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## **Fiscal justice in Brazil:** pathways to progress

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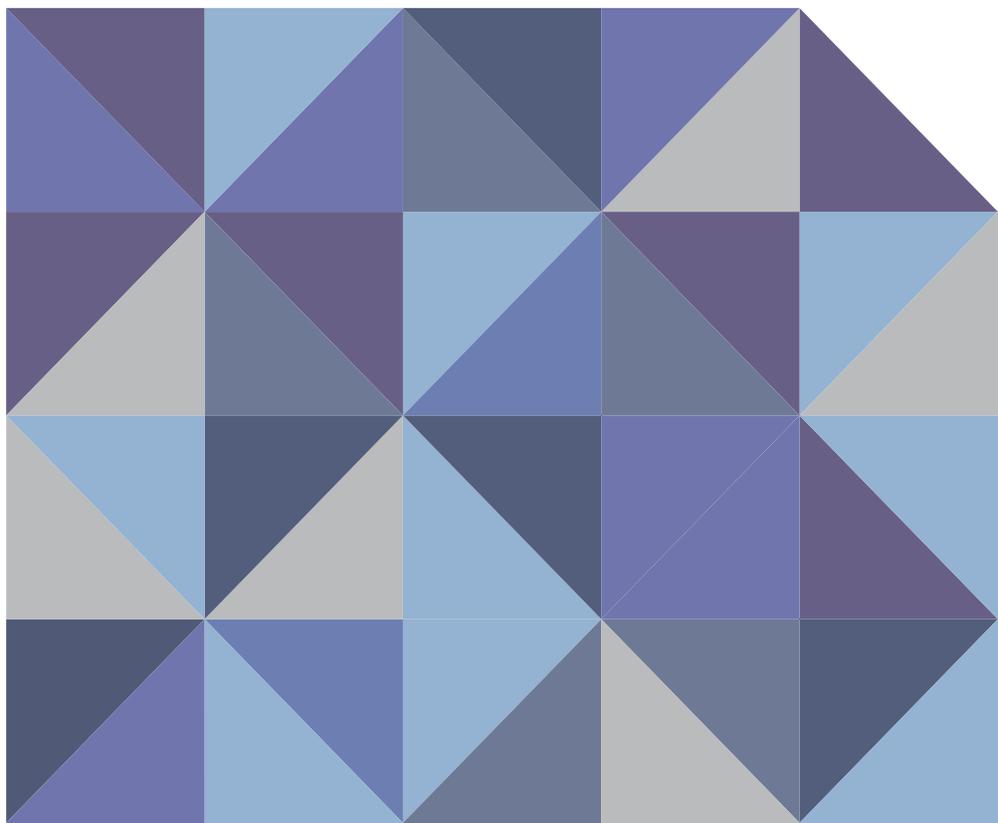
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# FISCAL JUSTICE IN BRAZIL: PATHWAYS TO PROGRESS<sup>1</sup>

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The purpose of this paper is to clarify the debate around the importance of fiscal justice in the promotion of equity and possible pathways to achieve it. To that end, the study included an analysis of the Brazilian tax system and of the existing literature on its distributive role and its efficiency. The findings point to inefficient taxation that is still very unequal, but with clear room for improvement. To increase efficiency and promote economic growth, we propose a change in the taxation of goods and services through the creation of a value-added tax (VAT) and changes in payroll so as to make it tax-exempt. Five pathways are suggested to improve fiscal injustice: a reduction of indirect taxation; changes to the rates and thresholds for personal income tax; the reintroduction of taxation of profits and dividends; the institution of a tax on large fortunes; and an increase in social spending. The current fiscal and economic crisis in Brazil points to the need for fiscal reform under these terms to ensure both efficiency and equity.

**Keywords:** fiscal justice; equity; taxation; efficiency

## INTRODUCTION

The debate around taxation in Brazil has long revolved around issues related to tax burden, efficiency, competitiveness and simplicity. Despite recent fiscal problems and a better understanding of the extent of the concentration of income and national wealth, the relevance of a progressive tax system as a tool to fight inequality still enjoys little space in mainstream media discussions. The traditional focus of the Brazilian debate on the tax burden is due to the fact that the State absorbs a considerable proportion of gross domestic product (GDP)—approximately 32 per cent in 2016—as taxes. This sets Brazil apart from other countries with similar income levels: its tax burden is one of the highest in Latin America, even greater than in some developed countries such as Spain and Canada.

Another issue related to the country's disproportionate tax burden compared to its income and development level is fiscal inequality. While the Brazilian tax system is regressive regarding revenue composition, it is neutral from a distributive viewpoint, considering other methodological aspects in the specialised literature (Siqueira et al. 2017). These factors reinforce the unambiguous conclusion that the tax system has limited potential to combat inequality, which is one of the country's biggest socio-economic problems.

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1. A version of this paper was previously published in Portuguese (Passos, Guedes, and Silveira 2018).

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Therefore, the objective of this paper is to clarify the debate regarding the relevance of fiscal justice in promoting equity and the pathways to achieve it. To that end, the text is divided into three further sections, in addition to this introduction and the conclusion. The following section briefly describes the design of the Brazilian tax system from a historical perspective. The third section highlights the main inefficiencies of this system. The fourth section details the inequalities of the system and discusses tax progressivity as well as social spending as possible ways to promote equity in the national economy.

## 1 HISTORICAL ASPECTS OF THE BRAZILIAN TAX SYSTEM

According to Oliveira (2010), from the 1930s onwards the development of the Brazilian tax system is considered in light of changes in revenue dependence and a 'new' federal pact. The legal instrument that defined the basis for the State's revenue was the 1934 Constitution. In short, the external factors that had previously played a decisive role in generating its revenues played only secondary roles. The changes in productive bases and the shift of the dynamic centre (Furtado 2003), as well as the improvement of revenue mechanisms—especially regarding income taxes—are considered the main elements of the new national tax structure.<sup>5</sup>

Soon after the 'New State' (*Estado Novo*), a period characterised by a larger centralisation of government activities, the 1946 Constitution was largely responsible for the 'cooperative federalism' character of the tax system.<sup>6</sup> In it, the rule of constitutional transfers institutionalises the federal government as the revenue operator for states and municipalities, as well as the state for its municipalities. This alteration affected the roles of the federal and state governments, ranging from areas of competence to the distribution of income shares. The regional aspect gained prominence, and the main objective of the system was to reduce inter-regional income inequality and federal imbalance—the Constitution set a minimum value of federal expenses to be allocated to certain areas of the Northeast, the Amazon, the São Francisco river and its tributaries (*ibid.*). As the State had an even larger role in the 1950s,<sup>7</sup> the income-generating capacity of this system became compromised, and there was a recurring imbalance (Oliveira 2010).

The priorities defined during the period of military rule in the country (1964–1985) included the reinstatement of the State's financing capacity; the need to transform taxes into a tool to help expedite the accumulation of capital; and the creation of incentives to support strategic sectors. In short, the final objective was to resume growth, since the adverse behaviour of economic activity in the early 1960s invalidated any strategy for economic, political or social gain at the time. However, it is worth highlighting that the changes introduced in the new system valued modernisation and adaptation to the new necessities in the national economy. However, the extinction of 'cumulative' taxes in favour of value-added taxes, considered the most efficient and effective<sup>8</sup> form of taxation, as well as the advances towards direct taxation over the period, were not enough to make the system more effective regarding aspects of social justice (*ibid.*).

Regarding the impact of taxation, the three periods can be considered from the perspective of tax burden and tax composition. As presented in Oliveira (*ibid.*), during the 1930s the tax burden was around 10–12 per cent of GDP (at the end of the 1950s, it reached 17.4 per cent), while the contribution of indirect taxes went from something close to 80 per cent of the tax burden to values close to 70 per cent by the mid-1940s (these values would remain stable by the end of the 1950s).

This contribution is related to the importance of direct taxes over the period—increasing from 17.6 per cent to 30 per cent in the 1940s. With the reforms in the 1960s, especially tax reform, the State's revenue capacity expanded, and the tax burden jumped to something around 25 per cent of GDP, remaining stable during the 1970s. Regarding the composition of taxes, the main highlight is the fast growth of direct taxation as a result of the reforms in personal income taxes (*Imposto de Renda*—IR) and the increasing levels of the population's per capita income. Gobetti and Orair (2016) note that the top rate in Brazil climbed from 8 per cent to 65 per cent under President João Goulart, in the early 1960s. During military rule, this rate was set at 50 per cent, while the USA reduced its income tax rate from 90 per cent to 70 per cent. Nevertheless, the relative contribution of income taxes to the tax burden did not surpass 20 per cent, and this meant that the system was still quite a long way from achieving social justice.

In the early 1980s, the external crisis imposed restrictions on the military government's growth model. Problems with external financing and the impact on national debt, among other issues, reinforced the political deterioration of the regime and contributed to the process of re-democratisation. The 1988 Constitution symbolises the democratic movement in this period. According to it, changes to the tax system would value decentralisation and social policies, especially with the introduction of social security. Furthermore, the main result for the federal government was a decrease in revenue, as highlighted by Oliveira (2010, 39):

“(...) The federal government lost unique taxes (levied on electrical energy, fuels and minerals) and special taxes (road transport and communication services), which were integrated into the new state tax—the Tax on Circulation of Goods and Transportation and Communication Services (*Imposto sobre Circulação de Mercadorias e Serviços*—ICMS)—and the share of revenue from income taxes and the Federal Excise Tax (*Imposto sobre Produtos Industrializados*—IPI) was transferred to states and municipalities (from 33 per cent to 47 per cent, in the case of income taxes, and from 33 per cent to 57 per cent, in the case of the IPI).”

Revenue corrections would come from a 'tax on large fortunes' (*Imposto sobre Grandes Fortunas*—IGF), which has not been regulated since, and from a rural land tax (*Imposto Territorial Rural*—ITR), which has a low impact on fiscal revenues and should still be shared with municipalities.<sup>9</sup> Since then, the measures aimed at correcting the country's tax imbalances have been pragmatic from a revenue perspective and ineffective in resolving problems, reproducing and often amplifying the main distortions.<sup>10</sup>

The result of the changes that have been taking place since the 1990s is reflected in the current composition of the tax burden. Unlike most of the countries in the Organisation for Economic Co-operation and Development (OECD), in 2015 the tax burden on income, profit and capital gains as a proportion of GDP in Brazil was around 6.7 per cent; on goods and services 13.2 per cent; and on property approximately 2 per cent.<sup>11</sup> In 2014, the OECD average was 11.5 per cent for the first type of taxes, 1.2 per cent for the second and 1.9 per cent for the third. In countries such as the UK and France, property taxes are close to 4 per cent of GDP. It is important to highlight how these factors contribute to the current economic distortions in the country.

## 2 INEFFICIENCIES OF THE NATIONAL TAX SYSTEM

It is important to define what the literature understands as efficiency in taxation to identify the distortions of the Brazilian tax system that harm the economy. Unlike aspects related to equity, whose concerns regard the equality between taxpayers and their contributive capacity, the efficiency of a tax system regards its capacity to minimise the distortions that taxation can cause

in the economy. Therefore, it is important to examine each aspect of taxation by considering the needs of society. As pointed out by Orair and Gobetti (2017), depending on the goals and interests and under certain circumstances, efficiency and equity can point to different paths in the design of a tax system that intends to improve or adjust aspects related to social justice.

The main tax inefficiencies in Brazil, beyond aspects related to the distribution of income, are reflected in the volatile, stop-and-go nature of its growth rate, in the low levels of investment and in the composition of the tax burden—especially taxation of capital, but also in the organisation of taxes on goods and services.

Regarding the inefficiency of productivity and its impact on economic growth, it is worth highlighting the following: a patchwork of taxes and complex legislation; an incoherent and pro-cyclical tax base; overlapping tax bases; cumulative taxes and taxation at source; and fiscal war. Factors that affect distributive and revenue efficiency include the low progressivity of taxation of income and capital<sup>12</sup> and the low revenue capacity, considering property taxes in general and the lack of regulation of the IGF. This section focuses on aspects of inefficiency related to productivity and growth, as well as possible alternatives to correct them.

## 2.1 PATCHWORK OF TAXES AND COMPLEX LEGISLATION

The Brazilian tax system can be considered costly, complex and inefficient. There are many tax mechanisms (taxes, social contributions, economic contributions, improvement contributions etc.), and all three spheres of government have prescriptive capacity to levy taxes.

The high cost of the tax system, both direct (i.e. the tax authority) and indirect (i.e. taxpayers), together with its complexity, leave room for tax planning and evasion. In addition, the system has little economic efficiency, mostly due to the myriad rates of the IPI and the ICMS, the existence of cumulative taxes, such as Cofins and the PIS-Pasep, and the high number of special regimes in specific sectors and products, both regarding the ICMS and the PIS/Cofins, which result in complex legislation with productivity-distorting effects (Appy 2015; Lima 1999).

Appy (2015) highlights that the complexity of the Brazilian tax system results in very high verification and revenue costs (conformity costs). According to data from the World Bank, Brazil is the country where companies spend the most time meeting their tax obligations (a medium-sized company needs 2,600 annual work hours, which is more than double the next-ranked country). The author also considers that the complexity and uncertainty around tax rules lead to an increased caseload in litigations between taxpayers and the tax authority, in both the administrative and the judicial spheres.

The legislation that governs the system is notoriously complex. A survey by the Brazilian Tax Planning Institute (Instituto Brasileiro de Planejamento Tributário—IBPT) reveals a voluminous production of legislation in the field of taxation. Between the enactment of the 1988 Constitution and September 2013, the three government spheres published 309,000 rules. In addition to this vast amount of legislation, it is important to highlight that the system's complexity is also reflected in the existence of 27 distinct regulations, given that subnational entities have the prerogative to establish rules, since they determine the main consumption tax—the ICMS. A similar situation is observed in taxes on assets, which are diverse and widely dispersed but represent a low proportion of GDP. These factors leave room for tax planning, increasing the cost borne by taxpayers to fulfil their tax obligations and justifying the dubious honour of 'tax madhouse' bestowed on the Brazilian tax system (Oliveira and Biasoto Jr. 2017).

Furthermore, indirect taxation also contributes to the complexity of the system through the appropriation of different tax bases and rates, largely incident on inputs. This complexity obscures the final effect of taxes on prices paid by households, resulting in effective tax rates to the consumer that deviate significantly from legal (or nominal) rates (Siqueira et al. 2012).

## 2.2 THE PRO-CYCLICAL CHARACTER OF TAXES

An over-reliance on taxes on goods and services highlights the inefficiency of the tax system, as it contributes to the pro-cyclical character of revenue and, therefore, to greater fiscal fragility in periods of recession. The country's tax revenue derives from economic activities at a ratio of greater than one. This means that in times of economic expansion, the country's revenue capacity increases more quickly and leaves room in the budget to accommodate excess expenditures. However, during economic decline, the country's revenue capacity becomes more fragile, requiring disproportionate expenditure cuts in periods of crisis. The indirect application of the system and its asymmetry reinforce this effect and impose greater volatility on the fiscal framework, compromising the sustainability of policies and implying the necessity of severe adjustments that potentialise adversity over economic growth (Orair and Gobetti 2017; Pires 2017).<sup>13</sup>

## 2.3 OVERLAPPING BASES, TAXATION OF PRODUCTION AND CUMULATIVE TAXATION

The overlapping of bases is largely due to a model that favours indirect taxation, with many taxes or contributions falling cumulatively on consumption, such as the PIS and Cofins. In this type of taxation, costs are transferred to goods and services, which reduces consumption and affects the competitiveness of companies.

Cumulative taxation also has adverse effects on economic growth. This is due mainly to the 'cascade effect' of taxes, which emphasises the costs of capital goods and discourages investment. It is important to highlight that cumulative taxes also harm competitiveness—taxes that are levied on revenue at a single rate obfuscate the amount of taxation of each product. In these cumulative taxes, there is a distinction between legal and effective rates, given that the latter supersedes the former. Little is known about the effective weight of cumulative indirect taxes on tax structure, as even the ICMS, which is ostensibly a non-cumulative tax, represents a significant cumulative level when one considers that a proportion of its credits is not adequately paid back to payees. Furthermore, its collection system is 'from within'—or, in other words, it amplifies the impact on the product's final price (Oliveira and Biosoto Jr. 2017).

## 2.4 FISCAL WAR

Fiscal war occurs as a consequence of taxing production—not consumption—through a state tax, which leaves room for individual states to hijack taxation for other purposes. We refer to taxation of production, not of consumption, given that it is collected at source, not at destination. Fiscal war is understood as a regional development mechanism; however, according to Appy (2015), it is inefficient, given that a significant share of fiscal incentives dedicated to it serve only to cover additional logistical costs, not to mention that the illegality of the practice enables an environment of corporate judicial uncertainty, which negatively affects investment in the country.

One of the main normative prescriptions of the theory of fiscal federalism states that tributes on economic bases with greater mobility should be under the purview of central governments. Therefore, the attribution of this competence to regional governments can give rise to federative conflicts manifested in a 'non-cooperative game of fiscal war', through unbridled competition for fiscal benefits in local jurisdictions (Orair and Gobetti 2017).

Oliveira and Biasoto Jr. (2017) highlight that fiscal war yields inestimable losses in revenue and a new organisation of productive capacity, grounded on tax situations and not—as it should be—on productive efficiency. They highlight that the phenomenon of fiscal war has been watched from afar by the federal government, discarding the role that it should play in the maintenance of the federative system and in regional development policies.

## 2.5 ALTERNATIVE SOLUTIONS

A promising way to combat the tax system's inefficiency is the institution of a VAT. The VAT is applied at all stages of production and commercialisation. For each of the stages, the credit relative to the tax charged during the previous stage is secured. Therefore, the VAT is characterised by its neutrality, as its application does not depend on the organisation of the productive process.

The shift in Brazil's indirect taxation towards a VAT could potentially solve the problem of the cumulative nature of taxes, in addition to simplifying the taxation of goods and services. Another advantage of the VAT, along the lines of shifting the source of taxation from the source of production to consumption, is the softening of the fiscal war, given that taxes on production offer strong incentives for states to use the tax system for other purposes.

The literature has been moving towards consensus regarding the advantages of introducing a VAT in Brazil, in accordance with international experience. Ideally, according to Appy (2015), there should be a national VAT, shared between the federal government, states and municipalities, but as there is significant resistance from other subnational entities against this configuration, the alternative would be the creation of two VATs: a federal one and a subnational one, gathering the bases of the ICMS and the ISS. According to the author, for this configuration, the proper procedure would be to apply the same legislation for both VATs, preserving the autonomy of states to establish the rates of the subnational VAT. This structure leaves room for the creation of a selective tax that would be applied to goods whose consumption is discouraged, such as cigarettes and liquor.

Orair and Gobetti (2017), in turn, propose that the reform of taxation of goods and services in Brazil should be inspired by the Canadian model, with the initial creation of a VAT and a selective tax (applied to fuel, liquor and cigarettes), restricted to federal taxes—that is, excluding the ICMS. In a later stage, the ICMS should be revised to comprise all services in its base and to be made compatible with the federal VAT. For the authors, this gradual and flexible shift would maintain a certain degree of autonomy in the subnational sphere and would fit the particular characteristics of the country's federalism.

The shift in taxation of goods and services towards a VAT would, therefore, enable reform favouring economic growth. Other measures which could potentially facilitate GDP growth could be adopted regarding payroll, so as to adjust it and relieve its high tax burden, such

as subtracting from payroll a myriad of contributions that are not linked to the contributory benefits of the employer and reducing the employer's social security contribution. These measures must be adopted in parallel to changes in direct taxation to preserve the burden level and increase progressivity.

We have, therefore, briefly presented ways to achieve greater efficiency in the tax system, regarding productivity and economic growth. Regarding the distributive impact of taxes, the next section points out the need for tax reform to follow the tenets of progressivity and social investment as a way to aid an improved distribution of the tax burden, correcting some of its flows and, therefore, addressing the problems that lead to fiscal inequality.

### **3 TAX PROGRESSIVITY AND SOCIAL INVESTMENT: PATHWAYS TO EQUITY**

For a long time, the fiscal policy model was centred on the consensus that the search for distributive effects must be relegated to a secondary role in tax policy. This orientation gave root to a belief that the progressivity of a tax system was not socially beneficial, given that the penalisation of individuals and entrepreneurs could hinder economic growth. In other words, neutral tax systems, which would have less perverse effects on the economy, would ensure greater revenue than state initiatives in the fields of redistribution and social protection.

Administrations in Brazil have appropriated this discourse, claiming that taxation is not the way to achieve redistributive initiatives, given that it might distort the allocation of resources from the economy and result in capital flight to other countries with lower taxes on company profits, assets and labour income (Oliveira and Biasoto Jr. 2017). As a result of these influences, Brazil now has a tax system with a regressive distributive impact, which reflects the need for reform given new insights from the theory of optimal taxation and the pressing demand for equity.

At the heart of the international fiscal crisis of 2008, the paradigm of neutral taxation was questioned, and new perspectives highlighting the distributive role of taxation have gained traction. The current defence is that optimal taxation should not eschew tax progressivity and taxes on capital, signalling that there is room in times of crisis, such as now, to fight social injustice.

The scenario presented by Piketty (2014) of a high and rising concentration of income and wealth reignites a demand for equitable taxation. To that end, the author defends the need to tax capital concomitant to other public policies that are effective in the regulation of the accumulation and distribution of global wealth. This recent literature highlighting the distributive role of taxation has stimulated debate worldwide on fiscal justice, and the theme of tax reform has reached central stage given the limitations that still exist regarding the recovery of economies around the globe.

In Brazil, whose literature has been following global trends, debate has grown on the need for tax reform and for taking ownership of fiscal policy as an instrument to be used to reduce poverty and inequality.<sup>14</sup> The Brazilian tax system, given its inequity and inefficiency, provides a negative example.

### 3.1 REDUCING TAX INEQUALITY

One of the roots of fiscal inequality in Brazil is the country's tax structure, which prioritises indirect taxes<sup>15</sup> rather than direct ones.<sup>16</sup> Indirect taxes are a greater burden on the poor population, given the distinct marginal propensity to consume between families and the inadequate selectiveness regarding the essential character of the product. Therefore, the defence of taxation focusing on consumption—aiming to stimulate savings and investment—must be smoothed, given that it tends to deepen the levels of inequality in Brazilian society. As the average rates applied on consumption are practically the same across all income levels, and the disparity of income among all social classes is extremely high in the country, there is no escaping the fact that indirect taxation reinforces inequality.

The regressive character of indirect taxation in Brazil is made clear in the example provided by Zockun (2017). The author points out that, considering single-rate indirect taxes, households in the first income decile, with a marginal propensity to consume of 1.249, experience an indirect tax burden which is 2.28 times greater than families in the last decile, with a marginal propensity to consume of 0.547. Thus, to design a tax system with a predominance of indirect taxes, given individual rights in a society with high levels of poverty and inequality, is to fail to consider, or lessen—or even reverse—the redistributive role of fiscal policy. An important way to mitigate fiscal inequality is to lighten the burden of indirect taxes on the system, in favour of direct taxes. By smoothing consumption taxes, the poorer population would experience an improvement in their well-being, having more disposable income to spend on goods and services.

The extreme levels of poverty and inequality which characterise Brazil must, therefore, be considered when discussing the tax system. From 2004 to 2014, the poverty rate decreased by almost 14 percentage points (pp). However, the proportion of poor people in the overall population is still high—6.15 per cent in 2014. Extreme poverty decreased by 4 pp over the same period, reaching 2.51 per cent of the total population in 2014. The Gini index, considering per capital household income, decreased in recent years, according to data from the National Household Sample Survey (*Pesquisa Nacional por Amostra de Domicílios—PNAD*), from 0.5888 in 2003 to 0.517 in 2015, which is still high. Regardless of the positive results of social policies in terms of social inclusion, the concentration of income in Brazil is still one of the highest in the world. According to Zockun (2017), Brazil ranks 131<sup>st</sup> out of 136 countries in a comparison between the incomes of the richest 10 per cent and the poorest 10 per cent of the population.

It has been known for a long time that household surveys present limitations in the verification of income inequality, given the difficulties in capturing the incomes of the upper strata. According to Hoffmann and Ney (2008), income data captured through surveys are always subject to significant declaration errors, given the general tendency of underdeclaration of income. For Medeiros, Souza, and Castro (2014), household surveys underestimate income inequality by not conveniently capturing the income of the richest people, and this finding is corroborated in international literature. Furthermore, with personal income tax data having recently been made available by the Federal Revenue Service in Brazil, it has been possible to verify the thesis of underestimation in Brazilian household surveys, leading to significant effects on inequality indicators, as well as to assess the level of concentration of wealth in the country.

Souza and Medeiros (2017), using data from the PNAD re-weighted with tax data and measuring inequality through the Gini index, show that the general picture between 2006

and 2014 was one of stability rather than redistribution. For Lettieri (2017), the personal income tax declarations of Brazilians reveal that wealth (accumulated assets) is distributed in an even more asymmetrical way than income.

Given this scenario of acute poverty, inequality and injustice, it is necessary to put forward tax progressivity and social spending as ways to promote equity. Both elements are presented as potential mechanisms for ensuring fiscal justice. It is worth noting that the first paragraph of Article 15 of the 1988 Constitution envisages the principle of progressivity: taxes must be personal and structured according to the economic capacity of the taxpayer, respecting their individual rights according to the law, their income and economic function. This principle seeks to ensure economic fairness, by determining that each citizen must participate in the financing of the State according to their contributive capacity as measured by their income.

Nevertheless, the Brazilian tax system attends to this principle only superficially. In addition to taxation being overrepresented by indirect taxes, which makes it regressive, there are inconsistencies in direct taxation that reduce its progressive potential. Over recent decades, the progressive character of the most important instrument of direct taxation—personal income taxes (*Imposto de Renda para Pessoa Física*—IRPF)—has been attenuated. We must remember that during military rule, the IRPF's top rate was 50 per cent, with 11 tax brackets; today, the top rate is 27.5 per cent, with five tax brackets.

This decreased progressivity in the IRPF has contributed to fiscal inequality, given the reduction in the top rate, which affects those with greater contributive capacity, and the reduction in the number of brackets. However, this gradual decrease in top rates and in progressivity was not particular to Brazil, having occurred throughout Latin America over the last two decades (Jimenez 2017).

Fernandes, Campolina, and Silveira (2017) point out that the various tax exemptions and deductions, allied with a top marginal rate of 27.5 per cent, restrict the contributive capacity of direct taxation in Brazil, so much so that its potential is driven below those of the OECD countries. The authors also state that there is a bias towards the richest people in IRPF legislation: while progressive rates are applied to labour income (from 7.5 per cent to 27.5 per cent), regressive rates are applied to capital income (starting at 22.5 per cent, decreasing to 15 per cent). Income from profits and dividends are completely tax-exempt.

For Lettieri (2017), data from the Federal Revenue Service allow us to infer that the tax system not only fails to reduce income concentration, it also amplifies the accumulation of wealth, given the biased treatment of capital income compared to labour income. The 28,433 taxpayers with a monthly income greater than 320 minimum wages received an average annual income of BRL9.6 million, of which 71 per cent was tax-exempt and only 9 per cent taxable. At the other end of the spectrum, the 8,192,252 taxpayers with a monthly income of between three and five minimum wages received an average annual income of BRL33,500, of which 86 per cent was taxable and only 9 per cent considered tax-exempt (Lettieri 2017).

Given that progressivity is ostensibly the IRPF's guiding principle, data from income tax declarations have shed quite a different light on the matter. A close look by Pinheiro, Waltenberg, and Kerstentzky (2017) at the structure of the IRPF revealed a tendency of smoother progression closer to the top of the income distribution, after the 97<sup>th</sup> percentile—violating the very principle of progressivity. The authors show that the average effective rate of the IRPF ascends to a peak of 11.7 per cent around the 97<sup>th</sup> percentile and then descends sharply. Along these lines, Gobetti and Orair (2017) show that there is an inflexion in average

rates at the top of the distribution—they ascend to a peak of 12.3 per cent at the 50<sup>th</sup> percentile and then decrease to 7 per cent at the top 0.005 per cent.

The exemption of profits and dividends from personal income taxes, grounded on Law No. 9.249/95, implies under-taxation of the highest incomes—therefore reinforcing inequality. The Brazilian government adopted this measure to attract capital and encourage investment. This exemption, together with the possibility of deducting from taxable income a fictitious expense termed ‘interest on own capital’ (*Juros sobre Capital Próprio*—JSCP), which was included in the same law, are two features of the Brazilian tax system which establish privileges for the taxation of capital and reduce the progressive character of the system. The combination of these two measures which exempt profits from taxes implies an increase of shareholders’ profits by about 21 per cent, given a JSCP rate of 10 per cent on gross profit (Fernandes, Campolina, and Silveira 2017).

The violation of the progressive character of taxation and of the principle of vertical equity is, therefore, notorious in these measures. Law No. 9.249/95 reduced taxes for individuals with greater contributive capacity, with lower effective rates applied to the richest people than to the middle-income strata, whose incomes mainly originate from labour, not capital.

The assessment of fiscal equity includes the consideration of whether the tax system weighs and treats the different types of income differently—that is, whether it respects the principles of horizontal and vertical equity. Vertical equity is understood as the just tax treatment of individuals with different income levels. Horizontal equity is understood as the just treatment of people with the same income levels. Considering the IRPF, the application of horizontal and vertical equity demands equal (or neutral) rates between taxpayers with equal income and increasing (or progressive) rates for groups with greater contributive capacity. However, the current structure of the IRPF violates both principles, given that lower average rates are applied to earners of dividends (horizontal inequality) and that rates decrease at the top of the income distribution (vertical inequality).

Fernandes, Campolina, and Silveira (2017) demonstrate this break in vertical equality, observing that the relationship between effective rates and income level is parabola-shaped, starting at 0.20 per cent at the lowest income level, rising to 12.05 per cent at the income level between 40 and 80 minimum wages and then decreasing to 7.30 per cent at the last income bracket. The violation in horizontal equity is demonstrated by the effective tax rates that are applied to receivers of profits and dividends being systematically lower than those of other groups with similar income levels.

Regarding equality in the treatment of labour and capital income, we should point out that an initial step has been taken with Law No. 13.259/2016, which established progressive rates on capital income.

On the inconsistencies and limited progressivity of personal income taxes, Gobetti and Orair (2017) estimate that the IRPF leads to a 2.3 per cent reduction in the Gini index, from 0.6466 to 0.6319.

Based on these considerations, it is possible to infer that there is space to reformulate personal income taxes. We propose four measures, especially in the current scenario of fiscal restriction: i) increase the number of income brackets; ii) increase the top rate; iii) increase the revenue base by eliminating some deductions and/or exemptions; and iv) alter the legislation of personal income taxes to promote equality in the treatment of sources of labour and capital income. These measures have the potential to not only advance the progressive aspect of taxes but also to increase revenue, promoting efficiency and equity in tandem.

Hoffmann (2017) points out that it would be possible to increase the progressive character of income taxes by creating an additional bracket with a higher rate. According to his proposal, the 27.5 per cent rate should be applied to incomes between BRL5,000 and BRL7,000, and a new bracket should be established, with a 40 per cent rate for incomes above BRL7,000. Based on this scenario and using data from the 2015 PNAD, the amount collected through income taxes would be enough to cover 92.3 per cent of all income poverty, considering a poverty line of BRL1,050.

Together with increased rates and more income brackets, the tax base should be extended through the reinstatement of taxation of dividends and distributed profits. One promising way to do this is to return to taxing dividends based on a progressive table instead of at a fixed rate, as was the case previously in Brazil.

In 2013, the IRPF generated revenue of BRL149.7 billion and reduced inequality through a decrease of 2.78 per cent in the Gini index. Gobetti and Orair (2016) estimated four scenarios:

- The taxation of dividends in the way they used to be taxed until 1995, at a linear rate of 15 per cent exclusively at the source, regardless of the total income of the employer: This would reach an audience of 2.1 million people, increasing revenue by BRL43 billion (in 2013 values). Inequality would fall by 3.67 per cent—0.89pp more than the current situation.
- The taxation of dividends according to the IRPF's current progressive table, with an exemption bracket and rates ranging from 7.5 per cent to 27.5 per cent, according to the payee's income: This would generate BRL59 billion in extra revenue from a taxpayer public of 1.2 million and less inequality manifested in a decrease of 4.03 per cent in the Gini index.
- The maintenance of the tax exemption of dividends while altering the IRPF table by establishing three new rates (35 per cent, 40 per cent and 45 per cent) starting from moderate income levels (BRL60,000, BRL70,000 and BRL80,000, respectively), so as to reach the same additional revenue as the first scenario: This would lead to a less significant reduction in inequality and reach fewer taxpayers.
- The creation of an additional rate of 35 per cent, only for very high incomes (above BRL325,000) and simultaneously establishing the progressive table for dividends: This would yield similar effects to the second scenario, with a taxpayer audience of around 1.2 million, BRL72 billion in extra revenue and a reduction of 4.31 per cent in the Gini index.

The fourth scenario seems the most appropriate. It signals feasible ways to meet demands for increased revenue and the promotion of equity. Estimates by Fernandes, Campolina, and Silveira (2017) align with those by Gobetti and Orair (2016). For the authors, the reintroduction of taxation of profits and dividends leads to a reduction in inequality while significantly increasing revenue.

Another inequity in direct taxation that deserves mention is the insufficient taxation of assets and the lack of regulation, as stated in the 1988 Constitution, of the Tax on Large Fortunes.

Brazil currently has five property taxes (ITBI, IPTU, ITCD, ITR and IPVA), which collectively comprise around 1.9 per cent of GDP. In other countries with a similar tax burden, these taxes are higher. This mode of taxation in Brazil is unbalanced regarding its incidence on various sources of assets, with greater weight falling on taxes on automotive vehicles (IPVA) and real estate (IPTU), which represent almost the entirety of revenue from property taxes.

Taxes on asset transfers are underrepresented, and luxury goods (such as jets, yachts and jewellery) are even exempt. It is worth noting that taxes on assets have a significant potential to simultaneously promote efficiency<sup>17</sup> and equity and, as such, should not be ignored in any serious tax reform proposal. A defence of higher property taxes is grounded on increased revenue and its potential to tax households that concentrate capital.

Regarding the IPVA as a consumption tax, in tune with the perspectives of almost all countries and multilateral agencies, it is obvious that the share of GDP represented by asset taxes in Brazil—1.1 per cent rather than 1.9 per cent—is vastly lower than in other countries with a similar tax burden, as well as in other Latin American countries. This low figure illustrates the power of asset owners in the management of tax policy.

In respect to the IPTU, outdated registries and value tables imply an under-taxation of assets, which, together with the absence of progressivity<sup>18</sup> according to the value of the property, results in a neutral distributive profile for the tax (Silveira and Passos 2017).

In the case of taxes on inheritance and donations, the maximum rate is constitutionally limited to 8 per cent and restricts the prospects for progressivity, given that in central countries the maximum marginal rates approach 40 per cent. The current increases in maximum rates in many Brazilian states and the application of progressive rates are due to a search for resources to minimise the dire fiscal difficulties facing most states. In other words, these advances in taxation of inheritance and donations are not related to any changes in the tax or fiscal culture, but are rather a result of an immediate, urgent necessity to find additional funds.<sup>19</sup>

After numerous attempts at regulation, the IGF, proposed in the 1988 Constitution as a substitute for the Tax on Net Assets (*Imposto sobre Patrimônio Líquido*—IPL), remains an open subject in Congress. As it is a controversial tax (international experience does not offer a single valid interpretation for its effectiveness),<sup>20</sup> it has not been very well represented in the tax reform proposals by the federal government and has not been regulated even in the 12 years of the country's administration by the Worker's Party (Partido dos Trabalhadores—PT).

The tax on net wealth, with a significant effect on the de-concentration of capital, rose to prominence in debates after the 2008 financial crisis. Although many proposals in the economic mainstream have granted central stage to the necessity of a progressive tax on consumption, Piketty (2017) reveals his preference for a progressive tax on net wealth, as it is easier to define, measure and monitor and is a better indicator of taxpayers' contributive capacity.

The study by Nascimento (2016) states that the IGF can be successful in Brazil, with a solid revenue base. Based on data from the Federal Revenue Service, the author estimated a revenue potential in the order of around BRL13 billion, or 0.24 per cent of GDP in 2014, considering two scenarios. In the first, an exemption limit of BRL1 million is established, with rates of 0.5 per cent and 1 per cent on the assets of taxpayers with a monthly income between BRL57,920 and BRL115,840 and above BRL115,840, respectively. In the second scenario, the exemption limit is BRL5 million, and a rate of 1.5 per cent is applied to the assets of taxpayers with a monthly income above BRL115,840.

In addition to the potential for increasing revenue, implementation of the IGF also answers the call for tax justice, as it favours a de-concentration of wealth in society. Its regulation must be a top priority in fiscal reform. The number of very rich people in Brazil attests to this need. According to Jimenez (2017), Brazil is one of the top 10 countries with the greatest number of billionaires in the world (around 43), which is a clear indication of the existence of large fortunes.

Carvalho Jr. and Passos (2017b) present a proposal for the implementation of the IGF in Brazil, which is in accordance with these demands for equity. To yield revenue of around 0.5 per cent of GDP, the authors propose the following measures regarding the regulation of the tax:

- The tax should apply to the national and international assets of people residing in the country beyond a given exemption limit, in addition to the total assets in the country of people or companies that do not reside in the country.
- The assets of companies must be taxed, so as to increase revenue and decrease tax evasion.
- The number of progressive rates must be reduced, so as to discourage evasion. The total exemption limit must not surpass BRL500,000. In this sense, the rate can be fixed at between 0.7 per cent and 1 per cent.
- The IGF tax base must be comprised of assets typically for personal use, such as residential real estate, leisure automotive vehicles, private aircraft and boats.
- Values that have been subject to the IPTU and the IPVA must be deducted from the IGF calculation.
- In the assessment of real assets, it is necessary to consider the highest value among the purchase value, the appraised value of the IPTU or IPVA and the market value as declared by the taxpayer or arbitrated by the tax office.
- In the assessment of financial assets, in the case of open-market securities, the average between the highest and lowest market quote over a period must be considered. The assessment of financial balances must consider the largest value between the balance of 31 December of the fiscal year and the average balance of the last 90 days of the fiscal year.

### 3.2 SOCIAL SPENDING AND EQUITY: LINKAGES

The other way to promote equity is through social spending. Social welfare States are founded on the redistribution of wealth via social spending, with taxes having a secondary (but still important) role relative to the social protection system. Both aspects of fiscal policy—taxes and expenditure—must serve the purpose of equity, as there is room to promote fiscal justice without compromising economic growth and productivity.

Silveira and Passos (2017) investigated the distributive role of social spending. They point out that social security presents, on average, a neutral profile in the distribution of income, largely due to the regressive nature of the welfare regime. Welfare benefits, especially the BPC-Loas and *Bolsa Família*, are progressive. Education expenditures have improved their progressive character significantly, and health expenditures present a slightly progressive behaviour. Therefore, as a counterpoint to the regressive character of the tax system, social spending is progressive.

Regarding a regressive tax burden financing federal expenditure, the advances in social spending represent a way to promote equity, both for its progressive character and for the growth in its most progressive aspects—social security floors, social protection benefits, public health and education. In other words, even though the poorest people have been relatively more burdened by taxes, they also benefit more from social policy. Increased social spending is a way to ensure fiscal justice.

Services and benefits provided by social spending comprise a significant distributive initiative, both directly and indirectly. More immediately, social spending enables an increase in final household income, improving quality of life and overall welfare. By promoting the strengthening of capacities, it indirectly facilitates access to the labour market in a less fragile manner and with higher incomes.

In this light, social spending is understood as an instrument that can be used to face the myriad social asymmetries that characterise Brazil. In advancing social policies, the State promotes better income distribution and provides opportunities as well as access to a broad range of essential services to society. However, despite the role of social spending in the promotion of equity, the future of social policies is uncertain.

In 2016, after an impeachment process based on shaky legal ground, the administration of President Michel Temer initiated a series of reform proposals that have weakened the set of social protection initiatives provided by the State. This goes against one of our proposed ways to reduce inequality. With the approval of Constitutional Amendment 95/16, a new fiscal regime (*Novo Regime Fiscal*—NRF) was instituted in Brazil. It establishes a spending ceiling, with 2016 as its reference year, for the federal government's primary expenditures. If it is maintained, this limit will be active for the next two decades. In other words, primary expenditures (comprising mainly health, education, social protection and social security) will be frozen in real terms to their values in 2016, with a possible review only in 2026.

As studies have shown (Paiva et al. 2016; Vieira and Benevides 2016), the NRF has a discontinuity risk and represents a step backwards in the provision of social services and benefits. It could result in a scenario of even less state protection for the poorer population, given rising demands in the areas of health, social protection and social security that naturally follow a process of population ageing. Therefore, if over the last decade there have been advances in social spending and in its progressive character, with clear impacts on the promotion of citizenship, the current scenario is one of increasing inequality, diametrically opposed to the proposition of fiscal justice.

With Constitutional Amendment 95/16, there can be no doubt that increased social spending is not understood as a way to promote citizenship, therefore relinquishing the welfare gains that could be obtained by an integrated fiscal policy that considers taxes and expenditures as instruments for achieving equity.

It is worth noting that, in addition to measures taken by the federal government, a lack of faith in the State's actions and complaints about taxation are perceived as current obstacles to fiscal justice. In the early 2000s, significant criticisms were levelled at the excessive Brazilian tax burden, largely sponsored by the corporate sector and grounded on the *impostômetro* (an electronic panel that enables the tracking of tax collection online) and the 'day without taxes', created in 2004 and 2009, respectively. Associations and civil society organisations were created with a focus on criticising the high amount of taxes paid in the country, which contrasts with the insufficiency or low quality of public policies they are supposed to finance. The inequality of Brazil's tax system contributes to the urgent demand for a lighter tax burden—therefore, for a reduced State.

It seems clear that these voices opposed to taxation grew in tandem with the announcement of policies to lighten the tax burden and provide tax exemptions—something that seems extemporaneous, given that the largest increase in the tax burden occurred between the mid/late 1990s and the early 2000s. What was new during this period was the

increase in social spending, with a progressive character. Therefore, the disconnect between an increased tax burden and the strengthening of its criticism, as social spending increased, might represent, in practice, some veiled criticism—especially by the middle classes—of increased social protection.

The federal government's current conservative initiatives regarding fiscal policy, allied to the general discontentment of the population with taxation and services provided by the State, could weaken the still-budding social welfare State even further.

We have highlighted various pathways that could lead to the promotion of equity in a country that exhibits uncivilised levels of poverty and inequality. However, with the rise of conservatism in society and in Congress, it is becoming increasingly difficult to promote fiscal reform that could lead to greater equality.

## FINAL CONSIDERATIONS

Contrary to what the economic mainstream has proposed for a long time, taxation has a central role in the promotion of equity. However, Brazil presents various inconsistencies in its tax system, which makes it unique in terms of inefficiency and inequality. Regarding inefficiency, the following are worth highlighting: the jumble of taxes and their complex legislation; the absence of a coherent taxable base and its pro-cyclical character; the overlapping of bases and the cumulative incidence of taxes; and fiscal war. As for revenue inefficiency, we highlight the low revenues derived from personal income taxes on income and capital—resulting from the low progressivity of the IRPF—and from property taxes.

The questions raised in this paper point to many inequities in the Brazilian tax system, ranging from the greater weight of indirect taxation to the flaws in direct taxation—such as the tenuous attention paid to individuals' contributive capacity demonstrated by the low incidence on higher incomes, capital gains and accumulated wealth.

In this light, five ways to promote fiscal justice and equity were suggested: lowering the proportion of indirect taxation in the tax system; changes to the rates and thresholds for personal income tax; the reintroduction of taxes on profits and dividends; regulation of the tax on large fortunes; and increased social spending.

Our proposals for greater efficiency and economic growth included changing the taxation of goods and services through the introduction of a VAT, and changes aimed at reducing the taxes on payroll. These proposals are revealed to be feasible and desirable in promoting equity and efficiency given the poverty levels and deep inequality that characterise Brazil and can lead to greater revenue and aid fiscal justice.

In a context of three consecutive years of reduced revenue, the theme of fiscal reform is at the top of the federal government's agenda. However, in light of the urgent demands for fiscal justice and larger and more comprehensive social protection, the proposals currently being considered will hardly suffice. Few measures similar to what has been proposed in this paper exist in the government and legislature's action plan, and a few initiatives already started by the government seem to validate the asymmetries of the Brazilian society, as demonstrated by the backpedalling on social policies through Constitutional Amendment 95/16, which establishes a ceiling for primary expenditures.

Given this pressing scenario, what remains is to continue to shed light on the shortcomings and unjustified privileges embedded in fiscal policy and spur society towards demanding tax reform that promotes efficiency without losing sight of the equity of the system, if the overall objective is to improve the living standards of the vast majority of workers in Brazil.

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## NOTES

5. "The new system, on the one hand, sought to better define the tax competence of the three spheres of government, especially of municipalities, which had not been expressed clearly in the previous institutional framework. On the other hand, aiming to eliminate the existing patchwork, it attempted to standardise and rationalise taxes and tributes, placing all units under certain standards of nomenclature and coherence in tax objects" (Lopreato 2002, 23).
6. One aspect that confirms this characteristic is highlighted in Lopreato (2002, 32): "The 1946 Constitution determined the distribution of 60 per cent of the total revenue of taxes collected by states and municipalities, proportionally to their surface coverage, consumption and production. Furthermore, 10 per cent of the revenue accrued from personal income taxes was awarded to municipalities, distributed in equal shares and mandating the application of at least half of the resources on rural benefits."
7. The National Steelworks Company (Companhia Siderúrgica Nacional—CSN), Companhia Vale do Rio Doce, Companhia Nacional de Álcalis, the National Motor Company, the São Francisco river hydroelectric plant, Petrobras and other institutions were created, comprising the organisational structure of the Brazilian State and with the goal of driving the industrialisation of the country.
8. The efficiency of a tax system corresponds to "...the attribute according to which the State must mandatorily collect resources from citizens to finance the programmes and services that society deems necessary for the government to provide, in amounts and modes that are appropriate to the socioeconomic conditions of the country" (Zockun 2017, 1).
9. According to Oliveira and Biasoto Jr. (2017), the ITR represented only 0.04 per cent of total revenue in 2013.
10. Corrective measures that were applied in the 1990s include: i) an increase in the Finsocial rate (now known as COFINS); ii) a broadening of the incidence of the PIS; iii) the institution of the 8 per cent rate for the Tax on Financial Operations (*Imposto sobre Operações Financeiras*—IOF); and iv) the creation of the social emergency fund, among others. See Oliveira (2010).
11. The data for Brazil are distorted, given that it is the only country that considers the tax on vehicle ownership as a property tax and not as a tax on goods and services. Given that the tax on automotive vehicles (*Imposto sobre a Propriedade de Veículos Automotores*—IPVA) corresponds to 0.8 per cent of GDP, ownership tax represents 1.2 per cent of GDP.
12. Another distortion in the Brazilian tax system is the higher income tax on companies *vis-à-vis* on individuals. This has negative effects in terms of equity by reducing the burden on the richest, and in terms of efficiency, by increasing the burden on capital.
13. This characteristic is reinforced by the empirical literature. Gadelha and Divino (2013) estimate equations through the generalised method of moments (GMM), and results converge towards confirming the pro-cyclical behaviour of fiscal policy during the period analysed. In short, their paper found a positive and statistically significant relationship between the output gap and the ratio between public expenditures and GDP, which confirms the pro-cyclical nature of the country's fiscal policy. As highlighted by the authors, arguments about the variability of the tax base, corruption and the informal economy also help explain this pro-cyclical character.
14. For more information, see Gobetti and Orair (2017); Fernandes, Campolina, and Silveira (2017); and ECLAC (2014).
15. It is worth pointing out that the characteristics that set the ICMS apart from a 'classic' VAT, including collection at the source and cumulativeness, negatively impact the economy but also deepen inequality. This is because states with greater productive capacity collect more taxes and have more space to grant benefits, while less developed states are relegated into not granting any benefits except those destined to attract investment. Absurdly, the rates applied to automobiles in São Paulo are lower than those applied to rice and beans in Paraíba.
16. As shown in the previous section, the way in which indirect taxation is structured in Brazil leads to an inefficient tax system, which is complex and harmful to competitiveness and economic growth.
17. Property taxes are considered to present the least harmful effects on the behaviour of economic agents and in factor allocation.
18. Almost 30 years after the Constitution was promulgated, only now has the progressivity of the IPTU and the ITCMD been considered constitutional. The judiciary did not previously consider the principle of contributive capacity applicable to such taxes.
19. The tax on rural property (ITR) delivers even poorer results, representing 0.06 per cent of tax revenue, demonstrating yet again the precariousness of taxes on assets.
20. For more information, see Carvalho Jr. and Passos (2017a).



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