

The need for tax reform in Brazil— guidelines for moving forward

Rodrigo Octávio Orair, Institute for Applied Economic Research (Ipea) and
International Policy Centre for Inclusive Growth (IPC-IG), and Sergio Wulff Gobetti, Ipea

The evaluation of a tax system is notoriously controversial in Brazil, as elsewhere. In the case of Brazil, the controversy is further fuelled by the fact that the country's tax burden has increased significantly since 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. This increase came at the expense of the tax system's efficiency and equity, largely motivated by the imperative to increase revenues during episodes of short-term fiscal adjustments, while matters regarding quality were considered of lower priority. Since then, the tax burden has remained close to 33 per cent of GDP for over a decade. Even during this period of stability, the quality of taxation has 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 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 State Tax on the 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 undertaking other structural changes, such as those of taxes levied on payroll and income.

The consequences are well known. The Brazilian tax system is often referred to as a 'tax madhouse' due to its complexity and lack of logical consistency. To change this scenario is no simple task, and depends on political agreements. However, a good starting point is to update the diagnosis about major problems to be faced and discuss potential alternative solutions.

We can envisage 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 a specific tax system design exists 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.

Orair and Gobetti (2019) present guidelines for a tax reform in Brazil that recognises the importance of modernising the taxation of goods and services but is not restricted by it. In their paper, the authors highlight the merits of a set of proposals designed to correct distortions of taxes on goods and services in Brazil.

They also diagnose distortions in income and payroll taxation in the country, and present a discussion of income tax models that are able to achieve horizontal and vertical equity with consistent integration of personal and corporate taxation—such as the dual income tax model and the adjusted comprehensive model. One of the main concerns is 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 tax benefits. Simultaneously, it seeks a counterbalance through personal income taxes, with a model that treats different sources of income more consistently and pursues a higher degree of progressivity.

The choice for each of the models ultimately depends on the balance of political forces, the ability to negotiate and social preferences. The paper does not attempt to provide answers to all these issues. Its sole purpose is to provide inputs to the debate.

References:

- Orair, R., and S. Gobetti. 2019. "Tax Reform in Brazil: Guiding Principles and Proposals under Debate." *Working Paper*, No. 182. Brasília: International Policy Centre for Inclusive Growth.
- Varsano, R. 2014. "A tributação do valor adicionado, o ICMS e as reformas necessárias para conformá-lo às melhores práticas internacionais." *Documento para Discussão*, No. 355. Washington, DC: Inter-American Development Bank. <<https://publications.iadb.org/publications/portuguese/document/A-tributa%C3%A7%C3%A3o-do-valor-adicionado-o-ICMS-e-as-reformas-necess%C3%A1rias-para-conform%C3%A1-lo-%C3%A0s-melhores-pr%C3%A1ticas-internacionais.pdf>>. Accessed 31 January 2019.