What can African countries learn from Brazil's inclusive growth and development?

Research briefing:

Taxation, redistribution and the social contract in Brazil

Summary

- Brazil has managed a remarkable 7 percentage point increase in tax revenue as a percentage of GDP between 1995 and 2010, a rise from 26.9% in 1995 to 34% in 2010.
- Improvement in public finances has provided Brazil with the fiscal space to pursue innovative approaches to redistribution, via social and developmental policies. Arguably, the rise in the tax/GDP ratio is the foundation of a Brazilian 'Development Model'.
- The rise in revenues is not the result of any significant change in tax code or tax administration, but Brazil has reaped the benefits of comprehensive and early reform undertaken in the mid-1960s.
- The recent increase in Brazil's tax revenues has been made possible by a combination of democratisation, strong preferences for redistribution, fiscally responsible centre-left coalitions, and bureaucratic capacity.
- The recent public debate on tax suggests that a future rise in the tax/GDP ratio might threaten the sustainability of the fiscal contract.

Reaping the rewards of 60s tax reform

Until the discovery of oil fields in the late 2000s, Brazil did not possess significant mineral wealth and was a relatively closed economy. Historically, Brazil avoided both the resources curse and exposure to the ups and downs of a globalising world economy, which has affected many Latin American countries.

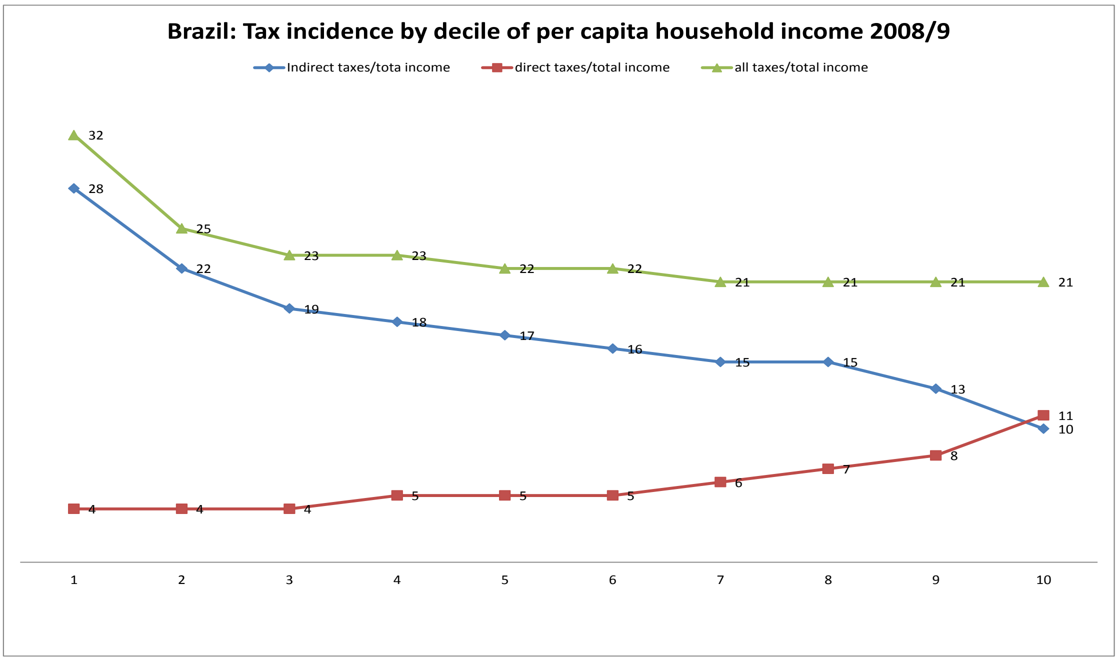
Brazil has shown longstanding capacity to collect tax revenue. Recent administrations have reaped the benefits of wholesale reforms undertaken in the mid-60s.

As part of its state building effort, the military enacted major tax reform in 1966, introducing innovative measures that had a strong fiscal impact. Brazil adopted a modern tax code, became the first country to introduce VAT and revamped its tax administration. In the following 7 years, the tax burden doubled as a percentage of GDP, reaching 26% in 1971.

There were no significant tax reforms in the 1990s and 2000s to explain the rapid increase in taxation in this period. The changes in the tax rules in the democratic period have been incremental. They typically reflect technically driven marginal efficiency improvements and piecemeal responses to advocacy by pressure groups.

Proposals for more substantial tax reform have never materialized. This is in part because comprehensive reforms would require changing the constitution, which has discouraged significant changes. Successive governments have opted to maintain an inefficient system with high extractive capacity in preference to a more efficient system with uncertain future revenues.

Figure 1:



Data Source: Silveira, F. G.; J. Ferreira; J. Mostafa and J. A. Ribeiro (2011), Qual o impacto da tributação e dos gastos públicos sociais na distribução de renda do Brasil? Observando os dois lados da moeda.

Additionally, policy makers have converged on the view that redistributive objectives are best secured via spending, not taxation.

The current Brazilian tax system is beset by complexity and inefficiencies. In distributional terms, the tax system is neutral in the sense that rates of tax are roughly similar across the income distribution, as shown in Figure 1. The progressivity of direct taxes is neutralised by the regressively of indirect taxes.

The structure of Brazil's tax system

The 1988 Federal Constitution provides the institutional framework for the current Brazilian tax system. The Constitution assigns tax competencies to the different tiers of government, allowing the imposition of taxes on a wide range of economic activities as well as revenue sharing schemes.

In 2009, tax revenues amounted to 34.3% of GDP, the bulk of which was collected by the federal government (56.3%), followed by the state governments (25.2%) and the municipal governments (18.5%).

The tax system consists of taxes, fees and contributions. The so-called contribuições are levied on payrolls, but also on employers' profit, as well as on lotteries, government revenues and licensing. The complexity of Brazil's tax system is a consequence of the proliferation of taxes covering a common base.

The most important federal taxes are the income tax and tax on manufactured goods (IPI), which account for over 90 percent of federal revenues. The personal income tax is levied on the income and proceeds of any nature earned by Brazilian-based individuals at a progressive rate of 15% or 27.5%, contingent upon the taxpayer's ability to pay.

Corporations pay a 15% rate Corporate Income Tax (IRPJ), based on their actual or estimated earnings, or on earnings ascertained by tax authorities. The IPI is a value-added, single-stage tax on production collected based on the sales price when a product leaves the manufacturing stage, or upon import, at a rate dependent on the classification of the product.

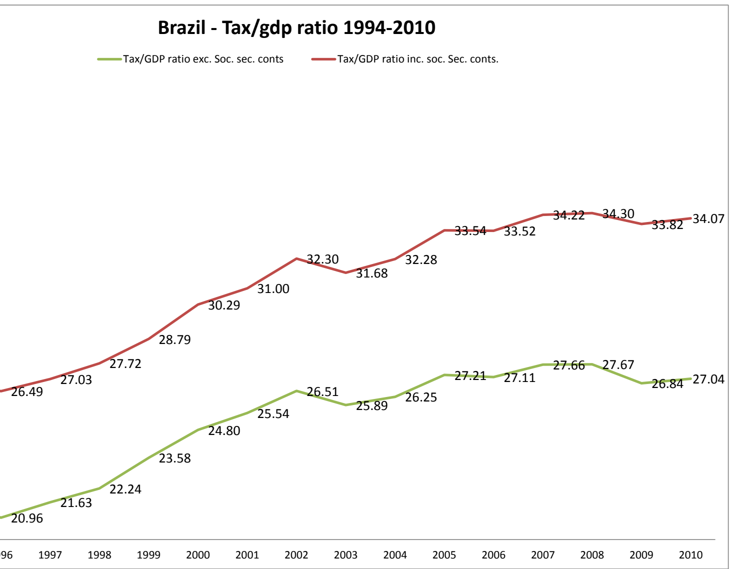
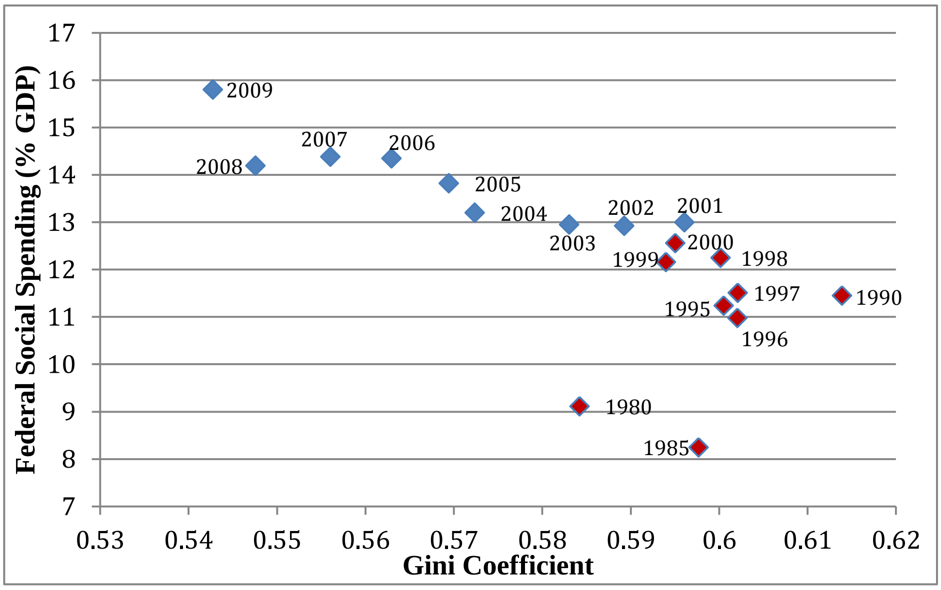


Figure 2

Data Source: Base CIAT-BID

Figure 3: Changing Levels of Inequality and Redistribution over Time



Source: Authors from Federal Social Spending data for 1995 to 2009 from IPEA (2011). Data for 1980, 1985 and 1990 calculated using estimates of total (federal, state and municipal social spending) in IPEA (2009: 42-44). Gini data from www.ipeadata.gov.br/

Additionally, the federal government collects a Tax on Financial Transactions (IOF), comprising credit, foreign exchange, insurance and security operations.

The states collect their own VAT (the ICMS), which is imposed on sales of goods and carrier/telecommunications services. The ICMS represents over 20% of total tax revenue (a significant 7.22% of GDP).

The politics of the recent tax/GDP rise:

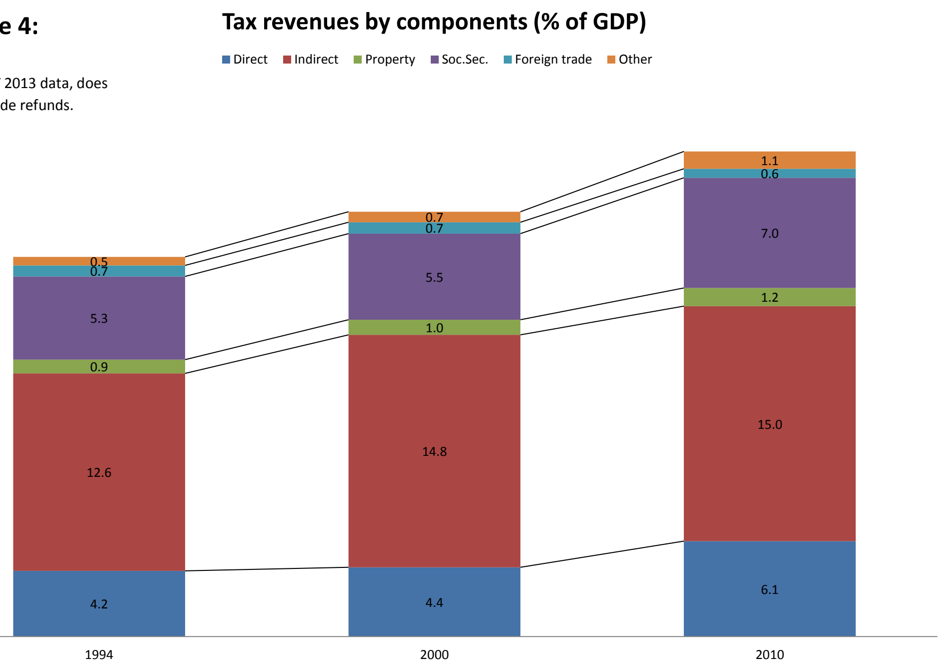
The rise in the tax/GDP ratio in Brazil has not been the result of radical tax reform or improvements in tax administration. This suggests that policy models are of less relevance than political factors in explaining the rise. Political consent to the rise in tax revenues is linked to the renewal of Brazil's social contract after democratisation.

The extension of the franchise to illiterates in 1985 incorporated a large share of the population in informal and low-income employment. In line with median voter models, there was an increased pressure for redistribution, set against a context of large polarization and vast inequalities within society. Political competition and the influence of large governing coalitions form the left and centre-left helped translate popular demand into effective redistributive policies.

The ramping up of social pressure was a necessary but not sufficient condition for sustained redistribution to occur. Fiscal sustainability and institutional capabilities were also a fundamental component of the inequality reducing outcomes. Defeating hyperinflation, with prudent fiscal policies set against a context of rising tax revenues, enabled a balanced approach to redistribution. Political incentives responded to the new fiscal contract.

Figure 4:

BID-CIAT 2013 data, does not include refunds.



How sustainable is the fiscal contract?

Economic growth and the rise of the tax/GDP ratio in Brazil have enabled successive governments to expand inclusive social policies without the need to reallocate resources from existing programmes and therefore avoid damaging conflict. An enhanced fiscal space has enabled social policy activism without undermining pre-existing entitlements.

However, this approach has been placed under stress as the space for tax and spend policies has diminished with a slowing economy. Taxpayers have become increasingly disgruntled by high taxes. More Brazilians agree that taxes are too high than any other nationality in the region.

Members of the middle classes have been described as having a 'dissatisfied customer' relationship with the state; they are not satisfied by the quality of public services they receive for their contribution in practice.

Low income households have become increasingly aware of high taxation. 66.7% percent of Brazilian respondents to the Latinobarometer survey in 2011 agreed that taxes were too high.

Brazil is now facing a critical juncture. The high level of taxation, the politicisation of the issue and the pressures for better quality in public services are engendering a new accountability.

This may see people demand less corruption and better services in exchange for tolerating high taxes, but the final outcome is far from certain.

This briefing is based upon an IRIBA working paper 12, Taxation, redistribution and the social contract in Brazil, by Marcus Melo, Armando Barrientos and André Canuto Coelho available at **http://www.brazil4africa.org**

Further reading:

- Alston, L. J.; M. A. Melo; B. Mueller and C. Pereira (2012), Changing Social Contracts: Beliefs and Dissipative Exclusion in Brazil, NBER Working Paper 18588, Cambridge MA: NBER.
- Higgins, S. and C. Pereira (2013). The effects of Brazil's high taxation and social spending on the distribution of household income. Tulane, Tulane University.
- Melo, M. A.; C. Pereira and S. Souza (2010), The Political Economy of Fiscal Reform in Brazil, Working Paper IDB-WP-117, Washington DC: Inter-American Development Bank.
- Melo, M. A. (2007) Institutional weakness and the puzzle of Argentina's low taxation, Latin American Politics and Society, 49 (4), pp. 115-148.

IRIBA is a DFID funded research programme, based at the University of Manchester. It brings together an international team of researchers, examining how lessons from Brazil's development experience can be learned and adapted for African countries.

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