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# TAX REFORM IN BRAZIL: GUIDING PRINCIPLES AND PROPOSALS UNDER DEBATE

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## 1 INTRODUCTION

The evaluation of a tax system—that is, the set of legal rules that governs the exercise of authoritative rule by various government entities in the form of tax collection in the country—is notoriously controversial in Brazil, as elsewhere. The tax system plays a central role in a modern economy, insofar as it affects a country's economic growth and competitiveness in various and complex ways, as well as its social and regional distribution of income. It is also a crucial way to determine how much of the costs each group of citizens and companies, and from which regions of the country, will have to shoulder to finance a given State type and size, and its provision of public services and goods.

In the case of Brazil, the controversy is further fuelled by the fact that the country's tax burden has increased significantly after the enactment of the 1988 Federal Constitution, from 23.4 per cent of gross domestic product (GDP) in 1988 to 33.6 per cent of GDP in 2005. In this period, this increase happened at the expense of the tax system's efficiency and equity, largely motivated by the imperative to increase revenue during episodes of short-term fiscal adjustments, while matters regarding quality were consigned to the background. Since then, the tax burden has stopped increasing and has remained close to 32 per cent or 33 per cent of GDP for over a decade. Most recent estimates indicate a burden of 32.3 per cent of GDP for 2017.[3] Even during this period of stability, the quality of Brazilian taxation still deteriorated due to increasing tax benefits and badly calibrated special regimes, as well as little and erratic progress regarding the reform agenda.

For over two decades, tax reform efforts were concentrated almost exclusively on the taxation of goods and services—either through broad proposals to merge the many federal and local taxes into a single value-added tax (VAT) or through more modest ones, such as the standardisation of the Tax on Circulation of Goods and Services (*Imposto Sobre Circulação de Mercadorias e Serviços*—ICMS). These reforms were hampered by federative and distributive conflicts, which ended up legitimising the relative paralysis of the federal government in

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undertaking structural changes starting with federal taxes, such as those levied on corporate gross revenues (*Programa de Integração Social* and *Contribuição para o Financiamento da Seguirdade Social*—PIS/COFINS), on industrial products (*Imposto Sobre Produtos Industrializados*—IPI) and on corporate income (*Imposto de Renda sobre Pessoa Jurídica* and *Contribuição Social sobre o Lucro Líquido*—IRPJ/CSLL). Over the last few years, payroll exemptions—originally envisioned in 2004 to reduce multiple taxes in a transition effort towards a VAT—became a temporary measure to improve the cash flows of companies. Initially, it should have been restricted to a few export-driven and labour-intensive labour sectors weakened by a loss of competitiveness and increased international competition, but it became distorted and lost its selection criteria, being arbitrarily extended to retail and non-tradable goods and services.

The Brazilian tax system is often referred to as a 'tax madhouse' or a 'disjointed and chaotic structure'. It is hard to find logical consistency, based on theoretical foundations, that can justify the country's existing tax structure. To change this scenario is no simple task and depends on political agreements that fall outside the analytical scope of this paper, but it is a good starting point to update the diagnosis regarding major problems to be faced and discuss potential alternative solutions in light of economic theory and international experience.

To that end, this paper seeks inspiration in other deep reflections on the tax system, such as those undertaken at Ipea by Rezende et al. (1987) and more recently by a team of specialists gathered by Scottish economist James Mirrlees, known as the Mirrlees Review. In the several years of debate brought about by the Mirrlees Review, Mirrlees et al. (2011) have tried to identify the characteristics of an ideal tax system, which can provide guidelines for coherent and integrated tax reform, systematising the various existing options and opinions, and delineating where technical-economic judgement ends and where political and social choice begins.

Similarly, we intend to confront such a prototypical ideal system with the imperfections of the Brazilian tax structure, but with an additional concern: that this system should be capable of supporting policies for development. Based on this confrontation, we plan to outline some guidelines for a proposal for tax reform, aiming at contributing to the debate and to the government's action plan on the theme.

We can picture two paths for tax reform. The first is radical change, which would be difficult to implement. The second, more pragmatic, path is of gradual change or 'sliced reform'. However, it is necessary to distance this second alternative from mere superficial tweaks. Varsano (2014, 47–48) states that "superficial tweaks have often been wrongly referred to as a sliced reform. It is impossible to serve slices of a cake that does not exist". When we imagine that a reform is to be 'sliced', it is implied that there exists a specific tax system design which is to be reached in the future but whose implementation is fragmented to allow for an easier transition and for some course corrections.

In other words, regardless of the pace of the reform, the most important thing is for there to be a common destination point—to bring Brazil's tax system closer to an ideal system, whereby the myriad elements are properly adjusted, and any unnecessary distortions are duly eliminated. This paper hopes to contribute with a reflection regarding this destination point.

The text is divided into three sections, in addition to this introduction. The next section discusses some of the guiding principles for an 'ideal tax system'. The third section is dedicated to exploring two questions regarding the diagnosis of the Brazilian tax structure and detailing reform proposals that are currently under debate. How distant is Brazil from this ideal system, and what are the recommended reforms to bridge the gap? The last section is dedicated to final remarks.

Before we continue, however, it is worth highlighting that this is a preliminary version of an ongoing study; as such, it is by no means comprehensive. On the contrary, its analytical perspective is still quite general, focusing on three of the main tax sets: goods and services, payroll and income. We hope that further versions can deepen this analysis and address various gaps, such as the incorporation of property and environmental taxes, and also provide reflections on the new challenges resulting from the digital economy, social security financing and financial system regulation.

## 2 AN IDEAL TAX SYSTEM

This section briefly presents some guiding principles for a proposal for reform which seeks to bring the Brazilian tax structure closer to an 'ideal system', with principles drawn from economic theory and international experience. The starting point for the design of a tax system is given by some of its basic objectives:

- Revenue: to accrue enough revenue for the government to achieve its expenditure goals
- Vertical equity: to promote progressivity by proportionally levying higher taxes on those who have greater contributive capacity, according to the government's distributive goals and social preferences
- Horizontal equity: to avoid arbitrary, unequal tax treatment across taxpayers, economic sectors and sources of income.
- Efficiency: to minimise economic and administrative distortions related to tax collection, while keeping the system as simple and as transparent as possible

The design entails pursuing a system intended to combine and balance efficiency and equity, which under some circumstances can be contradictory goals and, therefore, are at the core of what is known as 'optimal taxation theory'. Among this theory's initial concerns is the need to ensure that measures geared towards promoting fiscal justice do not have net negative effects on social welfare, due to distortions in the decisions of economic agents such as disincentives to labour supply, investment and savings. However, a proper assessment of these effects depends on a wide set of variables and hypotheses about the responses of individuals, households and companies to these measures and on a subjective element that falls outside economic models, which is the value society attributes to equity.

There is no practical consensus today, even in the realm of neoclassical public finance theory, about the optimal design of a tax system. The Mirrlees Review is one perspective among many—an attempt to reconcile the differences between a potentially ideal proposal for tax reform with a systemic approach which seeks to consciously link the various parts of the structure in a cohesive manner.

However, the conventional view based on the basic objectives listed above often neglects the role that a tax system can play in supporting economic and social development. Therefore, an additional concern is how an 'ideal system' may incorporate objectives and instruments of the social, industrial, regional and environmental policies required for an integrated approach to development.

Under such an integrated approach, there is no need for all parts of the system to simultaneously pursue all of its objectives. It might be recommended for this system to have a modern VAT to more efficiently increase revenue—that is, a simple VAT with a broad tax base, limited scope for special rates and full credit, resulting in complete exemption of investments and exports.[4] There are potential drawbacks to this VAT, such as a regressive effect on the income distribution and a restriction on the use of tax benefits for social, industrial and regional policies. This should not be an issue as long as it is counterbalanced by other parts of the system, such as the personal income tax (*Imposto de Renda sobre a Pessoa F*ísica—PIT) which is considered a much more appropriate tax for pursuing distributive purposes, or when the VAT's revenues are channelled to reinforce alternative instruments of social, industrial and regional policies.

Over the last decades in Brazil, there has been a constant deterioration of development tax incentives due to design shortcomings, non-selectivity and susceptibility to lobbies—notably in the case of regional policy granting ICMS benefits, which led to a predatory fiscal war among state governments. This is why revising tax incentives does not necessarily mean abandoning development policies. Indeed, such policies might even be reinforced if this revision leads to instruments that are more conducive to objectives related to development.

The integrated approach also does not imply that every part of the system must be static and pursue a single goal. It would be ideal for the PIT to be integrated with payroll taxes and with the corporate income taxes (*Imposto de Renda Sobre Pessoas Jurídicas*—IRPJ) under a model that provides a coherent approach to all sources of income (productive capital, financial income, wages etc.). This is crucial to attain horizontal equity and avoid tax loopholes.

Even the principles of horizontal equity and efficiency must be relative. The goal of efficiency is compatible with the discriminatory treatment of certain sectors and goods—for example, when taxes are used to disincentive activities and behaviours in sectors that might lead to environmental damage, or tobacco or alcohol consumption, or to incentivise investments in research and development.

Another issue is the potential role of a tax system in reducing social inequalities. According to the Latin American structuralist school of thought, for instance, the progressive taxation of income and wealth is a key instrument in reducing extreme inequality and in changing the consumption structure to support development, by simultaneously boosting mass consumption and curbing opulent consumption by those in the top income brackets.[5]

The distributive issue has recently become central to mainstream economists in their review of the role of taxation in inequality. This review is related to a methodological and historical evolution in optimal taxation theory, which was originally based on highly restrictive hypotheses regarding individual behaviour and economic dynamics, which resulted in extreme models and proposals in the 1970s and 1980s recommending that capital incomes not be taxed to avoid economic distortions. Under the influence of restrictive interpretations of this literature and against the backdrop of the1970s neoclassical revolution questioning Keynesian fiscal policies, a sort of consensus was built in mainstream economics, positing that tax policy should refrain from distributive goals that could be achieved with less economic distortions through public expenditures policies.

Over time, however, several mainstream authors reassessed their previous views and embraced a more realistic and pragmatic approach. This overhaul in optimal tax system design includes works from authors of both the new generation, such as Thomas Piketty and Emmanuel Saez, and the founder generation, with James Mirrlees, Peter Diamond, Anthony Atkinson and Joseph Stiglitz.[6] As a result, a new view has emerged within optimal taxation theory claiming that there are theoretical reasons for taxing capital and savings. However, there are still controversies regarding the level and design of these taxes.[7]

On the one hand, Mirrlees et al. (2011) follow a more parsimonious approach, suggesting that taxes on capital should be restricted to inheritances and excess returns on savings, while normal returns to capital should remain exempt. Conversely, Piketty, Saez and Zucman (2013) present theoretical arguments that support progressive and comprehensive taxation of capital incomes, as well as of inheritances and wealth. It goes without saying that these propositions are far from being a consensus in optimal taxation theory, but nonetheless they reflect a renewed concern about the role of taxation in regulating top incomes and the concentration of wealth.

In addition to their basic objectives and principles, an additional aspect to be considered is that tax systems are historically determined and outlined by international taxation trends. Some current examples include:

- the standardisation of taxes on goods and services, most commonly through VAT, featuring increasingly broader bases and limited scope for special rates and exemptions, in the face of the ever-growing economic integration between countries;[8]
- the broad conceptualisation of the VAT taxable base (not restricted to goods and services) to deal with the challenges of the new digital economy (intangibles, electronic platforms etc.) and the financial sector;
- a review of tax benefits, given the empirical and theoretical findings that such incentives, largely implanted over past decades, are not the best way to foster investment and growth, in addition to generating income inequalities;
- the gradual depletion of models based on payroll taxes, not only due to structural changes in employment contracts to more flexible modalities, but also due to their impacts on national competitiveness; and
- the erosion of the tax base and pressure for reduced rates on corporate profits, in the face of increased capital mobility, fiscal war (tax havens) and the flexibility of new productive arrangements, allowing for easier arbitration and tax planning by large multinational corporations.

Furthermore, there are other, circumstantial—rather than structural—trends. The imperative of promoting fiscal consolidation was one of the main motivations behind a wave of tax reforms in the years following the 2008 international financial crisis. Since 2015 there has been a re-orientation, and tax policies have become driven mainly by the goal of regaining growth, as highlighted by reports by the Organisation for Economic Co-operation and Development (OECD 2016, 2017). These reports gather the most recent tax reform trends in OECD member countries, such as the following:

- There is a greater emphasis on regaining growth, with a greater predominance of tax-cutting measures on labour income and corporate profits, aiming at providing stimuli to boost consumption and investments.
- The trend of reducing tax rates on corporate profits, which had decreased soon after the 2008 crisis, was reinvigorated. Many reforms envisage reductions in the tax rates, although partially compensated by measures to increase the tax base (specifically those destined to protect national bases from tax evasion or tax avoidance by multinational corporations).

- A significant number of reforms regarding labour income tax focus on reducing taxation of low- and middle-income taxpayers, reflecting concerns about reducing social inequalities and boosting consumption.
- The trend of increasing taxation on high-income taxpayers has been maintained due to the renewed focus on the role of taxation in promoting fiscal equity, with many countries increasing rates and eliminating tax benefits on dividends and other sources of capital income at the personal level, among other measures. Therefore, an overhaul of the differential tax treatment between labour and capital incomes has been promoted.
- The reduction of taxes on labour income and corporate profit has also been counterbalanced by increases in value added taxes (VAT) and environmental taxes.
- The recent trend of increasing VAT standard-rates, which was quite evident in the aftermath of the 2007-2008 crisis, has slowed down since the year 2015. More recently, the focus has shifted towards standardising the tax base, broadening its scope to deal with the digital economy and reducing the scope of special rates and exemptions for certain goods and services.
- In the case of environment-related taxes, most reforms are limited to minor tax adjustments regarding the use of energy and automobiles.
- There has only been limited reform of property taxes, suggesting that the potential to leverage revenue more efficiently through property taxes, especially regarding residential property, has not been fully explored.

In sum, it is possible to identify two opposing forces among the main ongoing trends. On the one hand, there have been reductions in payroll taxes and corporate income taxes, both driven by structural and circumstantial issues such as economic integration and resumed growth. On the other, there have been increases in the taxation of goods and services, of direct taxation of individuals and, incipiently, of environmental taxes.

The increased offsetting of this group of taxes has partially been driven by fiscal consolidation efforts pursued by many countries, one of the main legacies of the period after the 2008 economic crisis. However, it has also been motivated by efficiency and equity concerns. The increase in taxation of goods and services has occurred in parallel to attempts to standardise tax practises, towards a modern VAT (simple, with a broad base and full use of tax credits, efficient and with high revenue potential), which facilitates tax coordination.

Similarly, the increase in personal income taxes—which is a response to the renewed focus on inequality and, additionally, the concern of protecting the base of the income distribution from the burden of fiscal adjustments—has often been guided by models seeking to be as efficient as possible. This is the case of the 'dual model', initially adopted in Nordic countries in the 1990s, which has undergone continuous revisions and has inspired many tax reform designs, such as the one implemented in Chile in 2014 and the one proposed for the UK in Mirrlees et al. (2011). The dual model is an attempt to coherently integrate corporate and personal income taxes and to promote neutrality in the tax treatment across different sources of income, while preserving the progressive nature of labour income taxes and of the excess returns from savings.[9]

The main point is that the trend of reducing the levels of payroll taxes and corporate profits has been counteracted by a combination of two main paths: the taxation of goods and services and the direct and progressive taxation of individual personal income. There is no general rule, with some countries adopting one path and others following the other. Strong recommendations regarding this matter require value judgements on social preferences and political contexts that we choose to avoid in this paper, but the renewed focus on inequality and the overhaul of differential tax treatment between labour and capital income have been supported not only by international experience but also by theoretical debate.

Finally, it is worth noting that these recent trends in taxation are grounded in empirical studies, such as the ones conducted by OECD researchers (e.g. Johansson et al. 2008), which examine the design of the tax structures that are most conducive to economic growth, and which conclude that there is a tax ranking. Property taxes—more precisely, those applied to residential real estate property—are considered the most efficient because they offer fewer distortions of the decisions of production and investment. The taxes that follow, from least negative impact to most negative impact on growth, are: consumption taxes (and other property taxes); personal income taxes; and (the most harmful to growth) corporate income taxes. The same studies recognise that replacing income tax with consumption tax can reduce the progressive nature of the tax system and increase inequality, whether by price effects or by tax relief for upper incomes. Therefore, as an alternative to improve the design of each tax source, they suggest broadening the base of consumption taxes, reducing corporate taxes (the most harmful among all in this ranking) and increasing personal taxes on dividends and other capital incomes.

In short, the main international trends in the field of taxation reflect not only pragmatism in the face of circumstantial and structural challenges but also theoretical and empirical reflections and assessments of social preferences. It goes without saying that international experiences should not be imitated, but rather reassessed in light of Brazilian legal, political and cultural specificities to extract useful lessons on the guiding principles for potential tax reform in the country. This is our purpose with this paper.

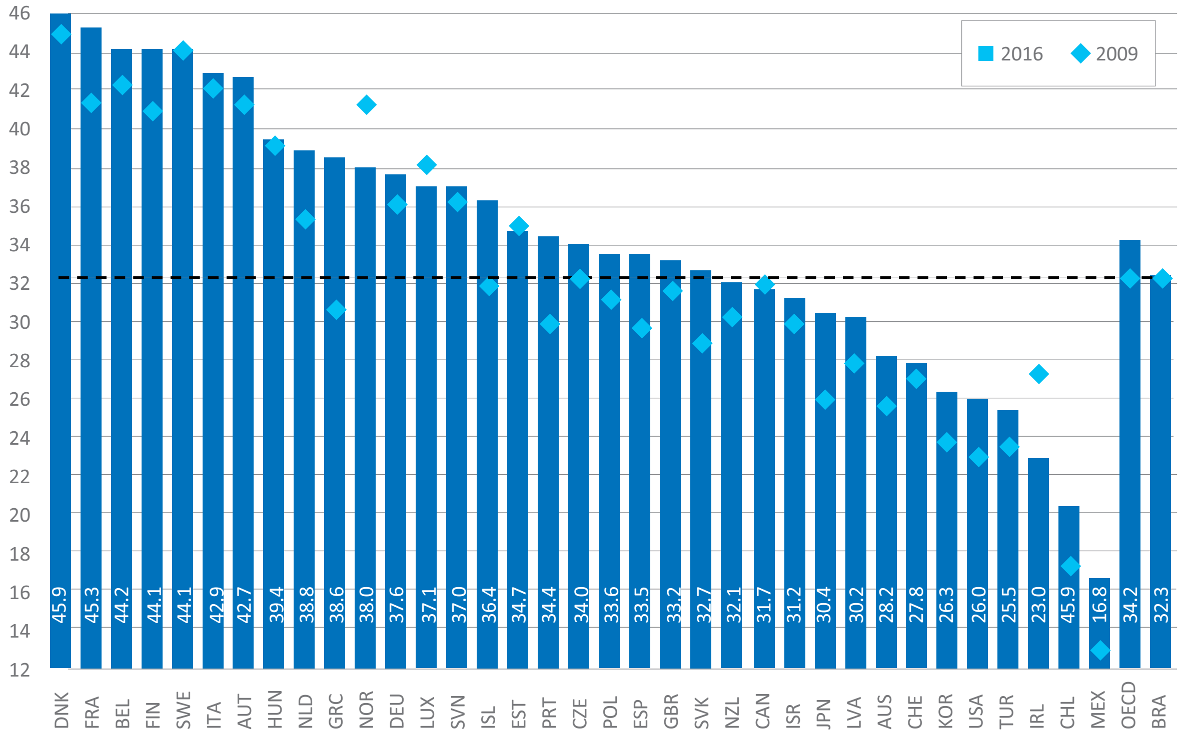
## 3 THE BRAZILIAN TAX SYSTEM: DIAGNOSTICS AND REFORM PROPOSALS

Brazil has one of the highest tax burdens of all developing countries, reaching 32.3 per cent of GDP in 2009 and 2016. Coincidentally, this burden was identical to the average in OECD countries, of 32.3 per cent of GDP in 2009. It has been diverging since then. While the Brazilian tax burden remained fairly unchanged, most OECD countries introduced tax measures to increase public revenues and as a result their average burden reached the historical peak of 34.3 per cent in 2016 (see Figure 1).

However, what is most troubling—even more than its level, which can be partially explained by the intention of implementing a welfare State in Brazil—is its inefficient and regressive structure. Unlike the most common pattern in OECD countries, where income tax is the main source of state financing, in Brazil more than 40 per cent of the burden results from taxes on goods and services, while taxes on income represent slightly more than 20 per cent.

Compared to the OCDE country average depicted in Figure 2, Brazil's burden has a higher concentration in taxes on goods and services, a lower one in income taxes and similar levels for payroll and property taxation.[10] There are still idiosyncrasies within the generic tax categories. Among income taxes, the burden in Brazil is a little higher when it applies to corporate profits (9 per cent of the total compared to the OECD average of 8 per cent) and much lower when it applies to personal income (8 per cent of the total compared to the OECD average of 25 per cent).[11]

FIGURE 1
**Tax burden in Brazil and in OECD countries, 2009 and 2016 (as a percentage of GDP)**




Source: Authors' elaboration based on own calculations for Brazil, and OECD data for the other countries (available at <http://stats.oecd.org/>).

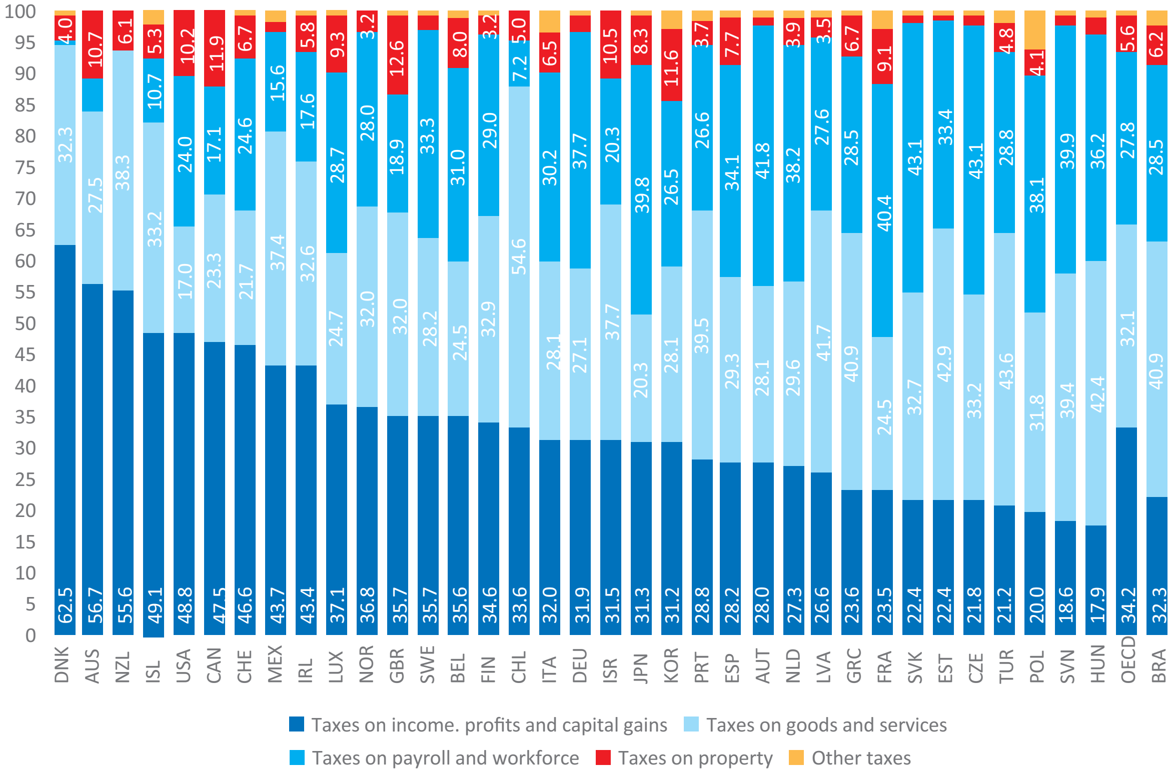
Countries: Australia (AUS), Austria (AUT), Belgium (BEL), Canada (CAN), Chile (CHL), Czech Republic (CZE), Denmark (DNK), Estonia (EST), Finland (FIN), France (FRA), Germany (DEU), Greece (GRC), Hungary (HUN), Iceland (ISL), Ireland (IRL), Israel (ISR), Italy (ITA), Japan (JPN), Korea (KOR), Latvia (LVA), Luxembourg (LUX), Mexico (MEX), Netherlands (NLD), New Zealand (NZL), Norway (NOR), Poland (POL), Portugal (PRT), Slovak Republic (SVK), Slovenia (SVN), Spain (ESP), Sweden (SWE), Switzerland (CHE), Turkey (TUR), United Kingdom (GBR), United States (USA), OECD average (OECD), and Brazil (BRA).

In sum, the Brazilian tax burden is characterised by relatively high taxes on the production of goods and services, as well as on payroll and corporate profits, whose counterpart is the low weight of taxes on the income of individuals. How did this asymmetry come to be, and what are its main consequences?

Its roots hearken back to a long historical process, but it has accelerated over the last few decades, with the crystallisation of a low weight of direct taxation on individuals, at the same time as (in a contradictory sense) the country purported to build a robust welfare State. From a centralising federative system, which was active during the years of military rule, the country went through a phase of decentralisation of the provision of public services and increased state participation in the social area. Simultaneously, there was an effort to endow regional governments with increased grants and tax bases, including the maintenance of the unusual practice of delegating to the regional sphere the leveraging of some of the main taxes of the national tax system which fall on goods and services (the ICMS and ISS).

FIGURE 2

**Composition of the tax burden in Brazil and in OECD countries, 2016 (as a percentage of total)**




Source: Authors' elaboration based on own calculations for Brazil, and OECD data for the other countries (available at <http://stats.oecd.org/>).

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This contradiction originated in a dilemma in state financing, because while the project of constructing a social State through expenditure made some progress—whether through social benefits or through social services such as health, education and assistance—the more recent Brazilian experience has faced greater resistance regarding the direct taxation of individuals. The income tax was significantly restructured in the 1980s and 1990s, restricting its progressive nature and revenue potential, and it has changed very little since then. In turn, certain instruments which have allowed increases of progressive taxation on wealthy traditionally face enormous political, legislative and judicial obstacles.

The solution to the state financing dilemma was to promote legislated increases in the 'least visible' components of the tax burden (payroll and corporate production and profit), with the added aggravating factor that these were often driven by short-term fiscal adjustments. In these episodes, the wiggle room of fiscal authorities is reduced due to the excessive focus on issues such as the revenue impact of tax measures and the feasibility of being approved in the short term, while more structural matters of efficiency and equity are consigned to the background.

This short-term nature also makes it difficult to implement tax reforms, which require long periods of legislative process and of coordinating agreements with affected groups. Therefore, the growth path of the Brazilian tax burden since the 1980s has been dominated by minor adjustments and revenue pragmatism, which resulted in the reproduction or even broadening of its innumerable distortions, until the consolidation of an asymmetrical tax structure, with high taxes on production, payroll and corporate profits.

There was a simultaneous attempt to mitigate this process through a broad spectrum of tax benefits and special regimes, some designed to alleviate the chokepoints of excessive taxation, but which ended up being extended to tax reliefs that lack technical justification and answer to pressures of interest groups. This results in increasingly more arbitrary discrimination between taxpayers and economic activities, as well as enormous loopholes in tax planning.

This tax structure has a few merits, such as high revenue collection, which allows the government to finance a social protection network that is quite dense for an average-income country and to provide a certain level of autonomy to the budgets of regional governments. However, it has unnecessary complexities and inconsistencies, and unfortunately its negative characteristics are overwhelming:

### Anti-growth bias

The composition of the Brazilian tax burden runs contrary to what is indicated by empirical studies such as by Johannson et al. (2008). These studies suggest that tax structures with a greater weight on corporate profits are the most damaging to economic growth, while those with a greater weight on property are more efficient. An assessment of tax systems based on these general categories is important, but, as suggested in these studies, must be taken into perspective and complemented by additional aspects. There is a consensus in the literature that the characteristic inefficiencies of Brazilian taxation (too many taxes, complex legislation, lack of coherent vision of the tax base, overlapping bases and cascading effect, a multiplicity of special regimes and tax benefits, high conformity costs etc.) are harmful to productivity and economic growth.

### Source of federative conflicts

One of the main normative prescriptions of the theory of fiscal federalism recommends that taxes that fall on economic bases with greater mobility should fall under the purview of central governments.[12] To delegate fiscal competence over mobile bases to regional governments can give rise to federative conflicts through an uncooperative game of fiscal war—that is, predatory competition and excessive profusion of tax benefits offered by local jurisdictions wishing to attract each other's economic enterprises, which results in the corrosion of their collective tax bases. This situation is similar to the Brazilian experience, where fiscal warfare conflicts are frequent, resulting in an inefficient allocation of resources and aggressive tax planning practices by corporations.

### Volatility in public financing

The collection of taxes from bases that are more sensitive to business cycles, such as the production of industrial goods and corporate profits, tends to transmit a pro-cyclical bias to fiscal policy. Public revenues tend to respond by increasing disproportionally during economic booms, which opens fiscal space for overspending. Conversely, decreasing revenues during economic busts may require disproportional expenditure cutbacks. The asymmetrical Brazilian tax structure, which over levies industrial production and corporate profit, end up transmitting volatility to the whole fiscal framework.

### Regressive Effect on Income Distribution

The direct taxation of income and property at the personal level tends to produce a greater burden on the rich than the poor, even under Brazil's tax structure, which makes very limited use of progressive tax rates. Conversely, indirect taxes on the production of goods and services, which impose a cost to companies and, as such, tend to be passed on in pricing, are usually regressive because they penalise proportionally more those who dedicate a larger portion of their income to consumption—that is, the poorest population. The combination of relatively low (and not very progressive) direct taxation and a greater emphasis on indirect taxation makes for a regressive overall tax burden, which is socially unjust, as taxation reinforces the concentration of income in one of the most unequal countries in the world.[13]

From this diagnosis and the general considerations from the previous section, it is worth defining some guiding principles for tax reform in Brazil. In the country's current fiscal crisis, the wisest course of action would be to undertake reform that at least preserves the current level of tax burden or even allows for an initial growth in the first years to contribute to the effort of tightening up the public finances (even if it is partially or totally reversible over the following years).

However unreasonable it may be, in the current scenario, to promote substantial alterations to the level of tax burden, we might propose something different about its composition. There is space for changes to reduce Brazil's high levels of taxation of payroll and corporate profits, which implies compensation through direct taxation and/or the taxation of goods and services, as seen in the main international experiences. In Brazil, the taxation of goods and services has few parallels worldwide. Therefore, we will focus on a reformulation that makes it more efficient. There will be a greater emphasis on increasing direct taxation, but this alternative must be carefully considered, starting from guidelines combining aspects of equity and efficiency, and ideally converging towards a coherent model of income taxation.

The goal of this paper is to determine the guidelines of tax reform that, through a change in the composition of the tax burden and the reformulation of its specific components, brings us closer to an 'ideal system', according to the guiding principles and international practices outlined in Section 2. The following are detailed diagnostics and specific proposals for three main tax sets (goods and services, payroll and income).

## 3.1 TAXATION OF GOODS AND SERVICES

Few subjects can boast consensus shared among tax analysts. One such subject is, without question, the assessment that the taxation of goods and services in Brazil is one of the most inefficient in the whole world. The 1988 Constitution confirmed the practice of subdividing taxation into various taxes under the purview of different federal bodies. The main one—ICMS—was bestowed to the states, while the purview of the IPI and the ISS fell to the federal and local governments, respectively. The federal government is also responsible for PIS/COFINS, among other taxes.

Taxation is rendered extremely complex by this fragmented system alone. In addition, there are so many specific problems with each tax that it is impossible to provide a comprehensive prognosis about the shortcomings of the taxation of goods and services in the country. What follows is a brief description of some of these issues:

- Limited use of credits in allegedly non-cumulative taxes, such as the ICMS and the non-cumulative regime of PIF/COFINS, which leads to cumulative cascading effects
- Coexistence with cumulative taxes and regimes, such as the ISS and the cumulative regime of PIF/COFINS
- Conflicts of jurisdiction (such as between the ICMS and the ISS, and the IPI and the ISS) due to the fragmentation of tax bases
- Accumulation of credits in the IPI and PIS/COFINS, even after a special procedure was introduced through a compensation law, and especially in the ICMS, as not every state legislature foresees clear and effective compensation mechanisms
- Fiscal war over taxes with regional purview, such as services taxed by the ISS and, especially, the interstate operations of the ICMS, where there is a hybrid system of principles of origin and destination
- Too many special rates and exemptions, which make coordination difficult and raise the costs of tax administration
- Mainstreaming of tax substitution, whose original purpose was to facilitate single-phase collection in specific sectors, but which became a common practice for ICMS collection; the problem is that there is often a disconnect between the presumed tax basis and the true value of market transactions
- Extreme complexity and unjustifiable, arbitrary treatments lead to substantial legal disputes and conformity costs.

Given these issues (and others), it is clear that the current set-up for the taxation of goods and services in Brazil is far from an ideal system. There is also a widespread view in the specialised literature that a possible way to mitigate many of the aforementioned problems is through a simplifying reform that includes the fusion (or substitution) of many taxes (ICMS, ISS, IPI, PIS/COFINS and CIDE, among others) and the creation of a modern system based on a VAT and an excise tax, with characteristics aligned with best international practice. That is, a VAT charged at the destination, with full credit and the broadest possible tax base (comprising all goods and services, including intangibles and financial ones), featuring a limited number of rates and avoiding, as much as possible, special rates and exemptions. This should be supplemented by an excise tax for regulatory (non-fiscal) purposes, to be levied on specific goods such as cigarettes, alcoholic beverages and fuels.[14]

The most significant issues lie in the design and operationalisation of reform that allows for a transition to this ideal system. Many versions of such reform have been proposed over the last few decades, from the creation of a single VAT under federal administration and shared with regional governments to a dual-VAT system, comprising federal taxes, on the one hand (IPI, PIS/COFINS etc.), and maintaining the ICMS on the other (with or without the incorporation of the ISS), under the purview of state governments.[15] Given the resistance of state and local governments in the face of losing their tax autonomy, among others, reform efforts were unsuccessful, and their initial drive was diluted across three vectors of minor change: the federal government attempting to modernise PIS/COFINS collection, municipalities introducing a minimum rate and increasing the list of services subject to the ISS, and states seeking a deal (as yet unfinished) to end the fiscal war and correct the distortions of the ICMS. Given the distributive conflict between different government spheres and the sectors of the economy affected by these changes, there have been minimal concrete advances after two decades of debate, and Brazil's incredibly inefficient tax system continues to endure.

The main reform proposals currently being discussed can be subdivided into three axes, according to the speed and breadth of changes proposed. The first, more pragmatic, axis is of specific changes—for example, the restructuring of PIS/COFINS proposed by the Ministry of Finance to improve the use of credits and standardise all companies in the non-cumulative regime.[16]

A second, bolder, axis features sweeping reforms, such as the proposal currently under discussion at the Tax Reform Committee of the Brazilian Chamber of Deputies, led by the rapporteur Mr Luiz Carlos Hauly. This proposal seeks to abolish nine taxes (IPI, IOF, PIS, Pasep, Cofins, Salário-Educação, Cide-Combustíveis, ICMS and ISS) and create two new ones. The first is a state-level, modern VAT and the second is a federal excise tax to be levied at source in a single phase, on a broad list of goods and services (fuels, electricity, telecommunications, tobacco, beverages and automobiles).[17] There is a second, comprehensive reform proposal by the Tax Citizenship Centre (*Centro de Cidadania Fiscal*—CCiF), for a progressive replacement of five taxes (PIS, Cofins, IPI, ICMS and ISS) by a VAT-type tax aligned with the best international practices, which is named tax on goods and servies (*Imposto sobre Bens e Serviços*—IBS). The tax administration of the IBS is proposed to be coordinated between federal, state and local governments, but with each government unit having autonomy to set rates within their own jurisdiction. This proposal also intends to create a more restricted federal excise tax, which is levied exclusively on goods and services that generate negative externalities (such as cigars and alcoholic beverages).

The outstanding new feature introduced by the proposal is its transition model, comprising two basic steps. First, the two new taxes are going have very low rates during a two-year test period (for example, a 1 per cent tax rate for the IBS, offset by a reduction in the PIS/COFINS rate). In the second step, the rates of the new taxes are planned to gradually increase over the next eight years, while the rates of the pre-existing taxes should gradually decrease until zero. This phase-in/phase-out process is designed to maintain total revenue and to ensure a gradual and predictable transition period. The main goal is to make it easier for taxpayers and tax administrations to adapt to the new model, which, in turn, is supposed to reduce and overcome resistances faced by previous tax reform proposals.[18]

The third axis, inspired by the Canadian model and the reform currently underway in India, is a sort of middle ground between the other two axis, proposing an even more gradual and flexible transition to a modern VAT system that preserves higher tax autonomy for state governments.[19] A project inspired by this model includes the initial creation of a VAT and of an excise tax (fuel, liquor and cigarettes) exclusively with federal tributes (PIS/COFINS, IPI and CIDE), not including the ICMS but anticipating a future integration. Simultaneously, measures to modernise the ICMS should be implemented to bring it closer to the federal VAT, so that during a transition period the two taxes will coexist with converging practices. A future next step would be to implement a complete overhaul of the ICMS, including all services in its tax base and making it compatible with the federal VAT.

The ISS might be incorporated into the expanded ICMS, with municipalities sharing its collection. Alternatively, it could be replaced by a local (non-cumulative) retail sales tax. The model also envisages that some states can optionally adopt a harmonised tax, which will fall on the same base as the federal VAT but preserving the state's autonomy to set its own rates. In other words, individual states can opt for a single harmonised VAT, which is a dual VAT featuring both federal and state rates. The adoption of this harmonised tax would depend on negotiations between each state and a financial counterpart from the federal government.

In this paper, we avoid going too deeply into the technical details of each of the tax reform proposals previously listed, but it is worth noting that they all share the same goal of implementing a modern system for taxing goods and services in Brazil. Their main differences lie on the transition model and flexibility of the tax system. The reformist axis, inspired by the Canadian model, proposes a more gradual transition to a modern VAT and a more flexible system that preserves higher degree of tax autonomy at the regional level, which might be more appropriate for a heterogeneous country such as Brazil to deal with its federal characteristics. Another advantage is that, from a political standpoint, there is a reduction in the federative conflict resulting from the proposal to adopt a homogeneous national VAT regime from the outset. However, this decentralised model introduces many operational complexities and may hamper coordination of tax practices between regional governments. The proposal of a more gradual and sliced reform also means maintaining the current distortions of the tax system for a longer period and accepting a greater risk of a halt to modernisation. There is no guarantee that the political cost of promoting sliced reforms over time is lower than a single-phase reform. Therefore, political issues are ultimately decisive in choosing a specific tax reform proposal.

A second common feature of the tax reforms under discussion is that they are not intended to produce revenue gains or losses. This neutrality is seen as a twofold way to reduce tax payer resistances and to assure stability for the public budgets. In fact, most of the tax reform proposals currently under debate foresee that the coefficients used for revenue sharing between government units are to be kept constant during a transition period, as well as those coefficients linked to social security and other earmarked revenues. In other words, their main goal is to modernise goods and services taxation without raising its burden as a percentage of GDP or causing sudden changes in the public budgets.

Such a modern system of taxing goods and services, with a main focus on revenue, might have a regressive effect on the distribution of income. This is a crucial reason why this reform should be accompanied by a reform of direct taxation on individuals, which is a distributive instrument by nature. We will return to this theme in subsection 3.3.

### 3.2 PAYROLL TAX

The Brazilian model of payroll tax is dysfunctional, and its negative aspects affect both employers and employees in different ways. The example in Table 1 was drawn from Appy (2017) and adequately illustrates some distortions in the taxation of high-income salaries. The table compares taxes on a service provided with the value of BRL30,000, considering three different scenarios: i) a wage employee under the normal tax regime; ii) a partner of a company under a special tax regime, typical of medium-sized companies (presumed profit regime); and iii) a partner of a company under the tax regime governing micro and small companies (simple regime).

TABLE 1
**Example of taxation for a service provider (in BRL)**

| | Employee | Company partner | |
|---|---|---|---|
| | | Presumed profit | Simple |
| A. Gross income (value of service) | 30,000 | 30,000 | 30,000 |
| B. Corporate tax | 9,788 | 4,518 | 2,463 |
| Payroll (except for the FGTS) | 5,316 | 1,038 | 0 |
| FGTS | 1,617 | 0 | 0 |
| Others | 2,856 | 3,480 | 2,463 |
| C. Personal tax | 5,103 | 974 | 974 |
| INSS | 571 | 571 | 571 |
| Income tax | 4,532 | 403 | 403 |
| D. Net income (A-B-C) | 15,109 | 24,508 | 26,563 |
| E. Total taxes (B+C) | 14,891 | 5,492 | 3,437 |
| F. Tributes/gross income (%) | 49.6% | 18.3% | 11.5% |

Source: Appy (2017).

The table shows that the tax wedge for a wage employee is almost 50 per cent, which is quite high by international standards. In fact, this example is not very far removed from the rule governing most Brazilian companies. Tax wedge on payroll is usually above 40 per cent, when we include the employee's social security contributions (between 8 per cent and 11 per cent of the contributory wage) and the employer's (20 per cent), workplace accident insurance (between 0.5 per cent and 6 per cent), FGTS (8 per cent), Education Wage (2.5 per cent) and contributions to the S System (*Sistema S*—2.5 per cent), among others. These myriad taxes overburden national production, harm its competitiveness and stimulate informality and tax avoidance.

One example is the practice of constituting companies under special regimes for the specific purpose of tax avoidance. As Table 1 illustrates, it is possible to reduce tax wedge from 50 per cent to 11 per cent, when the wage worker becomes a service provider who is a partner in a company under the presumed profit or simple regimes. On the one hand, this mechanism is advantageous to the company, which is exempt from most payroll taxes and other labour obligations. On the other, the service providers also reap benefits, since instead of dealing with personal income tax rates of up to 27.5 per cent on labour income, they will be subject to the lower rates of special regimes and will not incur any additional costs when distributing this revenue to themselves, as current Brazilian legislation exempts distributed profits and dividends from personal income taxes. All these service providers have to do is set a level of compensation for their work as a partner in their own company—the so called *pro labore*—at a minimum, which will allow them to stay inside the PIT's tax exemption bracket and contribute minimally to federal social security (INSS), distributing the remaining earnings to themselves as tax-exempt dividends.

Once again, it is worth highlighting that the didactic example of Table 1 is not very far removed from general practice, including among very personal activities (self-employed professionals, artists, athletes etc.). This phenomenon, known as *pejotização*, tends to increase given the current situation, where the criteria for simplified regimes and legislation governing labour relations and outsourcing are becoming ever more flexible. In principle, the organisation of the links of the productive process through more flexible modes of service provision and of networks of small companies and self-employed professionals is not a problem. However, a problem arises when the parameters of the tax system are poorly calibrated and result in loopholes that distort the organisational decisions of companies and service providers and, therefore, productive allocations. Another problem related to *pejotização* is the corrosion of the tax base, for the PIT, pension contributions and other payroll taxes, as high-income workers have the most incentive to shift from labour income to capital income taxed at lower rates.

The correction of problems such as these includes at least three sets of measures. The first is the implementation of an income tax model that manages to consistently integrate taxation at the personal level with taxation at the corporate level. We will discuss this further in the next subsection. However, an integrated model by itself would not solve the problem of overburdened payrolls and, therefore, must be complemented by other measures.

A second set of measures is to remove from the payroll contributions that are not related to the contributory benefits of the employee. Such is the case of mandatory company contributions destined to private entities which comprise System S, whose financing could be converted into a mix of non-compulsory contributions with subsidy expenditures, which would integrate the fiscal budget. Another example is the Education Wage, which could migrate towards a federal VAT base. This could be a neutral change from a revenue perspective, so as not to compromise the financing of education expenses, which would become a percentage earmarked to the VAT. Contributions from System S and from the Education Wage are important instruments, enacted in the early 20$^{th}$ century, but which can be reassessed in light of current circumstances. These measures are important to pave the way for a more coherent model, where the remaining taxes levied on payroll are limited to those that are more narrowly related to the employees' contributory benefits (social security contributions and FGTS).

A third aspect to consider is the employer's social contribution, which is applied at a high rate (20 per cent) to the employees' entire wage, while benefits are limited by the ceiling established by the INSS (BRL5,531.31 in 2017). The employer's social contribution is the element responsible for the majority of the tax costs of a company's payroll and represents a large portion of the cost differential between high-income formal employees and company partners under special regimes. A natural way to minimise these distortions is to reduce its rate and, simultaneously, promote reform of the PIT to compensate for losses in revenue and in the progressive nature of the tax.

In sum, this set of proposals listed aims to reduce payroll costs and establish a model with a clearer relationship between contributions and their respective contributory benefits. Their main counterpart is the need to promote a reform of income taxes towards a model that can integrate the taxation of the individual and of companies more consistently, as well as expand the revenue and progressive potential of the PIT. The next section outlines a suggestion for income tax reform grounded in these guidelines.

It is worth noting that this discussion about payroll was restricted to high-income workers. Even if many of the distortions are generalised, this approach has neglected specific aspects of other income brackets, such as low-income workers—for whom the tax issue should ideally be integrated to a discussion on reforming the current assistance benefits. In particular, it is necessary to reflect about alternative models that can better distinguish between contributory and non-contributory benefits and establish specific sources of financing for each. This includes an assessment of replacing the current pension system with one that provides a basic universal benefit for the elderly, to be financed with general taxes, while maintaining the contributory nature for those pensions above this basic benefit. This topic will be covered in future revisions of this paper.

### 3.3 INCOME TAXATION

The current structure of income tax in Brazil is a patchwork, lacking any systemic logic and containing several loopholes that restrict its revenue and progressive potential. There are several distortions, such as:

- The statutory rates applied to corporate profits are relatively high (up to 34 per cent, comprising the IRPJ and CSLL), but there is a wide range of special regimes and tax benefits that in most cases greatly reduce effective rates. This results in arbitrary tax treatment across different economic sectors and taxpayers.
- There are asymmetries in the tax treatment between the various sources of capital income, with a negative bias against productive assets. Tax rates on corporate profits (up to 34 per cent) are often higher than those applied to capital gains (15 per cent), financial applications (usually from 15 per cent to 22.5 per cent, in addition to countless exemptions) and the maximum rate of the PIT (27.5 per cent). Asymmetries occur even for the same source of income, as is the case for rents received by individuals, which might be tax exempt when the individual is a shareholder in a real estate fund with stock-traded shares and their real estate comprises the fund's assets, or it might otherwise be submitted to rates of up to 27.5 per cent in the PIT, when the real estate is directly registered to the individual. Similarly, capital gains in the transfer of assets and rights are taxed at a rate of 34 per cent at the corporate level and 15 per cent at the individual level.
- There is asymmetry in the treatment of small businesses and self-employed workers compared to wage workers. Poorly calibrated parameters in special regimes, combined with the exemption of distributed dividends and high payroll taxes, result in incentives for the *pejoticação* phenomenon, where private individuals become company shareholders for tax avoidance purposes. While salaries would be subject to rates up to the 27.5 per cent, shareholders of companies under special regimes are taxed at lower rates—for example, in the services sector, total taxes vary from 4.5 per cent to 16.85 per cent under the simple regime, and from 16.33 per cent to 19.53 per cent under the presumed profit regime. This violates the basic principle of horizontal equity.
- A considerable share of the earnings of the high-income population is exempt from the PIT or subject to lower rates than those in the progressive table. Such is the case for sources of income that are concentrated at the top of the distribution, such as tax-exempt dividends, revenues from financial applications subject to withholding tax under linear rates (on average, 17 per cent), and certain activities of a personal character taxed exclusively at the corporate level by the lower rates of special regimes (artists, athletes, consultants, doctors, lawyers etc.). This violates the basic principle of vertical equity.
- A large number of deductions lack economic or social justification.

This brief list of distortions suggests that the Brazilian income taxation model is fragmented, incoherent and unfair, discouraging investment in productive assets (in favour of other modalities) and leaving countless loopholes and incentives for tax avoidance.[20] The issue remains of how to structure an alternative model that combines in the best possible way aspects of efficiency and equity. According to the guiding principles outlined in Section 2, the path to be taken is a reform that reduces taxes on corporate profits and, at the same time, increases the revenue and progressive potential of the PIT.

International experiences suggest that Brazil overtaxes corporate profits when compared, for example, to OECD countries, where there is greater balance in the taxation of corporate profits and dividends distributed to individuals, with average statutory rates of 25 per cent at the corporate level and 24 per cent at the individual level. Most of these countries implement mechanisms to integrate the taxation of corporate and individual profits and partially soften the taxation of dividends, but almost none exempts them completely. In Brazil, the taxation of profit varies according to the size of the company and can reach up to 34 per cent, while the dividends distributed to shareholders are entirely exempt. On the other hand, the Brazilian PIT not only raises less revenue in general but also has a much smaller redistributive impact than in OECD countries on average, and also smaller than the more developed countries in Latin America (Chile, Argentina, Mexico and Uruguay).[21]

The idea of increasing the progressive character of the PIT is usually linked to setting higher marginal rates for the richest people. However, under the PIT set-up in Brazil, a mere increase in rates would have very limited redistributive and revenue effects. This is because it would only reach incomes classified as taxable, which do not include dividends or earnings from financial applications, which are the main sources of income for very wealthy people. The burden of this measure would fall mostly on wage workers, and it would be partly counterproductive by encouraging the *pejotização* phenomenon even further. On the other hand, the reinstitution of taxation on dividends (for example, applying the linear 15 per cent rate that was in effect until 1995) would not solve the problem by itself either, since it would retain the imbalance in rates and the disincentive to invest in productive assets.

These findings reinforce the argument that ideally—and beyond simple measures—Brazil should adopt a model that affords a more coherent treatment of income taxation, if its aims are to effectively reach horizontal and vertical equity and integrate taxation at corporate and personal levels.

The taxation literature discusses several alternative models designed to achieve these goals. Barreix, Roca e Velayos (2017), for instance, suggest several adjustments to enable the revival of the classic comprehensive income tax, according to which all personal incomes fall under the progressive tax schedule (whether they come from labour or capital) in an integrated way, with the corporate income tax and the wealth tax. Among these adjustments, it is worth highlighting the use of the accrual accounting rules to define the tax basis in order to avoid the well-known lock-in effect (for example, it considers the shareholder income that comprises both distributed and retained profits). A second adjustment is the establishment of a tax credit system to integrate the PIT and the CIT, by allowing tax already paid at the corporate level to be fully compensated at the personal level. In other words, the tax levied on capital incomes at the corporate level is considered an advance or a prepayment of the personal income tax. Given the fact that all incomes without exception are taxed at the same progressive rates, the adjusted comprehensive model assures horizontal and vertical equity.

One of the main technical obstacles to adopt this type of model in Brazil is the implementation of the tax credit system. Unlike the most common practices worldwide, the personal income tax rates in Brazil are below the statutory rates of the corporate income tax.

Therefore, the adoption of the adjusted comprehensive model would demand a realignment of these rates, through increases in personal income tax rates and reductions in corporate income tax rates, and probably a partial (instead of full) system of tax credit.

A second alternative is the dual model, initially adopted by Nordic countries in the 1990s, which has undergone continuous revisions and has inspired many formulations for tax reforms, such as the one implemented in Chile in 2014 and the one proposed for the UK in Mirrlees et al. (2011). In Norway, for example, the profits of large businesses are taxed at a rate of 28 per cent, which coincides with the rate applied to earnings from financial applications and the lowest rate of the PIT's progressive scale. After the 2006 reform, the earnings of shareholders (comprising dividends and capital gains) up to the normal return on capital are exempt at the individual level, and those that exceed this normal return will be further taxed by 28 per cent. The method for calculating the normal return on capital is very similar to what is used in Brazil today to assess its allowance for corporate equity (*juros sobre o capital próprio*—JSCP), which is deduced from the tax base of the corporate income tax and calculated by applying an interest rate on corporate equity. Therefore, normal returns on capital will be taxed at the same 28 per cent rate, whether it results from financial or productive assets, as a dividend or capital gain. Total taxes on surplus returns will reach 48 per cent, adding the 28 per cent paid at the corporate level to the 20 per cent paid at the individual level (that is, 28 per cent on the 72 per cent of remaining profits), in line with the highest marginal rate applied to labour income (48 per cent). This results in an effective rate on shareholders' income at between 28 per cent and 48 per cent, as well as the effective rate on labour income under the PIT's progressive schedule, with rates varying between 28 per cent and 48 per cent.

The Norwegian system uses a similar mechanism for small businesses: the owner's (or shareholder's) income is subdivided between normal profit, which is considered capital income and subject to taxes on company profits (28 per cent) and exempt when distributed to the individual, and the remaining share is considered labour income, subject to the progressive rates of the PIT, ranging from 28 per cent to 48 per cent. There is an option for those who are self-employed or owners of small and family businesses not to adopt this special regime. In this case, they are subject to rates that are similar to the PIT's progressive table. This mechanism allows low-income, self-employed people to be exempt of income tax, just as it happens with low wage employees.

Among the advantages of this dual model are the integration of corporate income taxes and individual income taxes, the more equitable horizontal treatment dispensed to different sources of income and the elimination of incentives for income transfiguration (e.g. pejotização). The model is equivalent to exempting the normal return on savings from taxation, but the surplus returns are taxed fully under the theoretical argument that they do not create an economic distortion (that is, they do not discourage investment or savings).[22]

The main experiences in the application of the dual model indicate that it has led to revenue gains in income tax due to its simplification, standardisation and broadening of the tax base, as well as closing loopholes for tax planning. It has also enhanced its progressive nature in promoting the reassessment of tax benefits granted to capital income, because the people who benefit from these practises the most are the richest.

However, most of the criticisms are related to the exemption of the normal return on savings, given that there are many justifications to tax it on some level, even within neoclassical theories of optimal taxation. This exemption of savings tends to concentrate at the top of the income distribution and severely restricts the progressive character of the PIT, which is particularly relevant in a country as unequal as Brazil. It was no accident that the adoption of the dual system in Nordic countries entailed an increase in the taxation of individuals' property, with some countries such as Sweden still taxing normal return on savings.[23]

A practical example of the implementation of a similar dual model in Brazil would include a major restructuring of income tax rates, which are grossly misaligned. First, it would be necessary to reduce the rate for corporate profits to a lower level (for example, 22.5 per cent). This could be a window of opportunity to reassess tax benefits and poorly calibrated parameters of special regimes, in addition to standardising it with the tax rate applied to capital gains and the main financial applications. Second, it would be necessary to alter the PIT's progressive table to begin and end with higher rates—for example, three or four rates of 22.5 per cent to 35 per cent or maintaining only two of the current rates, 22.5 per cent and 27.5 per cent, and establishing an additional social contribution of 10 per cent for very high incomes, which would reach the same 35 per cent upper limit.[24] The change in the PIT table could be combined with an increase in the exemption limit, sparing those in the middle class and concentrating the burden on the richest people.

Finally, we must deal with the taxation of surplus return to shareholders—for example, at a linear rate of 15 per cent, which is the same that was applied to dividends in Brazil until 1995—if the objective is to align it with the top PIT rate of 35 per cent (that is, if the profit were already taxed at 22.5 per cent at the individual level and a rate of 15 per cent were applied to the remaining 77.5 per cent at the individual level, it would result in a total tax rate of 34.1 per cent). This must also envisage an instrument that allows deducting the below-normal returns to shareholders from the tax base. This mechanism does not require more information than already exists in large companies to assess allowances for corporate equity (JSCP), an instrument which would simply be adapted.

Regarding the special regimes of micro, small and medium-sized businesses, it would be ideal for them to migrate to simplified criteria to ascertain taxes on the company's added value (and not its gross revenue) and to adopt mechanisms to split between labour and capital income as in the main experiences with the dual system. Given resistance to these changes, it might be easier to operationalise a mechanism considering as normal return the profits that are currently presumed by legislation and to submit surplus profits to the additional rate, in the case of small and medium-sized businesses, and to the PIT's progressive table, in the case of microbusinesses and self-employed professionals.[25] Through this system, a low-income service provider would remain exempt at the personal level, while a high-income service provider would have a higher share of their income subject to the progressive rates of the PIT, similar to wage workers. Therefore, the simplicity of special regimes is preserved, but with a more balanced taxation of profits between companies of different sizes and between capital and labour income, reducing the tax incentives for income transfiguration anomalies such as *pejotização*.

It is worth noting, however, that this phenomenon would not be entirely eliminated by income tax reform, because there would still be a significant tax differential resulting from the high burden on payroll in the normal regime (relative to company shareholders in the special regimes). Therefore, it would be important for the largest share of any eventual revenue increase to be channelled into payroll exemption, especially social security contributions. One possibility is that additional rates on high incomes in the PIT and on the surplus returns of shareholders—to be created to turn the Brazilian system into a dual system—become social contributions with funds earmarked to social security. This seeks to establish new sources of financing for the social security budget, in this particular case as social contributions with the burden concentrated on high-income individuals, replacing the traditional financing through payroll taxes which excessively burdens the country's productive sector.

## FINAL REMARKS

This Working Paper is part of an ongoing broader project and makes no claim to exhaust the issue of tax reform in Brazil. On the contrary, it is only an overview focused on three of the main taxation sets: goods and services, payroll and income. We hope that further versions can deepen this analysis and address various gaps, such as the incorporation of property taxes and environmental taxes, and also provide reflections on the new challenges arising from the digital economy, social security financing and financial system regulation. It is also outside the scope of this paper to go in greater depth into the technicalities involved.

Our purpose is simply to present guidelines for a tax reform in Brazil that is not restricted to the modernization of the taxation of goods and services, while by no means neglecting the relevance of such an endeavour. On the contrary, the paper highlighted the merits of a set of proposals designed to correct distortions of taxes on goods and services in Brazil and tried to clarify that political (rather than technical) issues are the ultimately decisive for choosing the path to be taken.

In addition, the paper presented a diagnostic about distortions in income and payroll taxation in Brazil, as well as a discussion of income tax models that can attain horizontal and vertical equity with consistent integration between personal and corporate levels. Our concern, on the one hand, was to envisage the conception of a model compatible with a reduction in income tax rates at the corporate level, while seizing the opportunity to thoroughly reassess all tax benefits. On the other hand, we seek a counterbalance through individual income tax, with a model that treats different sources of income more consistently. These objectives follow the guiding principles and international trends described in Section 2.

We briefly discussed the necessary realignments to establish a dual income tax model in Brazil, whose expected gains in revenue and in progressiveness have more to do with the simplification, standardisation and broadening of the tax base, as well as closing the loopholes for tax planning, than with the realignment of tax rates. Indeed, the reference model outlined here maintains the exemption of shareholders' normal returns and, rather, only defends a moderate increase in the PIT's top rate, to a low standard compared to international experiences (from the current 27.5 per cent to 35 per cent). These are characteristics that restrict the PIT's progressive profile, which must be taken into account in an integrated tax reform. In many experiences of adopting the dual model there has been a complementary effort to increase property taxes.

A second alternative briefly discussed in this paper is the adjusted comprehensive model, according to which all personal incomes fall under the progressive tax schedule—whether they come from labour income or capital income—in an integrated way with the corporate income tax and the wealth tax. This is a possible solution if the goal is a higher progressivity of the income tax, which renders a wide-scope property tax unnecessary.[26] Again, it is worth noting that the choice of model ultimately depends on the correlation of political forces, the ability to negotiate and social preferences. This paper does not purport to give definite answers to all of these questions. Its sole purpose is to provide some inputs to the debate.

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## NOTES

3.  According to updated data from Orair et al. (2013).

4. La Feria and Krever (2013) discuss the basic principles and major shortcomings of a modern VAT.

5. Pinto (1969) explores the links between distribution, development and tax system from a structuralist perspective.

6. For a further discussion, see Gobetti (2018).

7. Banks and Diamond (2010) discuss the justifications for taxing the normal return of savings based on the neoclassical theory of optimal taxation. One of the reasons listed is that taxes on savings can be an instrument to reach those with greater contributive capacity (inasmuch as it reflects cognitive abilities); the non-taxation of savings distorts decisions in favour of financial investments (to the detriment of human capital), given market flaws; and precautionary savings, given uncertainty about future income, have the potential to generate excess savings and a future reduction in labour supply.

8. The United States is the only exception of an economically relevant country that does not adopt a VAT, but rather a retail sales tax.

9. The dual model will be discussed in further detail in subsection 3.3.

10. There is still a last component of non-classified income tax. To avoid arbitrariness, the classification of Brazilian taxes sought to be as close as possible to OECD's official criteria. A common practice in the Brazilian literature is to adopt reclassifications that usually increase the level of tax on goods and services–such as the reclassification of the vehicle personal property tax (imposto sobre a propriedade de veículos automotores—IPVA) or the corporate income tax under the special regime of presumed profit. Even though this may sound reasonable in many cases, such reclassifications give rise to to comparability problems with international statistics. It is also worth noting that international comparisons should be cautious due to the specificities of the tax systems in different countries. One example is the integrated income tax system for small business and self-employed workers. Some countries, such as Norway, use a procedure of income split into profits, subject to corporate income taxes, and labour, subject to personal income taxes. In other countries, such as the United States, the integration occurs at the personal level and this overestimates personal income tax revenues. Conversely, in the Brazilian system the integration is at the corporate level and thus corporate income tax revenues are overestimated.

11. In more than half of these countries (21 out of 34), the tax packages included some measure increasing taxes on wealthy individuals, including dividends (Förster, Llena-Nozal and Nafilyan 2014).

12. In accordance with the principle of fiscal decentralisation, developed in Musgrave (1959) and Oates (1972).

13. See Silveira and Passos (2017) for a comprehensive assessment of tax progressivity in Brazil.

14. It is important to clarify a common confusion when equating this VAT system necessarily to a single tax. A VAT system can be adapted to multiple taxes, at least from a conceptual perspective. One may conceive of a state level VAT coexisting with two federal VATs—one earmarked to the social security budget and the other shared with states and municipalities. In fact, this already happens with the IRPJ/CSLL or the PIS/Cofins, which share the same tax basis with different rates and budget earmarks. The multiple tax system is more complex, but this might not turn into a significant problem if each tax preserves the desirable characteristics of a modern VAT. It also has the advantage of making the system more adaptable to the current Brazilian fiscal framework by preserving higher tax autonomy for state governments and the dual budget, where social contributions override general taxes.

15. Lukic (2014) analyses the main tax reform proposals discussed in Congress since the 1987-1988 Constitutional Assembly.

16. The details of the PIS/Cofins reform proposal are presented at the Brazilian Federal Revenue Secretariat website. Available at: <http://idg.receita.fazenda.gov.br/noticias/ascom/2015/dezembro/fazenda-conclui-reforma-que-simplifica-a-contribuicao-para-o-pis>.

17. The documents presented by the rapporteur  are available at the Committee's website: <http://www2.camara.leg.br/atividade-legislativa/comissoes/comissoes-temporarias/especiais/55a-legislatura/reforma-tributaria/noticias/relator-apresenta-proposta-para-a-reforma-tributaria>.

18. In the case of tax-sharing and intergovernmental grants, the transition model foresees an even longer period—50 years. The proposal is further detailed in CCiF (2017).

19. See Varsano (2014) and Lukic (2018) for a comprehensive diagnosis of the problems in the taxation of goods and services. They also describe in further detail the reform proposals, especially the reforms inspired by the Canadian model.

20. See Appy (2015) and Souza (2016) for a more comprehensive diagnosis of the distortions of Brazilian income tax.

21. See Gobetti and Orair (2017) for a comparative analysis of the Brazilian income tax relative to OECD countries, and Hanni, Martner, and Podestá (2015) for an assessment of the degree of tax progressivity in Latin-American countries.

22. This property is similar to an expenditure tax (known in the literature as the Kaldor tax), which is harder to operationalise given the current structure of national tax systems and which results in a more volatile revenue flow. For comparisons between income tax models, see Mirrlees et al. (2011, ch. 13).

23. Sorensen (2010) and Gobetti (2018) discuss the main theoretical principles underpinning the dual model and some case studies.

24. If an additional income of BRL1 million were already taxed at 27.5 per cent, a 10 per cent tax on the remaining BRL725,000 would yield a net income of BRL652,500, which corresponds to a total tax rate of around 35 per cent.

25. As an example, under the current system the profit of medium-sized businesses is 'presumed', applying a tax rate on gross revenue of 12 per cent for industry and 32 per cent for services, and taxes are calculated on top of this rate (IRPJ, CSLL, PIS/COFINS and ICMS or ISS).

26. The adjusted comprehensive model has a single tax base, obtained by adding the traditional labour and capital incomes to a differential income over the person's wealth. This is the reason why Barreix, Roca and Velayos (2017, 17) claim that since all incomes are taxed, there is no need to levy additional taxes on wealth, albeit with important provisos for other property taxes (such as inheritance taxes) to curb inter-generational injustice related to inherited wealth.

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