

## Final report

### *Ecological ICMS: from the field to public policies through a disturbing scenario*

#### **Context:**

The Tax on Circulation of Goods and Services (ICMS) is the most important state tax frequently representing, in the terms currently effective, over 90% of the states' revenue, besides constituting an expressive source of income for the Brazilian municipalities. It is an indirect tax, that is, supported by consumers as it is added to the price of things or services, similarly to value added taxes, or, ultimately, a fund collecting tax for the States of the Federation.

The Federal Constitution, in its Article 158, provides for 25% of the ICMS-related financial resources collected by each State to be allotted to their municipalities while the remaining 75% are allotted to the States. The Constitution also stipulates that at least 75% of the amount allotted to the municipalities should be distributed according to the added value generated in each one of them, that is, as much as each municipality collects. The States have the authority to determine the distribution criteria for the remaining 25%, or, 6,25% of the total collected. This allows the States to influence the municipalities in their priorities through motivating certain activities and discouraging others. Therefore, each state legislation defines a set of criteria such as number of inhabitants, geographical area, number of rural properties and primary production, which guide the distribution of that amount (25% of what is allotted to the municipality, or, 6,25% of the total) the municipalities are entitled to.

The State can, then, as regards those 25%, decide how to redistribute which ecological criteria can be introduced. This brought about the idea of the ecological ICMS. Amongst the criteria that guide the redistribution of the ICMS-related collected resources include, in general, the population of the municipality, the number of rural properties, the municipality area, the value of the agricultural production, the equitable sharing and their own added value, that is, the total the municipality has collected.

In 1992, the State of Paraná introduced an ecological criterion in the distribution of the ICMS. Noticing the experience of Paraná regards the ecological ICMS other States have also decided to introduce similar systems. Therefore, in 1996 the ecological ICMS entered into force in Minas Gerais and São Paulo, and a year later in Rondônia. After that, several other States have adopted this measure. Each state has adopted different environmental criteria, such as: existence and quality of protected areas, existence of water supply sources, reservoir formed by dams, solid residue deposits, amongst others.

It is possible to identify two major functions for the ecological ICMS, compensatory and encouraging:

**1. Compensatory function:** its role is to compensate the municipalities that face limitations while managing their territories due to the existence of protected areas or other strict-use areas. This compensation is related to land use restriction, that is, if there were no such

limitations the municipality could use the area for other purposes (e.g., production, trade or services) and, consequently, collect more ICMS and have a better return when sharing that tax. In the case of the protected areas, the compensatory impact of the ecological ICMS is rather important for the municipality owing to a large proportion of the protected areas being under federal or state domain. As a result, the municipalities have little opportunity to influence decisions related to designation and maintenance of a number of protected areas. In many cases, they find themselves forced to accept decisions made in other government levels, thus affecting their possibilities of developing productive activities and generating income.

2. Encouraging function: its role is to perform as an incentive to the municipalities by encouraging both the widening of protected areas and other relevant areas for the ecological ICMS - such as indigenous areas, watershed areas, or solid residue treatment systems – and the maintenance of their quality, where they exist, through incorporating qualitative criteria into the ecological ICMS.

In some states, such as Minas Gerais and Paraná, the distribution of the ecological ICMS resources was subjected to the “quality” of conservation of the protected areas. In Paraná, the protected areas at the federal, state or municipal level, as well as the indigenous areas, are annually inspected in order to estimate the amount to be allotted to the municipality. Those states also have different scores for the several management categories of protected areas.

In Paraná, where the system has been in place for several years, the encouraging effect of the ecological ICMS is already evident. New protected areas have been created and the system introduced to evaluate the areas periodically has been influencing the interest of municipalities positively in improving management of protected areas. Between 1992 and 1997, there was an increase of 132,12% in protected areas cover within the several management categories and modalities.

It is because of the compensatory function that the ecological ICMS-related resources should not have a "marked" application, that is, the municipality should not have to use these resources towards the environment only, under penalty of losing the compensatory effect. The incentive effect of the ecological ICMS, described above, encourages the municipality to invest in that area. On the other hand, after some time the ecological ICMS had been established, it was decided, in some cases, to adopt some rules for the application of these resources, such as, for example, to allot part of the ecological ICMS resources to the peoples of the indigenous lands Kaingang and Guarani, in the State of Paraná. It is worth emphasizing that this is a special case, where these peoples have committed themselves to using such resources in reforestation and eco-tourism projects and other activities, thus, assuring livelihoods and improvement in the quality of life. Consequently, given that, at least, an annual analysis of the quality of the areas is carried out, these indigenous lands are better scored and contribute to increase the ecological ICMS-related resources for the municipality.

### *A short background of the project*

WWF-Brasil has identified, since 1996, the ecological ICMS as an important conservation instrument, due to several aspects: a) the characteristic of an instrument simultaneously compensatory and encouraging; b) the possibility of the state making clear to the municipality which are its priorities, including in the environmental area; c) the perception derived from the compensatory aspect of the ecological ICMS that protected areas and other conservation elements can generate direct benefits for the populations.

On that occasion, WWF-Brasil, with support of the Darwin Initiative and in partnership with IIED, developed a project to analyze the ICMS implementation in the states of Paraná, Minas Gerais and Rondônia. Besides that analysis, the project sought to disseminate the ecological ICMS and to carry out, in some states, a specific work aimed at stimulating and helping the implementation of this instrument (Fiscal Incentives for Biodiversity Conservation in Brazil, 1997-2000).

This first project has contributed significantly to make the ecological ICMS a known instrument throughout Brazil, as well as abroad. It has also helped to increase the interest of states, where the ecological ICMS was not established, resulting in its adoption by several other Brazilian states.

At a later time, a second project was drawn. This new project, also supported by the Darwin Initiative and in partnership with IIED, focused on monitoring the impact of the ecological ICMS in two states: Pernambuco and Mato Grosso. That focus was particularly interesting as in spite of the increased number of states adopting the ecological ICMS its direct impact on biodiversity conservation was, and still is, uncertain.

The project was targeted at drawing, analyzing and adjusting monitoring systems, with indicators of biodiversity conservation and of socioeconomic impacts derived from the implementation of the ecological ICMS, in Mato Grosso and Pernambuco. The work was initiated in both states. The partnership with IIED was targeted, particularly, on the socioeconomic indicators and a comprehensive document on the aspects to be considered and the methodology to be used was produced and a set of indicators was also suggested.

In Pernambuco, the project has faced many difficulties (see the section on project implementation problems below) derived from political uncertainties linked to the implementation of the ecological ICMS in the state, which was under the responsibility of two different secretariats, environment and finance. During the reorientation phase of the project it was suggested that the activities should be interrupted in that state.

In Mato Grosso, a preliminary set of indicators was generated and analyzed, however, a lack of political will in the state and the limited resources of the State Environment Foundation (FEMA), responsible for the implementation of the ecological ICMS, have showed that a detailed monitoring on direct impacts on biodiversity within protected areas could not be developed. During that phase, it was concluded that, in Mato Grosso, the project should accomplish a less ambitious monitoring and that it would be better to gather general data on the state and to deepen the analyses on some municipalities instead of

trying to collect detailed data of the whole system of state protected areas. Those recommendations guided the project reorientation attempt, described below.

Following WWF-Brasil's staffing changes, early in 2005, a project reorientation was suggested, with the support of IIED and welcomed by the Darwin Initiative. It aimed at taking into account and valuing an important political element at that moment: the fiscal reform. That reform, proposed by the current government, would modify several Brazilian tariffs and taxes, including the ICMS. One of the considered possibilities is to transform that tax into an added value tax under the federal legislation. It would require the incorporation of the ecological ICMS progresses into the federal legislation, under penalty of losing all of the efforts accomplished so far. Therefore, a new version of the project was designed focused on two major aspects:

1. Fiscal reform: in this aspect, a wide analysis of the positive and negative results generated by the ecological ICMS would be developed, through a participatory construction process, involving relevant stakeholders in this areas, and a set of recommendations serving as a base for an advocacy work with the National Congress, throughout the procedures of the fiscal reform.
2. Monitoring in Mato Grosso: in this aspect, activities would be developed in accordance with recommendations derived from previous work, that is, the conception of a monitoring system sufficiently generic for the whole state and a more detailed exam of three municipalities, culminating in the elaboration and application of a set of indicators of biodiversity conservation and of socioeconomic impacts from the ecological ICMS.

In spite of that reorientation effort, the project was interrupted in May 2005 due to the disturbing political scenario, both in the state of Mato Grosso, as well as at the federal arena. In the state of Mato Grosso, the Federal Police found out an enormous corruption scheme, which involved the president of FEMA as regards the high deforestation rate in the state. Right after that, another corruption scandal, one of the most serious ever seen in the country, was revealed in the National Congress. Accusations on a monthly tip supposedly paid to representatives, so they would approve projects by the federal government, and on the use of non-declared resources, in the 2002 electoral campaign, transformed the National Congress in a series of Legislative Inquiring Committees, immobilizing all of the parliament activities.

Given that scenario, WWF-Brasil concluded that it would be impossible to develop the activities programmed for the project and thus preferred to postpone them to a more favorable moment, possibly following the 2006 elections. As it turned out, that decision proved to be the most appropriate, for the climate at the National Congress, 6 months following the first accusations, remains the same and the political situation seems to be worsening as a result of new accusations, as well as from difficulties faced in inquiring into corruption crimes, which are already evident.

## ***Problems in implementing the project***

This project has faced many problems in its implementation. Some of them have already been mentioned above. This section intends to deepen the examination of those problems as well as to bring to light others not previously mentioned:

1. The Fiscal Reform: this reform, proposed by the current government, as previously mentioned, and which should have undertaken a wide revision of tariffs and taxes in Brazil, including the ICMS, proved to be a problem, in two different moments of the project and for two different reasons. Firstly, the reform posed a problem owing to it not being considered in the project design, thus, it seemed to threaten all and any progress derived from the ecological ICMS. Secondly, following the reorientation of the project, whose new version placed the fiscal reform in its core, the disturbing political scenario turned out to be a problem, making it impossible to carry out the advocacy work. Presently, the fiscal reform is formally taking place within the procedures of the National Congress, however, there is no progress foreseen by the end of the current government term.

2. Isolating the impact of the ecological ICMS: as it is constitutionally prohibited to link the ICMS-related resources, collected by the municipalities, to any purposes, it is rather difficult to recognize the impact of the ecological ICMS. If each municipality collects a certain amount derived from the general ICMS and applies that according to their priorities, it is possible to estimate what came from the environmental criterion, including in clarifying the compensation function. On the other hand, the direct impact on biodiversity is much more difficult to estimate, due to several activities being simultaneously developed in the municipality. In Mato Grosso, that challenge had to be faced while setting indicators, nevertheless, it is possible to develop methods of analysis that make possible, at least, a global vision of the benefits for biodiversity conservation in the state. Despite the fact that we were aware of the difficulties in measuring the impact of the instrument, owing to the constitutional restriction, our evaluation was that the instrument was a very important to conservation and that the efforts were well worthwhile.

3. Lack of a wide understanding on the operation of the ecological ICMS in each state: each one of the states that have adopted the ecological ICMS, created its own implementation mechanism. Such mechanism can be an arrangement with the environment or finance secretariats, with the state environmental organization, or any other. In order to perform within the state it is fundamental to understand those arrangements, their functioning and the power relationship involved. In Pernambuco, WWF-Brasil has, perhaps, lacked a wider understanding of the power relationships within the state and their consequences in implementing the ecological ICMS.

4. High staff turnover in WWF-Brasil: this project was one of the most affected by the constant high staff turnover. Up to the reorientation moment three different people had already been responsible for the project within the institution. Two aspects should be considered here: firstly, the institution needs to exam in detail the causes of such turnover and secondly, WWF-Brasil should adopt measures that can mitigate the problem, even before providing a solution. Amongst these measures an assistant could be designated to be responsible for the projects, what would lessen the impact of staff turnover.

5. Disturbing political scenario: in spite of that being the greatest problem, it is, usually, unexpected and difficult to deal with. Particularly, this scenario that has affected the project, besides its unpredictability, its dimensions have been, and are still causing impact on all of WWF-Brasil activities interfacing with the Brazilian politics.

## ***Results***

Most results reached by this project can be seen as lessons learned, both concerning the ecological ICMS and the way through which WWF-Brasil should work, as regards the issues that are the target of changing proposals, such as the ICMS within the fiscal reform.

As for the ecological ICMS, the project has showed that in spite of the wide consensus in recognizing the benefits for biodiversity conservation, those impacts have not been measured yet. Among the reasons for such situation there are: difficulties in developing indicators to measure biodiversity conservation; inexistence of information in the states; difficulties in isolating the impact of the ecological ICMS; and difficulties in getting state and municipal governments' support for those activities. That scenario can be a vulnerable point, in a possible advocacy work on the progresses of the ecological ICMS, within the fiscal reform process.

Another lesson learned concerns the political arrangements for the implementation of the ecological ICMS in the several states, and the need of fully understanding them so as to reach the expected results.

It is worth mentioning, as it is directly related to the ecological ICMS and its impacts, the document produced by IIED on the aspects to be considered, the methodology to be used and a set of suggested indicators to measure the socioeconomic impacts of the ecological ICMS. Although it was not thoroughly used it is an excellent guide to examine the socioeconomic impacts of the ecological ICMS. Once this disturbing political moment is over, probably after the presidential and state government elections in 2006, that document could serve as the base for an analysis of the socioeconomic impacts of the ecological ICMS, with a view to producing a document on the characteristics of the ecological ICMS to be preserved in the fiscal reform, as considered in the project reorientation attempt.

The project reorientation process showed that understanding the political scenario is fundamental while considering the dimensions of activities to be accomplished and not to forget important elements, such as the fiscal reform. In this respect, the flexibility demonstrated by the Darwin Initiative in welcoming the project reorientation proposal was essential and showed pragmatism and sensibility on the part of the donor, regarding the adaptive management principals, a crucial factor in public policy projects. Consequently, the activities that would be developed in Mato Grosso were resized and the fiscal reform was brought into the core of the project. It was not possible, however, to foresee the

political “hurricane” that would overcome on the Federal Government and the state government of Mato Grosso, thus preventing the progress of the project.

Nevertheless, it is worth emphasizing that the conception used in the reorientation should be adopted when the project can be resumed, probably in 2007, following the next elections.

### *Future perspectives*

Despite the interruption of the project, and the multiple problems it has faced, the issue as to how, and if, the ecological ICMS benefits will be incorporated into the coming fiscal reform remains and should be addressed. WWF-Brasil remains committed to working on this issue, and would be interested in developing a new project for submission to the Darwin Initiative in partnership with IIED from 2007. The development of a system to monitor the impacts of the ecological ICMS is fundamental in understanding the extension of benefits of that instrument and, particularly, for its advocacy during the fiscal reform procedures.

The production of an assessment document on the ecological ICMS and a strong set of recommendations for the fiscal reform are fundamental for an institution that has been working with this instrument for almost 10 years. Many gains have been secured from the ecological ICMS, and these need to be incorporated into the federal legislation in order for WWF’s efforts over the last decade, with support from the Darwin Initiative, to be fully maximized.

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