international policy centre for inclusive growth

The International Policy Centre for Inclusive Growth is jointly supported by the United Nations Development Programme and the Government of Brazil.

ONE PAGER 375

February 2018 ISSN 2318-9118

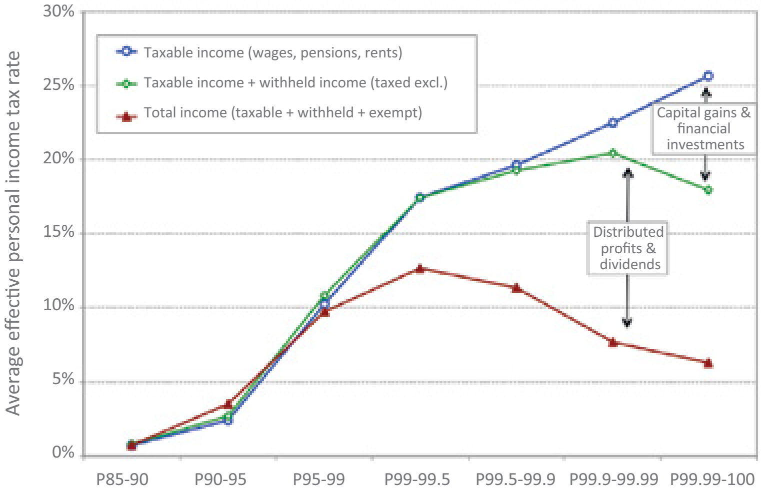
Elite taxation, rent-seeking and income inequality in Brazil[1]

Marc Morgan, Paris School of Economics and the École des Hautes Études en Sciences Sociales and World Inequality Lab

Brazil is a notable case of high fiscal income inequality coexisting with a weak regulatory personal income tax. These findings are a clear reflection of the separation of incomes in the country for fiscal purposes. As one moves up in the pre-tax fiscal income distribution, it is the sources of income received that matter most for the individual tax burden (Morgan, 2017). And such a fiscal separation of income can have a positive feedback on pre-tax income inequality. Figure 1 shows the different average effective tax rates applying on different categories of income in Brazil in 2015.

As Piketty, Saez, and Stancheva (2014) have argued, high marginal tax rates make it more difficult for individuals who have to bargain to increase their compensation (e.g. corporate executives) to receive a higher income. In Brazil, as in many other countries, corporate executives are likely to dominate the top of the distribution. With such low marginal tax rates on taxable income and low average effective rates overall (due to the tax exemptions for certain important categories of income pertaining to the top) the 'compensation-bargaining' constraint is not going to be very binding, and large income differences can easily persist.

Figure 1. Average effective income tax rates for different income distributions in Brazil, 2015



Source: Morgan (2017).

Crucially, the fiscal separation of income can influence the forms of remuneration chosen by asset-owning elites, linking the tax system to decisions that have important macroeconomic implications. This can be appreciated from decisions by corporate owners (i.e. shareholders) on whether to receive distributed profits (i.e. dividends) or to realise future capital gains by selling their shares later, or opting for share bonus schemes/buybacks, rather than accumulating wealth through retained earnings to re-invest in the company. In the Brazilian case, corporate owners pay less tax on distributed profits and share bonus schemes (being completely exempt) than if they were to accumulate profits in the company (either for induced capital gains—taxed at a 15 per cent rate—or for fixed investments that increase labour incomes—taxed at the highest marginal rate of 27.5 per cent). The Brazilian income tax system can thus be said to motivate distinct forms of rent-seeking behaviour among elites and promote the short-term vision of maximising shareholder value, given the prevailing tax incentives.

To satisfy the principle of progressivity and to limit elite rent-seeking, the average effective tax rates for total income should at least more closely resemble those for the taxable income distribution—the richer you are, the higher the share of your income you pay in tax. To do this, policymakers would need to remove regressive exemptions on incomes such as distributed profits and dividends, and apply the personal income tax schedule to all incomes currently withheld and taxed exclusively at lower rates. This means bringing capital gains and interests from financial investments into the existing personal income tax schedule.

One policy option would be to create a comprehensive personal income tax that includes all categories of labour and capital income, withheld at source and taxed according to a unique schedule of progressive effective tax rates on total income. The advantage of this option is its simplicity and transparency. A variant would be a dual income tax schedule, where investment income (from capital ownership) would be subject to higher and differentiable marginal rates than earned income (from labour). The overall objective should be to design a personal income tax regime that achieves tax equity, while serving as a regulatory tool in a national pay policy and in a national policy of economic development, limiting short-term rent-seeking and promoting productive long-term investments.

References:

Morgan, M. 2017. "Income Inequality, Growth and Elite Taxation in Brazil: New Evidence Combining Survey and Fiscal Data, 2001–2015." *IPC-IG Working Paper*, No.165. Brasília: International Policy Centre for Inclusive Growth.

Piketty, T., E. Saez, and S. Stantcheva. 2014. "Optimal Taxation of Top Labor Incomes: A Tale of Three Elasticities." *American Economic Journal: Economic Policy* 6(1): 230–271.

Note:

1. This One Pager is based on Morgan (2017).

International Policy Centre for Inclusive Growth
SBS, Quadra 1, Bloco J, Ed. BNDES, 13º andar
70076-900 Brasília, DF - Brazil

ipc@ipc-undp.org ▪ www.ipcig.org
Telephone: +55 61 2105 5000