validation of the irregular benefits.

A question that survives the revoking or invalidation of the irregular benefits is to know if the acquirers of the merchandise that was the object of the incentive have or not the right of credit for the tax illegally waived in the previous stage (as already pointed out, the ICMS is a value-added tax). The question gains importance when the producer and the acquirer of the benefited product are located in different Member States. The Constitution rules that one State should recognize credits for the ICMS collected, in prior stages, by the other States. But here, it is to be repeated, it is a question of knowing if such a duty extends to situations in which the tax has been unduly waived by the State of origin.

Two alternative solutions are logically possible:

- Authorize the destination State to deny the credits, on the supposition that the tax was not nor will be demanded at the origin. This solution harmonizes with the principle of liability, punishing the State that granted the irregular incentive with the definitive prohibition of the recovery of the tax unduly waived.
- Oblige the State of origin to collect the tax waived and impose on the destination State the acceptance of the corresponding credits. This solution starts out from the notions that the irregular incentive should not generate any effect and that the acquirer in good faith is not obliged to know that an irregular incentive was given in the previous operation, and because of this it cannot be made responsible for the composition of the damage derived from it. The solution clashes, however, with the virtual impossibility of obliging the State that granted the illicit incentive to collect the tax especially because the jurisprudence of the higher courts removes from the Public Ministry the power to file civil actions involving tax questions.⁸

The 1975 national law of general standards exaggerates in the reaction and envisages the two steps simultaneously: collection of the tax at the origin (without saying how it will be processed) and denial of the credits at the destination, a double burden that clearly violates the non-cumulative nature of the ICMS.

Although the question has been discussed for more than thirty years, the Brazilian courts, incredibly, have not yet arrived at a final position on it.

Both for the conflicts of competency as for the Brazilian fiscal war, a larger institutional problem is the tendency – either because of the insufficiency of judicial mechanisms, or the strategy of the authorities involved – of transforming direct wrangling between federated bodies into two independent disputes between each of these and the taxpayer who finds himself caught in the crossfire. This prevents the simultaneous analysis of the arguments of all the interested parties by the same judge and provides an opportunity for contradictory decisions not always harmonized – this is the plain truth – by the higher courts, which perpetuates the risks of double taxation or double non-taxation.

4. TAX EVASION

Without going into the inherent incompleteness of any statistics on this question, there is a consensus that 40% of Brazilian gross revenue, 50% of non-rural labour, and 90% of rural labour are in a situation of illegality, and do not pay income tax, social contributions, and the other taxes due.

Research by the Getúlio Vargas Foundation among 50,000 companies with up to five people found that only 15% paid taxes, 12.3% registered their employees, and 20.1% were formally incorporated.

Evasion spreads also among the liberal professions and medium-sized companies, and is appreciably less significant among the large companies, which are subject to strict supervision on the part of the tax authorities and to mandatory independent audit of their accounts.

To tax evasion is also associated the problem of piracy – the production, import, and sale of imitation or non-licensed products. Placing the two vices in the same category, it is estimated that 59% of the CDs and DVDs, 55% of software, and 30% of the cigarettes consumed in Brazil are traded in the informal market.

This scenario is considered as one of the main causes of the high tax burden imposed on the regular taxpayers, whose competitive disadvantage strikes the eye with force.

Paradoxically, the reaction of the public authorities and of society to such a state of affairs is not uniform.

On one hand, the legislator creates simplified taxing régimes favouring the small businesses, in an attempt to attract them to the formal economy (the so-called National Simple Tax that congregates six federal taxes, the ICMS and the ISS in only one calculation and payment; the so-called régime of the small importers, that brings together four federal taxes on overland imports of goods made by small companies from Paraguay – that country accounts for 50% of all the merchandise entering Brazil without the payment of taxes).

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⁸ On the supposition – inapplicable *in casu* – that tax discussions always involve individual rights (even if identical for thousands of people) and not collective or diffuse rights.

In addition, mechanisms are instituted – at times very questionable in the light of the Constitution – of concentration of payment of certain taxes in the production stage, exonerating the companies that trade the products up to their delivery to the final consumer, so as to facilitate and reduce the costs of tax supervision.

And, to check the accuracy of the taxpayers' declarations, means are imposed rather like the flow meters one finds in the beverages industries.

In offering facilities to formalize business and creating strict rules for the prevention of tax fraud, it was to be expected that the legislator would discipline harshly those who continued with this conduct.

But this is not what happens. In spite of carrying a prison sentence of two to five years, the crime of tax evasion is eliminated at any time (even after judgment in the last instance has commenced) by the payment of the tax evaded, increased by fines and legal interest. We are not talking here about simple attenuating circumstances or of a reduction in the sentence, but of the total extinction of the punishability, which surely constitutes a stimulus for wagering on the incapacity of the tax authorities to discover the fraud – the possibility of payment *in extremis* can always be counted on.

The wry affinity that exists in Brazil with the knave and the scoundrel can be seen from the fact that, in 2007, 42% of the population declared that they acquired pirated products, the percentage figures *growing* with the levels of schooling and income.⁹ And this in spite of 65% of the buyers declaring that they thought that piracy caused unemployment, of 72% that it feeds organized crime, and 81% considering that it stimulates tax evasion.

This leniency is also manifested in the other Powers. The Executive, whose taxing and police arms conduct increasingly successful actions against tax evasion and piracy, often builds and exploits – through its social assistance and economic development arms – shopping centres occupied predominantly by traders of imitation and/or deviously imported merchandise.

The Judiciary must also bear some of the blame. We remember that for some time in the *Superior Tribunal de Justiça* the view prevailed that the simple granting of tax instalments – in the place of suspending the punishability of the crime of tax evasion until the total payment of the tax (when the offence would be eliminated, in the terms of the already cited legislation) – sufficed to extinguish it immediately and irreversibly, even if the taxpayer ceased payments after one or two instalments.

5. FINAL CONSIDERATIONS

Tax conservatism, an attitude adopted by serious companies with aspirations to longevity, constitutes today in Brazil a disadvantageous competitive factor.

Indeed, innumerable States and Municipalities seduce contributors, with tax incentives that are difficult to resist in the short term, to take part in a war with future consequences that are not entirely predictable.

In addition, in spite of the undeniable opportunities offered by the State for companies to insert themselves in the formal economy, and of the effort of the tax authorities and the police in combating tax evasion, unpunctuality in the payment of taxes and tax evasion itself still receive from the legislator (and, at times, from the judge) treatment which is less severe than they deserve, not only because of the permanent possibility of salvation through payment *in extremis*, but also by the very frequent granting of amnesties,¹⁰ utilized as a simple instrument for increasing revenues, without any scruple as to the principle of equality (i.e., without any concern for the loss caused to the taxpayer who discharges his obligations on time).

Cleaning up this environment is a condition *sine qua non* for the enhancement of the principle of free competition in the country.

We are not defending the over-hasty collection of taxes, by means of direct and indirect coercion, as is being done at present (suppression of the stay of payment when the taxpayer is defending judicially against tax foreclosures, manipulation of the certificates of tax regularity as a means of compelling payment without discussion, etc.).

Much less do we support the trivialization of the criminal mechanism, by putting the mere tax default (either because of economic difficulties or of disagreement as regards the *an* or the *quantum debeatur*) on a par with crime, as also happens, especially as regards taxes withheld at source.

These are ill-advised measures that should be abandoned.

What is needed is good faith between the federated entities, without the adoption of surreptitious expedients and cynical behaviour (revoking of rules on the eve of judgments, immediately followed by their reinstatement), as well as reciprocal good faith between the tax authorities and the citizen: the first, not promising what they cannot deliver (irregular incentives subject to annulment, with damage to the taxpayer), and the latter responding – after

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⁹ Data are from the research work of the Fecomércio Rio de Janeiro & Instituto IPSOS, *O Consumo de Produtos Piratas no Brasil*. Available at <www.fecomercio-rj.org.br/publico/media/Pirataria_2007.pdf>. An enquiry of FIRJAN conducted with 300 people, only in the centre of Rio de Janeiro, leads to different, but equally alarming, results.

¹⁰ The total or partial removal of the fines and interests, under the condition of the payment of the tax.

all the appropriate tax discussion (administrative and judicial) and the due criminal process – for the consequences of the wrongs that he has committed.

When these conditions are met, we will finally be able to talk about free competition between companies in Brazil.

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