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Taxation, redistribution and the social contract in Brazil

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Abstract

The paper explores theoretically and empirically Brazil's tax revenue from a political and political economy perspective. The absence of 'big bang' reforms to the tax code and tax administration suggests that policy models are less directly relevant to explaining the rise in the tax/GDP ratio. The paper makes the argument that public consent to the hike in taxes is explained by a combination of democratisation, strong preferences for redistribution, fiscally responsible centre-left coalitions, and bureaucratic capacity. New political incentives under democracy combined with high state capacity and a powerful presidency with the political resource necessary to pass an agenda of social reforms to sustain this new equilibrium of high taxation and high redistribution. The current level of taxation and spending in the country in a context in which poverty and inequality is high (although declining rapidly) has prompted concerns about the fiscal sustainability of this equilibrium. The paper argues against pessimistic accounts of this dilemma - such as the arguments based on the concepts of fiscal illusion and inequality traps - and advances an optimistic perspective based on the notion that a new fiscal contract seems to be emerging.

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Table of Contents

1. Introduction

Among the significant changes experienced by Brazil in the last two decades is a step improvement in public finances. Brazil has managed a remarkable 9.4 percentage point increase in tax revenue as a percentage of GDPGDP between 1995 and 2012, from 26.9% in 1995 to 36.3% in 2012.[1] These figures include social security contributions to Brazil's large-scale social insurance schemes. Excluding them, the tax/GDPGDP ratio rose from 20.3% to 26.5% in the same period, an increase of around 30%. The level and the growth rate of the tax burden places Brazil at the top among Latin American countries and compares well with Southern European countries as regards the share of resources available to government.

There is wide consensus around the view that this improvement in public finances has provided Brazil with the fiscal space to pursue innovative redistribution policies, especially social and developmental policies. Arguably, the rise in the tax/GDPGDP ratio is the foundation of a Brazilian 'Development Model', and the clearest demonstration of a renewal in its social contract, although this has not been consistently recognized in the literature.[2] This paper examines the political and political economy factors explaining Brazil's success in raising tax revenue and assesses its contribution to a Brazilian 'Development Model'.

The recent rise in tax/GDP ratio in Brazil raises several intriguing questions. First, there is substantive macroeconomic and fiscal policy continuity since the mid-1990s, with fiscal stability sustained through the Cardoso and Lula governments. This continuity extends to tax policy. There are few significant changes in the tax code able to explain the rapid rise in the tax burden. The introduction of 'social taxes' in the mid-1990s was explicitly presented as a temporary instrument to finance social policy investment and constitutes one of the few inflexion points in an otherwise stable tax policy environment. It is intriguing that the rise in tax burden is not the outcome of substantive tax reform. We also rule out changes in tax administration, as it shows no significant changes in the period under examination.[3]

Second, the rise in the tax burden in Brazil has not changed the distributional neutrality of the tax system taken as a whole. The rise in the tax/GDP ratio has made little or no contribution to the reduction in poverty and inequality in the country, except through enhancing the distributive capacity of government. The redistributive capacity of fiscal policy is concentrated on the expenditure side. Third, until recently tax policy had not attracted much public attention. In the aftermath of the global

1 Historically, Brazil has managed relatively high tax/GDP ratio when compared with other countries in Latin America, a point explored below.

2 See Besley and Persson (2013) for a compelling analysis of fiscal capacity as a precondition of development and prosperity.

3 Brazil's improvement in public finances does reflect the standard advice from IFIs. See Tanzi and Zee (2000).

financial crisis, and the public demonstrations, which began in June 2013, more attention has been paid to the tax burden as demonstrated by the emergence of *impostometros* in many cities.[4]

The paper argues that Brazil's tax revenue outcomes are best studied from a political and political economy perspective (Melo 2003; Melo 2010). The absence of 'big bang' reforms to the tax code and tax administration suggests that policy models are less directly relevant to explaining the rise in the tax/GDP ratio. The paper makes the argument that public consent to the hike in taxes is explained by a combination of democratisation, strong preferences for redistribution, fiscally responsible centre-left coalitions, and bureaucratic capacity. New political incentives under democracy combined with high state capacity and a powerful presidency with the political resource necessary to pass an agenda of social reforms to sustain this new equilibrium.

In a nutshell, we argue that the rise in the tax burden was made possible by and it is a reflection of the renewal of the social contract in Brazil. The politics and political economy of redistribution provide a conceptual framework to make sense of Brazil's improvement in public finances. This approach can also explain the growing interest in tax and tax policy and could perhaps signal new tensions and boundaries in the social contract.

The significance of rising tax revenues for Brazil's inclusive growth is huge, but it has not been consistently acknowledged. Brazil's inclusive growth in this century, combining economic growth leading to large and sustained reductions in poverty and inequality is at the core of a hypothesized new Brazilian 'Development Model'.

Economic growth and the rise in 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.[5] Of course, the rise in tax/GDP ratio is not a win-win strategy when the rising burden on taxpayers is considered, a fact which is gaining prominence in domestic policy debates. To date the government have been successful in preventing resistance from taxpayers. A key issue to consider is whether growing attention to the tax burden could threaten the sustainability of an inclusive growth strategy.

These are the themes covered in the paper. Figure 1 illustrates the main arguments and their linkages. Brazil has historically been a closed economy with no significant

[4] See http://bit.ly/1zZGTp2

[5] For example, increasing minimum wages in real terms raises social assistance benefits to pensioners and the minimum pension benefit of the majority of social insurance pensioners.

mineral resources from which to derive revenue, and with high bureaucratic capacity. These preconditions facilitated the early introduction of modern indirect taxation (dual VAT) and consequently a very high tax burden compared to its per capita level. The transition to the democracy in the late 1980s and the attendant extension of the suffrage led to a reconfiguration of the social contract that was encapsulated in the constitution of 1988. As a consequence the redistributive pressures escalated leading a further expansion of the tax burden. Moderate left governments since the mid-1990s have implemented an agenda of social inclusion leading to a new equilibrium based on high redistribution and high taxation.

The paper is organised as follows:

Section 2 provides a brief introduction to the Brazilian tax system, looking at trends, components and distributional effectiveness. Brazil's federal structure, in which the federal government, the estates and the municipalities (*prefeituras*) have equal standing and capacity to collect taxes, makes for a complex tax system. The tax system is dominated by indirect taxes, especially when social security contributions are excluded.

Section 3 provides a brief review of the extensive literature on the factors influencing the extractive capacity of the state and the strength of preferences for redistribution. Insights from this literature capable of illuminating Brazil's experience are identified and discussed.

Section 4 offers a historical perspective on the tax/GDP ratio. There are two periods in Brazil's recent past when the tax/GDP ratio rose significantly. The first one is associated with tax reforms and improvements in tax administration associated with the authoritarian government in 1966-1971. They included the very early introduction of a VAT. The second period reflects the recent rise in the tax/GDP ratio under democracy. Whereas the rise in the tax burden in the authoritarian period followed 'big bang' type reforms, in the democratic period the tax ratio grew almost by stealth.

Section 5 discusses political incentives for redistribution, tracking changes in the political regime, franchise, and political competition.

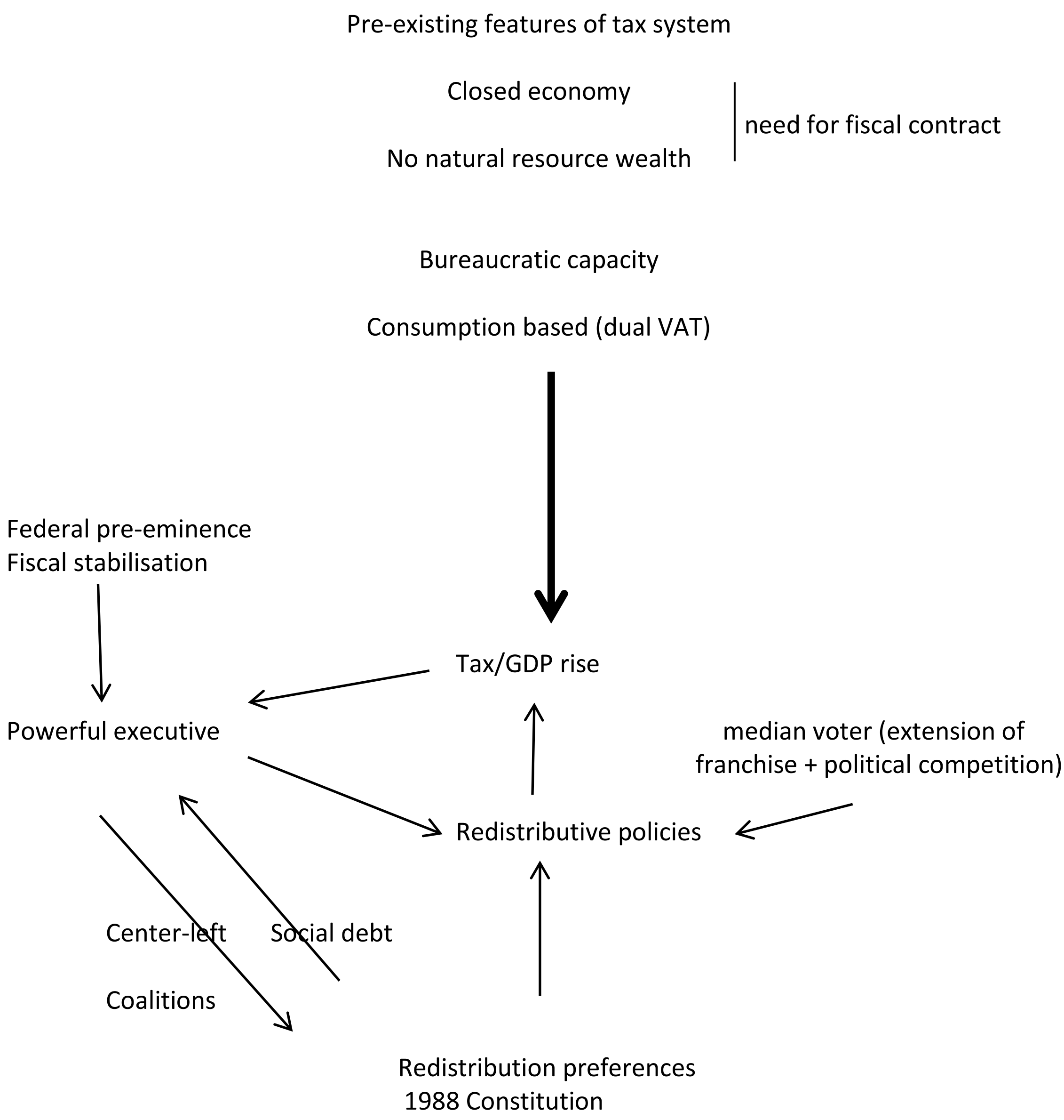
Section 6 discusses the role of bureaucratic competence and tax administration effectiveness that has been a long term feature of Brazil.

Section 7 attempts to identify discontinuities in the recent rise in the tax burden, and at the same time, the factors that prevent tax reforms. This is a crucial issue in the context of Brazil. There is a degree of consensus around the view that gains in effectiveness and fairness associated with tax reform might be heavily discounted by policy makers, especially if the tax system, with all its faults, is capable of generating significant resources to support redistributive policies.

Section 8 asks whether growing public attention on tax policy might be a signal that the rise in the tax burden might be achieving a ceiling. It also considers whether this could undermine the new social contract.

The final section draws out the main conclusions, places the Brazilian tax/GDP ratio in a global perspective, and identifies potential lessons for African countries.

Figure 1: The main argument

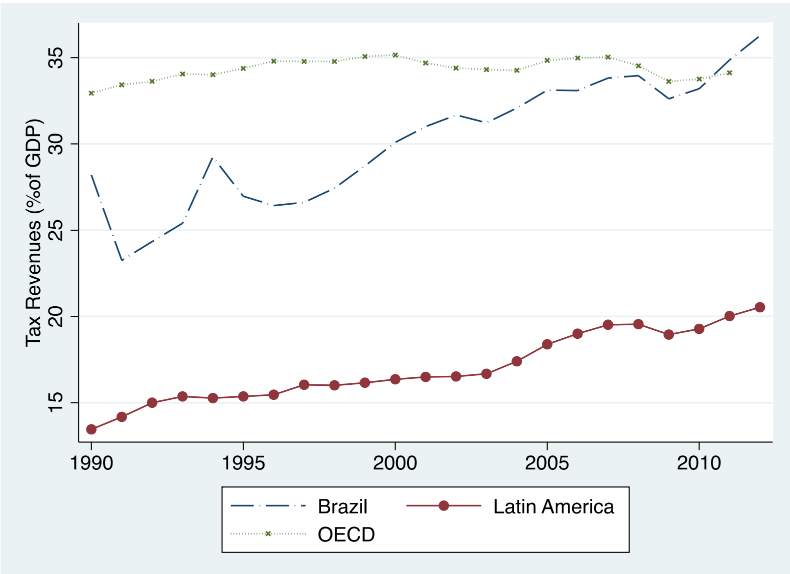


2. Brazil's tax system: components, trends, and distributional effectiveness

The main objective of this section is to place the rise in the tax burden in Brazil in the context of Brazil's tax system. To an important extent the rise in the tax/GDP ratio in Brazil has not been the result of radical tax reform or of step improvements in tax administration. As will be argued in the following sections, improvements in the extractive capacity of the different levels of government in Brazil are largely explained by changes in the economy and society, which have facilitated revenue collection through a largely unchanged tax system.

Brazil's tax system has a number of distinctive features but the very size of the tax burden is very significant. In fact, the country is an outlier when compared to countries in the same level of development. As figure 2 shows, the current tax level of 36% exceeds the OECD average of 34%. The tax revenue has increased almost monotonically over the last two decades. A significant component of the tax burden is social security that represents 9% of GDP – more than double the Latin American average and similar to the OECD average.

Figure 2: The evolution of the tax burden in Brazil 1990-2012



Source: OECD and CEPAL-CIAT

The 1988 Federal Constitution provides the institutional framework for the current Brazilian tax system. Since its promulgation, 29.600 thousand laws, decrees and administrative rulings affecting the tax system at the national level have been enacted, including 15 constitutional amendments, 1,470 laws, 203 provisional measures (*medidas provisórias*), and 1593 federal decrees (Amaral, Olenique, Amaral 2013). 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. The tax system consists of taxes, fees and contributions.

The so called *contribuições* are not exclusively levied on payrolls, but also on employers' profit, as well as on lotteries, government revenues and licensing. To an important extent, the complexity of Brazil's tax system is a consequence of the proliferation of taxes covering a common tax base. Table 1 describes the tax system in Brazil, distinguishing taxes collected by the three levels of government, and their contribution to the consolidated tax burden.

Table 1: Consolidated government tax receipts by tax instrument as a % of GDP

	2011	***2012***
Income Taxes (Corporate and Individuals)	6.03	6.00
Tax on Manufactured Products (IPI)	1.13	1.04
Tax on Financial Transactions (IOF)	0,77	0,7
Rural Land Tax (ITR)	0.60	0.68
Social Insurance Contributions (INSS)	6.56	6.87
Social Security Financing Contribution (COFINS)	3.82	3.96
Contribution on Net Profit (CSLL)	1.40	1.31
Contribution to the Social Integration Plan (PIS/PASEP)	1.01	1.05
Civil Servants' Social Security	0.55	0.52
Unemployment Guarantee Investment Fund (FGTS)	1.73	1.82
Federal Government	**25.39**	**25.38**
VAT (ICMS)	7.27	7.49
Others	1.15	1.12
Estates' Governments	**8.77**	**8.96**
Municipal Governments	**1.86**	**1.93**
Consolidates Government	**36.02**	**36.27**

Source: Instituto Brasileiro de Planejamento Tributário (IBPT)

In 2012, tax revenues amounted to 36.3% of GDP, the bulk of which was collected by the federal government (25.38%), followed by the state governments (8.96%) and the municipal government (1.93%). Federal government tax revenues can be divided into those supporting the general budget (8.24%), those supporting social policies (13.59%) and a residual category (2.53%). This is helpful in highlighting the fact that social policies are financed by a range of instruments aside from social insurance contributions. In fact, in 2012 social insurance contributions at the federal level alone accounted for 6.87% of GDP – states and municipalities represented an additional 0.51% of GDP.

The most important federal taxes are the income tax and tax on manufactured goods (IPI), which account for over 90% of federal taxes. The personal income tax is levied on the income and proceeds of any nature earned by Brazilian-based individuals at a progressive rate between 7.5% -27.5%, contingent upon the taxpayer's ability to pay. Corporations pay a 15% rate Income Tax (IRPJ), based on their actual or estimated earnings, or on earnings ascertained by tax authorities and an additional tax of 10% if the earnings per month exceed R$ 20,000. 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 that is variable per product classification. Additionally, the federal government collects a Tax on Financial Transactions (IOF), comprising credit, foreign exchange, insurance and security operations. [6] The central government also collects taxes on foreign trade, in particular the Import Duty (II) levied on CIF products and the Export Duty (IE).

Turning to the contributions, the federal government collects contributions on net profits and on payroll. They are intended to finance the social security system. The two most important contributions - the Social Security Financing Contribution (COFINS) and the Contribution to the Social Integration Plan (PIS) - are based on gross revenues and are collected at different rates according to the firm's tax regime (cumulative or non-cumulative). The Contribution on Net Profit (CSLL) is a surtax levied at a 9% rate on a company's adjusted net profits and at a 15% rate in case of financial institutions, ahead of the allowance for income tax. There are also contributions on specific economic activities, such as the CIDE-Fuels, levied on the commercializing and import of fuels, at a rate variable per type of fuel. As opposed to taxes, such contributions are not shared with the subnational tiers. The social contributions account for around 2/3 of federal tax revenue.

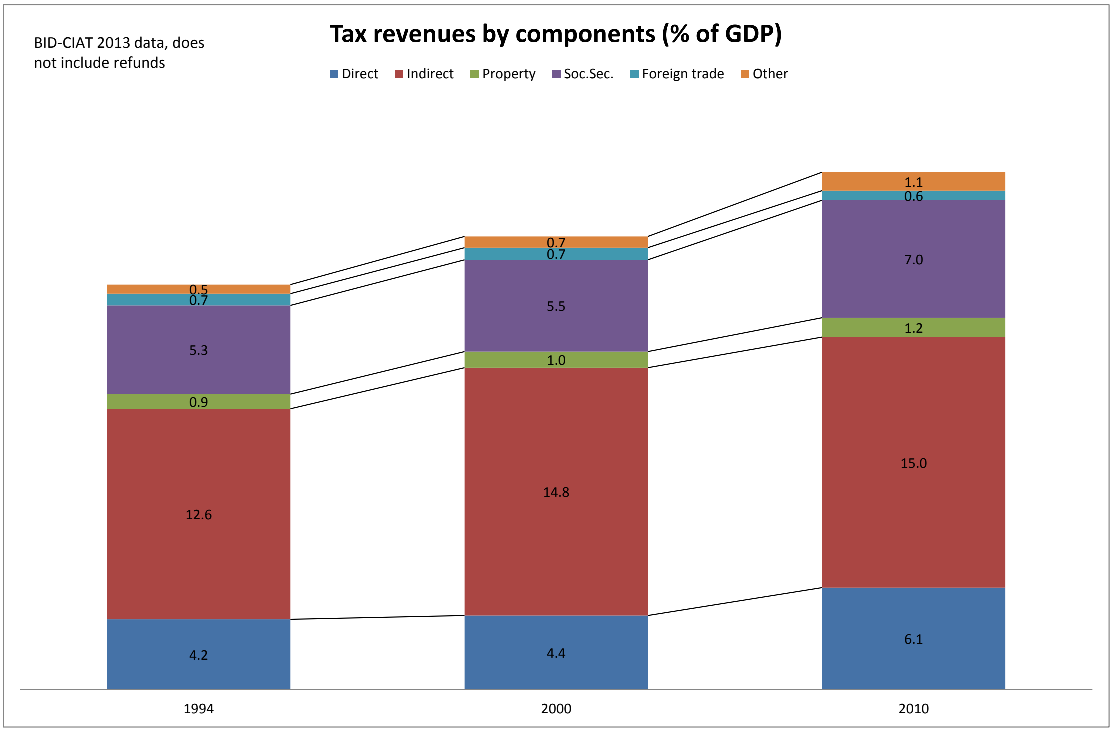
Brazil has a dual VAT system, with the states collecting the lion's share of VAT taxation. Brazil was not only the first country to introduce the VAT (Shoup 1991) but it was also the country in which the tax that yields proportionally more revenue is collected at the subnational level, not the federal /national level. The states collect their own VAT – the ICMS - which is imposed on sales of goods and carrier/telecommunications services. The ICMS is assessed all over the entire chain of trades from manufacturers to end consumers on a non-cumulative basis and the transaction value serves as the tax basis. The ICMS legislation differs across the 27 Brazilian states as each state can determine unique tax rates for intrastate trade (usually 17-18%), as well as use different criteria for tax breaks and incentives,

[6] A tax on financial transactions (CPMF) was also collected between 1997 and 2007 at a 0.038% rate on transactions between individuals and financial institutions, particularly current account debits.

usually to attract investments.[7] The ICMS represents over 20% of total tax revenue (an impressive 7.49% of GDP). Other state taxes include the tax on motor vehicle registration (IPVA) and the tax on inheritance. In turn, municipalities collect taxes on services (ISS), urban property (IPTU) as well as on transfer of real estate ownership (ITBI). [8]

Focusing on tax revenues by components, figure 3 illustrates the main changes over time. With the exception of taxes on foreign trade, all other components show increases over time, especially indirect taxes, direct taxes, and social security contributions. As in most countries in Latin America direct taxes are mainly levied on corporate profits. In 2010, personal income tax contributed 2.4% of GDP. Indirect taxes are the most significant source of revenue, collected at all the three levels of government.

Figure 3

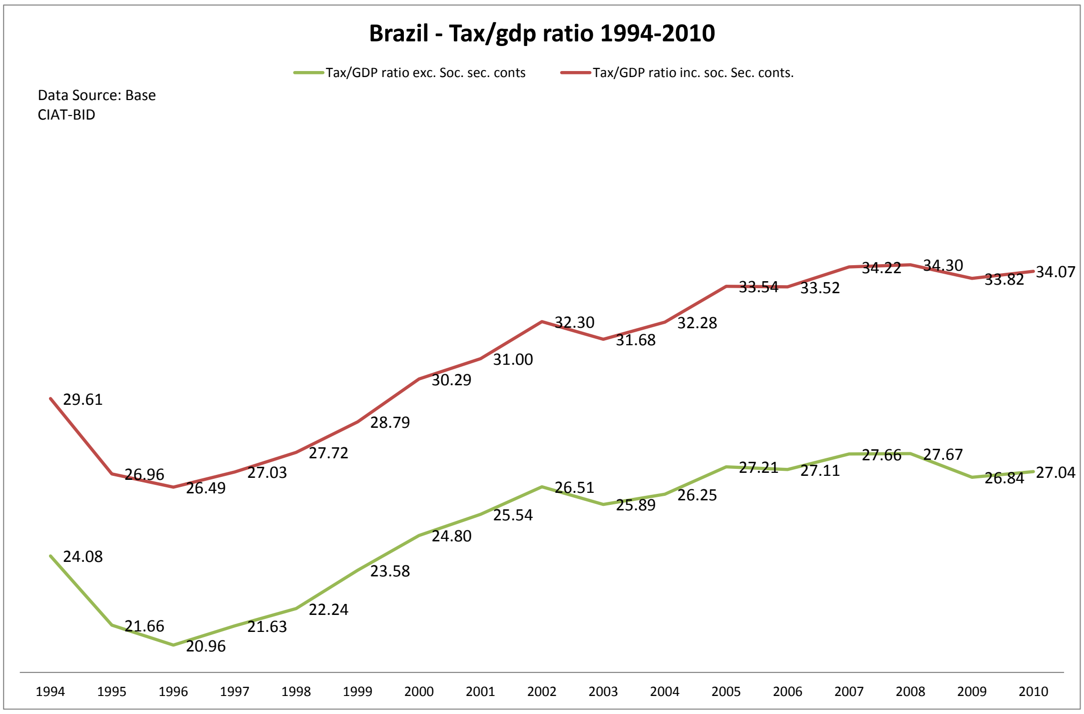


[7] The rates for interstate trade are fixed by the Federal Senate. These are currently 12% on transactions directing products and services to Southern and Southeast states and 17% to states in the North, Northeast and Center-West.

[8] The ISS is a cumulative tax levied on services provided by a company or self-employed professionals, from a list of services that are not subject to ICMS. The taxable basis of ISS is the price of the service rendered and the rate varies across municipalities (but typically around 5%). The municipality where the property is located collects the IPTU on an annual basis based on the market value of the property. The ITBI is levied on the transfer of titles to real estate and related rights at a typical rate of 2% of the property price, but according to municipal law it can be as high as 8%.

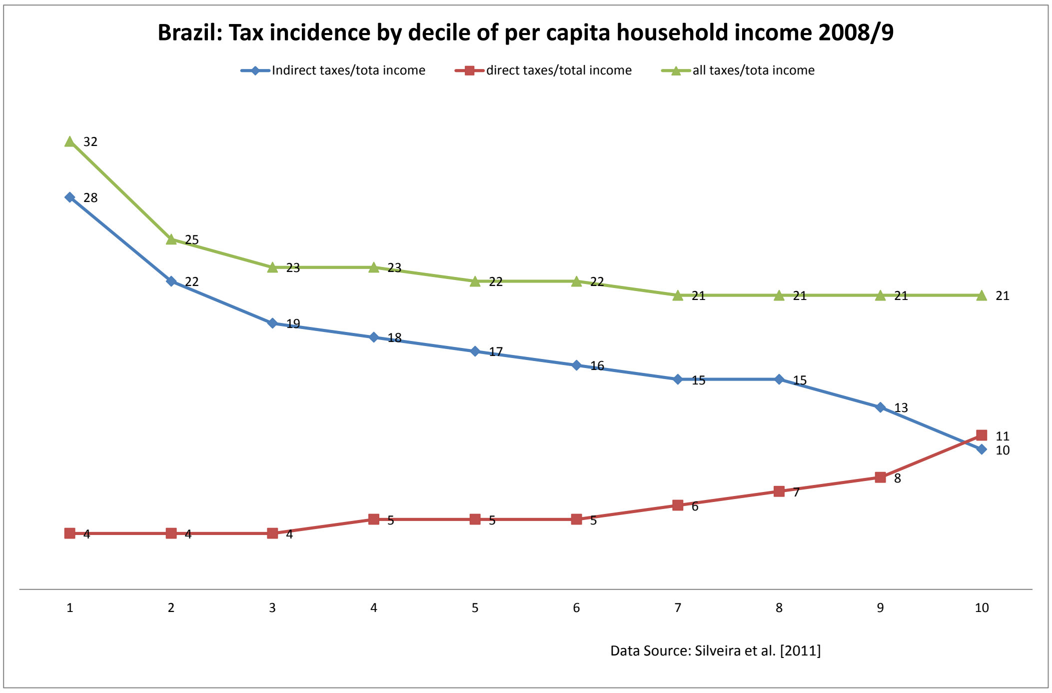
As shown in figure 3, the growth in tax revenues has been sustained over time, and is not a factor of a specific component. Figure 4 shows the rise in tax revenues with and without social security contributions. This is important in the context of international comparisons with countries which have private social insurance schemes or lack them altogether. Brazil is an outlier when compared to countries at the same level of economic development, and also when compared to countries in the region. Brazil's tax burden is currently 68% higher than the Latin American mean. Even when social security contributions are left to one side, the tax burden in Brazil is way ahead of the high tax cluster of Latin American countries: Argentina, Uruguay and Chile. Including social security contributions, the tax burden in Brazil compares well with Southern Mediterranean countries. The rise in tax revenues has generated fiscal space to support new policy priorities. It has enabled governments to make large investments in social policy without affecting existing commitments and budgets.

Figure 4



Remarkably, the growth in tax revenues have had limited impact on the distributional effectiveness of the tax system (Afonso, 2013). This is perhaps to be expected as the bulk of tax revenues come from consumption taxes, which tend to be regressive in their distributional effects. Indirect taxes are slightly progressive, but their weight and progressivity are insufficient to compensate for the regressivity of indirect taxes. Figure 5 reports on a study examining the distributional effects of direct and indirect taxes (Silveira et al. 2011).

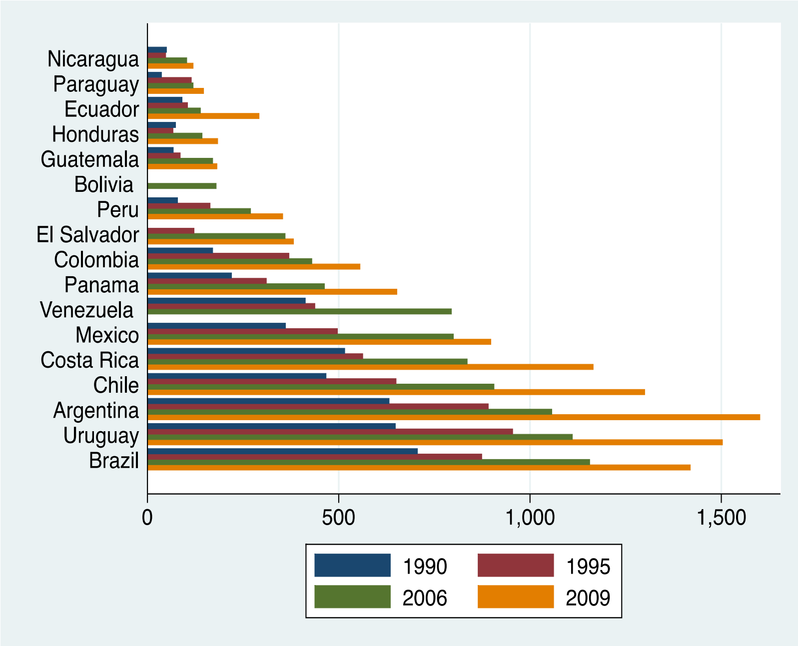
Figure 5



Overall, Brazil's tax system is neutral, as can be seen from the share of direct and indirect taxes in each decile of per capita household income. This is a finding that emerges from the small numbers of studies on this issue (Medeiros and Souza 2012; Pintos-Payeras 2010; Silveira 2008; Silveira et al. 2011). Silveira et al. (2011) provide a comparison between the distribution of taxes in 2002/3 and 2008/9, estimated from Pesquisa de Orçamentos Familiares (POF) data on a consistent basis, and conclude that in that period the tax system became slightly less regressive in some of its components, but remained neutral overall.

The rise in the tax burden has coincided with a surge in social spending. For the period 1990-2009, Brazil retains the highest social spending overall in Latin American measured in per capita terms (see figure 6). The rise in tax revenues and the rise in social spending are also coterminous with a sustained decline in inequality and poverty in Brazil, comfortably exceeding the regional average. The Gini coefficient declined at an annual rate of -1.04 % compared to the regional average rate of -0.6% (Lustig, Lopez-Calvo and Ortiz Suarez 2012: 21). Poverty declined 40% points during the same period leading to the emergence of a new middle class in the country. Significantly, in the period 2001 to 2009 Brazil experienced inclusive growth as the incomes of the richest decile rose significantly more slowly (0.6%) than the incomes of poorest decile (5.9%) (Lustig, Lopez-Calvo and Ortiz Suarez 2012: 22).

Figure 6: Per capita social spending 1990- 2009



This brief description and review of Brazil's tax system highlights the main issues for the rest of the paper. The rise in the tax/GDP ratio does not appear to follow large scale tax reform or tax administration, as recommended by the IMF and the World Bank. As discussed in detail in other sections of this paper political and economic factors have delivered fiscal space. A key task for the paper is to examine the extent to which the absence of tax reform is an unintended effect of failures in the political institutions or part of a strategy to ensure the financing of innovative social policies (Afonso, 2013). This also raises the question whether the lessons from Brazil as regards fiscal space are to maximize the extractive capacity of the government in order to expand redistributive social policies.

3. Economic and political explanations of extractive capacity

This section provides a brief review of theories explaining the extractive capacity of the state. The section turns first towards economic and political explanations for the growth in tax revenue, and then discusses explanations offered for redistributive preferences. Section 4 will then focuses on the discussion of the Brazilian case in the light of the evidence reviewed in this section.

3.1 Explaining the extractive capacity of the state

In the absence of large scale windfall revenue derived from natural resources and in the context of limits posed by globalisation on trade taxes, the state's capacity to tax its citizens is a precondition for sustainable redistribution. The conventional economic literature has identified a host of economic factors that might influence the extractive capacity of the state. They include: the level of economic development, trade openness, inflation, fiscal deficits, economic growth, and the abundance of natural resources.

The level of economic development, as measured by GDP per capita is a well-established predictor of tax burdens. Developing countries are often characterized by having a large share of agriculture in total output and employment, a small share of wages in total national income, and a large share of informal activities and occupations – all factors that undermine taxation. The availability of "tax handles", sectors like foreign trade that by their very nature facilitate tax collection are also good predictors of tax burden (Teera and Hudson 2004; Piancastelli 2001; Tanzi 1992; Bird, Martinez-Vasquez and Torgler 2004). Lieberman (2003) showed that income alone explains 40% of the tax burden.

Another factor depressing the tax burden is low trade openness. Rodrik (1998) found that exposure to international trade fluctuations prompted governments to play a risk-reducing role in economies exposed to significant amount of external risk, encouraging measures to raise tax revenues to support them. Natural resources wealth on the other hand enables governments to avoid the political costs associated with raising taxes from the governed (Ross 2001 and 2013; Barma et al. 2012). Rising commodity prices might turn out to be a double sword because commodity dependency may discourage governments from using direct and indirect taxes but it may shift the tax burden upwards.[9] Cornia (2012) finds that increase in world commodity prices contributed to raising the tax/GDP ratio in 7 of the 18 countries in Latin America, but he also notes that such increases started before the commodity boom and were associated with a broadening of the direct and indirect tax base (p. 13).

Other contributions in the economic literature have emphasized the role of crises in prompting taxation enhancement reforms (Mahon 2004). Scartascini and Hallerberg (2011) argue that debt crises make institutional reforms, including tax reforms, more likely but banking crises on their own, if anything, reduce the pressure for fiscal institutional reforms.

[9] Non-tax revenues may also reduce the vulnerability of fiscal policy to external constraints resulting from capital mobility (Campelo 2011; Kaplan 2013).

The political science and political economy literatures have explored the institutional factors that might affect extractive capacity including the role played by political regimes, constitutional structures, political instability, commitment problems and federalism.

There is considerable controversy regarding the impact of political regime on the level of taxation. In the most comprehensive study of the determinants of taxation available, Acemoglu et al. (2014) find a robust and quantitatively large effect of democracy on both tax revenues as a percentage of GDP and total government revenues as a percentage of GDP. The long-run effect of democracy is estimated to be about a 16% increase in tax revenues as a fraction of GDP. This pattern is robust to various different econometric techniques and to the inclusion of other potential determinants of taxes, such as unrest, war, and education.

However, Profeta, Puglisi and Scabrosetti (2013) did not find any robust effect of democracy on taxation in developing countries, and in Latin American countries in particular. Aidt and Sterovi (2011), in turn, found a positive effect of level of political participation on taxation but a negative effect for political competition. Conflictive estimates can be explained by the specification of the models estimated and by the time span and geographical coverage of these studies.[10] Profeta et al. (2013) offered three explanations for his surprising finding. First, low levels of political representation and vulnerability to elite capture could mitigate or even reverse the impact of democracy. Second, a low degree of financial disintermediation might constrain tax enforcement. Finally, the legacy of populism which was associated with efforts to keep taxation at very low levels in order to retain the support of the population, even at a cost of increasing debt. Earlier studies also found a weak or non-existent link between political regime and taxation (Cheibub 1998; Lee 2003). The expectation that ceteris paribus democracy leads to enhanced taxation is shared in median voter models but the evidence supporting them is mixed.

Raising revenue is a conflict-ridden process that entails losses for elites and interest groups. Elites' strength and its relation with the state is a key variable in this type of explanation (Fairfield 2012). As Steinmo has argued, the capacity to overcome resistance, crucially shaped by the institutional structure, is a key variable explaining taxation outcomes. In this context, political systems with majoritarian features have a superior capacity to impose taxation whereas democracies with numerous veto players (also called consensus democracies). The latter is characterized by the adoption of proportional representation ensuring a low effective number of parties, coalition governments, federalism, and bicameral legislatures. Features such as the adoption of open list proportional representation have been argued to undermine reform efforts (Scartascini and Hallerberg 2011; Mahon 2004). Political institutions that fragment political authority are viewed as hindering tax reforms because reform

[10] 184 countries for 1960-2010 for Acemoglu et al (2014), 18 latin American countries and 1900-2000 for Aidt and Sterovic (2011), and finally 1990-2005 for Profeta et al. (2013)

efforts are more likely to be vetoed at different stages. For the new democracies in Latin America this argument relates to the limited capacity of the executive branch to pass its agenda in systems marked by high political transaction costs (IADB 2006; Hallerberg, Scartascini and Stein 2009).

Steinmo (1988) found that democracies with majoritarian designs produced larger governments than systems based on a separation of powers (for a discussion see Gould and Baker 2002). By contrast, Persson and Tabellini (2003) found that systems based on a separation of powers produce larger tax burdens and that majoritarian elections produce smaller governments. Mahon (2004) discusses a number of explanations for the causes of tax reform in Latin America and found weak evidence for the role of political factors such as institutionalization of party systems, the number of parties and presidential powers of presidents in explaining tax reform outcomes. This finding contradicts the received wisdom that polities with a small number of disciplined parties and strong presidents, and with fewer veto points would be more likely to reform.

Institutional capabilities, including administrative capacity, are an important precondition for extractive capacity as they are required to overcome elite's resistance to taxation and secure tax compliance. As argued in Mares 2005, they also shape redistributive pressures. Political and institutional instability may also affect taxation levels as they affect institutional capabilities and incentives. A ground breaking contribution on the effects of instability on public finance is Cukierman, Edwards and Tabellini (1990) and Edwards and Tabellini (1991). These authors focus on the incentives faced by governments in the choice of alternatives for raising revenue: borrowing, taxation, and inflation tax. They argue that an inefficient tax system (i.e. one that facilitates tax evasion and imposes high tax collection costs) acts as a constraint on extractive capacity. Those who disagree with the goals pursued by the current government may welcome this constraint. More importantly, a government (or a legislative majority) may deliberately refrain from reforming a tax system for fear that a more efficient tax apparatus will be used in the future to carry out spending or redistributive programs that the current government disapproves of. This is more likely in countries with more unstable and polarized political systems. According to this model, more unstable and polarized political systems rely to a greater extent on inefficient taxes than more stable and less polarized countries. The intuition behind this argument is that tax reform is a public good and a weak government is discouraged from pursuing it because of the associated administrative and political costs. At any rate, it might well be future governments, and not the governments that initiated reforms, which will reap any potential benefits.

A related argument stresses *seignorage* and focuses on the impact of inflation on revenue. Following hyperinflationary episodes, stronger and more generalised resistance to revenue raising measures will prioritise efforts to collect non-tax revenues (Kaplan 2013; Melo 2007). Weak governments facing the prospect of losing elections have incentives to resort to inflationary financing, especially as fiscal deficits will have to be dealt with by future governments. With political instability and political polarization, strategic considerations may induce government to leave an inefficient tax system to its successor (Cukierman, Edwards and Tabellini 1989). Weak extractive capacity is ultimately explained by the alternative of resorting to *seignorage* to collect public revenue (Melo 2007). We could expect large tax increases following successful stabilization programs.

Tax administration becomes endogenous in this model. Bureaucratic capabilities develop when weak governments resort to delegating powers to independent institutions as a result of commitment problems. The neo-institutional approach to taxation predicts that the reform of fiscal and tax systems is dependent upon the ability of the actors to credibly commit to refrain from opportunistic behaviour. One way of solving the bargaining problem is for the actors to build institutions for credible commitments such as independent tax administrations (Taliercio 2004).

The impact of federalism on tax revenues is contested. Competition among jurisdictions may lead to a race to the bottom. However, federalism creates common pool problems and vertical fiscal imbalances. A common pool problem arises when politicians care only about the spending and revenue implications of their decisions on their constituencies and their tax burden is smaller than the full tax implications of their spending. Subnational units in federations may face this problem and the resulting bail out problems may entail enhanced taxation (Stein 1998).

3.2 Explaining the demand for redistribution

In a democracy the demand for taxation is associated with redistributive pressures. In this subsection we review briefly the literature on the demand for public spending. We later on draw on the insights gained from this section in order to examine the Brazilian case.

Over the last decade or so, a large literature has focused on the determinants of the demand for redistribution. Interestingly, the literature on advanced capitalist societies, which have experience a sharp rise in inequality in the last two decades, have placed a stress on the factors that prevent democracies from achieving greater equality. This was also the focus of the Latin American research in the 1990s and early 2000s.[11] The return to democracy in Latin America has coincided with a sustained decline in inequality levels in most countries in the region, particularly in the last decade or so. Current research on Brazil and on the region is now turning towards exploring how democracy could explain the observed decline in inequality, and particularly the role of social spending and redistribution (Cornia, 2014).

[11] See Kauffman (2009), Blofield (2011) and Cornia (2014).

The standard explanation in the political economy literature about the growth of public expenditures rests on the median voter model (Meltzer and Richards 1981). In this model public expenditures are primarily driven by the current distribution of income, particularly the demand for redistribution by the voter with the median income. “If politicians propose any policies other than those preferred by the median voter, they have no chance of winning, so the only issue is how much redistribution the median voter demands. Supply is irrelevant.” (Robinson 2010: 43). An implication from this model is that an extension of the franchise, which incorporates lower income groups, will inevitably result in increased social pension and redistribution from the rich to the poor. Fear of redistribution can be a powerful motivation for elites to restrict the extension of the franchise, or to find instruments to influence the preferences of the population (Acemoglu et al., 2013). However, the literature seeking to establish empirically the prediction from the median voter model has failed to provide conclusive findings.[12]

Richer models have been proposed to explain the paradox of rising inequality under democracies. A recent wave of models finds that the effects are non-linear and that multiple equilibria can be obtained depending on shared beliefs about redistribution (Benabou 2000; Alesina and Giuliano 2008; Alston et al. 2013). At any rate, we are particularly interested in the effects of democratization on redistributive policies rather than its final effect on inequality.[13]

Other explanations have explored the extent to which political institutions and political competition shape redistribution dynamics emphasizing how party systems, political parties, political polarization, voter turnout and electoral rules might affect redistribution pressures and taxation outcomes. The role of ideology in promoting redistribution has been discussed in Huber and Stevens (2012) Roberts (2012) and (Mahon 2013). In these studies, left and left-of-center parties act as political entrepreneurs of the poor and help them overcome collective action problems. Stein and Caro (2013) using a panel of 17 countries from 1990 to 2010 find that governments from the left are associated with higher total tax revenues (2.1% of GDP), and higher income tax revenues (1.3% of GDP). The study found no significant effect on VAT revenues or revenues from social security taxes. Other contributors have found that redistributive preferences are to an extent independent of ideology and that the decline in inequality has occurred under ideologically diverse governments (Kauffman 2009; Cornia et al. 2011).[14] Both findings are consistent with the median voter prediction, as any type of party would have to cater for the redistributive interests of the poor.

[12] For an updated review see Acemoglu et al. 2014.

[13] Admittedly, the impact of redistribution is not unimportant as it feedback on the preferences for redistribution.

[14] Cornia et al. (2011: 13) found that the left-of-centre countries performed somewhat better in terms of raising additional revenue and tax progressivity but also some conservative ones recorded—with the exception of Mexico—a surge in tax/GDP ratios.

The presence of strong unions, usually associated with socialist and social democratic parties, are similarly expected to strengthen the demand for redistribution pressures. The expected relationship is between high unionization and high equalizing pressures (Beramendi and Rueda 2007).

Other studies have focused on party systems and their influence on redistribution. Several authors have argued that party systems act as key intervening factors in processing demands for redistribution. Parties mediate demands and facilitate collective action (Blofield and Luna 2011, Robinson 2010). Poor voters may be unable to translate their demands for redistribution in the absence of programmatic parties.[15] Kitschelt et al. (2010) argue that the influence of democracy on redistribution is mediated by the degree of party system structuration: non-programmatic parties weaken or cancel the redistributive impact of democracy (see also Roberts 2012). Where parties are programmatic, redistribution becomes salient in the political agenda and the poor can be politically mobilized in support of redistribution.

Some findings contradict the central prediction of convergence of the median voter model. Blofield and Luna (2011) argue that political polarization matters because it prevents convergence on the median voter, resulting in policy instability and weak political support for redistribution (Daude and Melguizo 2010). Voter turnout is another variable explored in the literature because if it is inversely correlated with income levels it would reduce the political influence of the poor (Chong and Olivera 2008).

Another factor that has attracted considerable scholarly interest is the effect of upward mobility – actual and perceived – in preferences for redistribution (Benabou and Ok 2001). Faced with the prospect of upward mobility voters could refrain from current redistribution because they anticipate that they may benefit less in the future from widespread redistribution. Gaviria (2007) found evidence for the impact of social mobility hypothesis (POUM), whereas Daude and Melguizo (2010) and Morrow and Carter (2013) provide mixed results.[16] Gaviria (2007) found that the strong preferences for redistribution and the weak support for market outcomes in Latin America in the late 1990s could be explained by pessimistic views of social justice and equality of opportunities shaped by negative views of past and expected mobility. Perceived levels of meritocracy, corruption and tax morale may also affect preferences for redistribution (Alesina and Angeletos 2005). Daude and Melguizo (2010) and Torgler (2007) converge on the finding that satisfaction with public services correlates positively with support for redistribution and taxation.

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[15] Kitschelt et al (2010) defines Programmatic Party Structuration to indicate the extent to which politicians employ party labels to develop coherent policy alternatives in their public appeals. (p. 3).

[16] Daude and Melguizo (2010) found that people, who think that their children will move up, tend to support less redistribution, while those who experienced themselves upward mobility in the past tend to support more redistribution. The second finding could indicate that people who experienced successful upward mobility believe that their mobility was aided by redistributive public finance, and therefore continue to support redistribution in the present.

In sum, a rich literature from political science and economics have proposed rival explanations for the varying degrees of taxation and redistribution across countries with distinct political regimes, levels of development and social and institutional configurations. We now turn to the analysis of the Brazilian case in the light of the literature's findings.

4. Brazil's rising tax/GDP ratio in historical perspective

The most intriguing aspect of the Brazilian case was Brazil's role as a global pioneer in the introduction of modern indirect taxation and that its tax burden was already high by international standards: it surpassed 25% of GDP in 1970, at the height of the military government. Social security contributions had already reached 5.2% of GDP in 1968 (Malloy 1979: 168). Therefore, the causes of Brazil's high tax burden cannot be discussed only in terms of the impact of regime characteristics. Multiple causal mechanisms are at play and will be explored in the following sections.

In terms of its tax/GDP ratio, Brazil indeed is historically an outlier because its tax burden has been significantly higher than its level of economic development would predict (Aidt and Sterico 2011; Oxford Latin American Economic History Database). The economic history literature in Brazil has coined the expression Keynesianism *avant la léttre* to characterize the historical pattern of state intervention in the Brazilian economy. The state intervened extensively in the coffee economy to sustain prices during fluctuations in external demand, socializing losses during crises. This legacy of statism resurrected during the developmentalist era and represented an important legacy. It enjoyed great support among the economic and political elites. The state's ability to finance development projects depended on its extractive capacity. This policy legacy was crucial for explaining Brazil's high taxation during the military period.

Until the discovery of oil fields in the late 2000s, Brazil did not possess significant mineral wealth and was a relatively closed economy. Brazil's degree of trade openness has been among the lowest in the region. Brazil has therefore avoided the resources curse and exposure to the ups and downs of a globalising world economy. Importantly, Brazil has had relatively high levels of taxation since the early 20th century. There are two periods in Brazil's history when the tax burden rose significantly. The first step rise in the tax burden took place under the military regime in the period 1966-1977. The second period showing a rapid rise in the tax/GDP ratio is the 1995-2008 under examination in this paper. These two periods area associated with monetary stabilization plans. This is confirmed in Schroeder (2009) who found a correlation with lower inflation and higher revenues.

The military promoted a major tax reform in 1966, as part of a sustained process of state building. The reforms contained innovative aspects and had a strong fiscal impact. The first important innovation was the introduction of a dual VAT. According to Shoup[17] (1990: 4) "Brazil was the first country to introduce a comprehensive VAT", to be followed by France (1967), Germany (1968) and Denmark (1968). This early adoption of the VAT was a key innovation. It had immediate consequences in boosting tax revenue but it also provided a firm basis for the future path of tax revenue outcomes in Brazil. The second important innovation was the approval of a modern tax code in 1966. The third major reform involved the revamping of tax administration and its replacement with the Secretaria da Receita Federal.[18] The increase in tax revenue following the reforms was quite substantial. In seven years, the tax burden doubled as a percentage of GDP, reaching 26% in 1971. When institutions such as the World Bank, IMF and IDB began to support reforms aiming at creating or expanding value added taxation in the 1980s, as well as lower effective marginal rates for income taxation, Brazil already had an established tax system in place.

Instead, there are no significant tax reforms in the 1990s and 2000s to explain the rapid increase in taxation in this period (a topic discussed in detail in section 7). 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 (Melo, Pereira and Souza 2010). There are no significant improvements to tax administration, however, which could explain the rise in the tax/GDP ratio. Extractive capacity remains largely endogenous and reflects the intertemporal calculus of governments. This is consistent with the prediction that governments with extended time horizons able to reap the benefits of future tax increases typically initiate reforms that strengthen tax administration.

It appears obvious to link the rise in the tax burden in the latter period to the restoration and consolidation of democracy. Yet, important questions arise from looking at the issue in historical perspective, and comparing developments in the authoritarian and democratic periods. This suggests an expected null effect of political regime on taxation.[19] The only way to reconcile both arguments is to propose alternative causal mechanisms linking regime and the tax burden.

[17] Carl Shoup was invited as a consultant to Brazil and famously produced, in 1964, the first comprehensive report on taxation in Brazil – The Tax System of Brazil , Usaid - , which led to the comprehensive reform of the mid-1960s. See Shoup (1987).

[18] In 1968 the Secretaria da Receita Federal (SRF), which came to represent along with the Itamaraty and the Central Bank, one of the most professional sectoral bureaucracies in the country, was established.

[19] Schroeder (2009) provides the only empirical study of the impact of regime, trade openness and inflation on tax outcomes in Brazil. Calomiris and Haber (2014, chapter 12 and 13 contain an analysis of the political equilibrium underpinning the inflation tax in Brazil in the 20th Century. The study covers a long time period (1946-2007), spanning authoritarian and democratic periods. The author found a negative correlation between both democracy and trade openness and changes in the tax burden.

Macroeconomic stabilization leads to increased taxation both under authoritarianism and democracy. Regime influence the use of public expenditure and it is possible to conjecture that it boost taxation although the analysis of a single argument cannot offer a conclusive account.

By arguing that regime (democracy) explains the recent tax hike, we are siding with the most comprehensive work on the topic (Acemoglu et al. 2013). However, the evidence on Brazil is prima facie mixed. There are two forces pushing the tax burden up: economic stabilization and redistribution pressures. We could imagine a rise in taxation without a change in regime in late 1980. But the difference would be that the extra revenue would be channelled mostly to infrastructure projects. In case a conservative government were elected in the late 1980s, the electoral pressures (median voter) would imply some redistribution but much less so than moderate left governments. In this paper we are concerned with the creation of fiscal space for social spending and not exclusively with taxation levels.

There are other intervening variables which will be discussed in detail the next sections. State capability is crucial. New governments may have the goal of promoting redistribution but they may fail because they do not have the political capacity: interest groups may resist, other key actors in the political system may enjoy veto powers over change. They might include coalition partners, subnational governors or the military. In addition, redistribution requires state capacity: without capable bureaucracies, evasion is rampant, implementation of reforms is weak, and the redistributive outcomes may fail to materialize. Creating capable tax administrations require long political horizons. Some radical left governments have had the incentives for redistribution but resorted to unsustainable instruments: taxes on exporters windfall profits, revenues from windfall commodity exports and *seignorage*.

In the remaining sections we will develop the argument that in Brazil there was a virtuous combination of incentives - redistributive pressures, moderate left governments committed to redistribution - and capacities - political and bureaucratic stability.

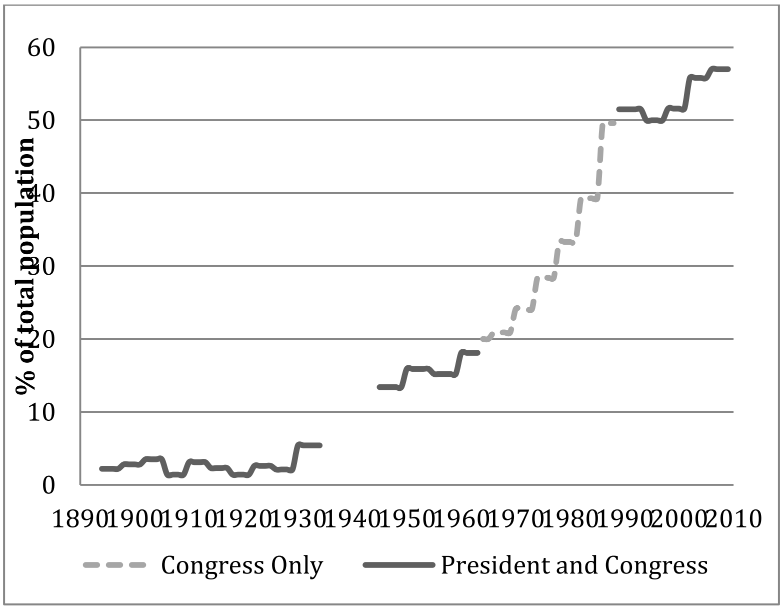
5. Political incentives for redistribution

As predicted by the median voter model, political competition has indeed provided a powerful incentive structure for redistribution in Brazil. Consistent with expectations from median voter models, we expect that the combination of voters' empowerment via expansion of the suffrage and massive turnout combined with high inequality and polarization along with strong societal preferences for redistribution to be instrumental in sustaining politically redistributive initiatives.

Empirically, it is hard to disentangle the effects of political competition from the predicted effects of democracy. But while democracy may increase the demand for redistribution it does not necessarily cause redistribution as in a democracy other factors - e.g. elite capture - may hinder redistribution. In addition there are measurement issues: democracy might be proxied by the extent of political participation or by the degree of "contestability" (Aidt and Eterovic 2011).

Brazil would appear as one of the most likely candidates for observing the extent of democratic influence on redistribution policy. Competitive elections in Brazil have enabled newly enfranchised citizens to massively support redistribution and inclusion. Figure 7 shows the evolution of the proportion of total population that effectively voted for Presidential and Congressional candidates from 1894 to 2006. Only in 1985 did Brazil authorize the right to vote to illiterates, so the first time that a majority of the Brazilian population voted for President occurred in the 1989 election. The previous presidential election had been almost 30 years earlier and less than 20% of the population voted in that election. Although Congressional elections took place during the 1964-1985 period, these were clearly of a less significant nature. This implies that the political scenario initiated in the 1990s was remarkably different than anything that the country had ever experienced before. The incentives of politicians were thus of a very different nature than those of previous periods. This is particularly true for Presidential elections given the strong presidentialism that prevailed after the 1988 Constitution.

Figure 7:
Percent of total population that voted for President and Congress 1894 – 2006



Source: Alston et al. (2013)

In available indexes for quality of democracy Brazil appears consistently below the top cluster, including Chile, Costa Rica and Uruguay, and on a par or above the remaining group of Latin American countries. Its Polity IV index scores are 8 (scale -10 to 10) for the period 1990 to 2010. The country's previous experience with competitive democracy in 1945 -1964 is comparatively strong by Latin American standards (Kitschelt et al. 2010). In the period 1945-1963 the Polity IV averaged 5. This suggests that the return to democracy might trigger strong demands for redistribution.

In the Checks and Balances index of the Political Institutions Database (Beck et al. 2001) which measures the extent to which the executive is checked by the legislature, Brazil ranks first in the average value for the 1980s and 1990s, and second for the 2000s. The average voter turnout in presidential elections during the six elections held during the democratic period 1989-2013 at 82.13% is the second highest in the Americas behind Uruguay.[20] Interestingly, the highest turnouts are found in the first two democratic elections, taking place in 1989 and 1994. Electoral races have been particularly competitive. Out of six presidential elections that took place after the democratization, in only two occasions, 1994 and 1998, were they decided in the first round, by margins of victory of 27% and 22%, and in four there were very competitive runoff episodes. The margins of victory were 12% in 2010, 20 percentage in 2006, 19% in 2002, and 6% in 1989.

More importantly, the presidential race involved two social democratic parties, the Workers' Party and the Party of the Brazilian Social Democracy, which in different degrees were committed to a program of social inclusion and redistribution. Indeed during the workings of the constituent assembly of 1987-1988 legislators from both parties supported universal health care and a generous social security system. This is consistent with the prediction that left of centre parties act as political entrepreneurs for the poor.[21] Union density around a quarter of the workforce in Brazil in the late 1980s and 1990s were high by Latin American standards and in the early 2000s were the second highest in Latin America (Roberts 2012). Again the Brazilian case is prima facie conducive to high equalization forces.

Since the early 1990s the national political agenda has been dominated by beliefs that have emphasized the expansion of social policy in the system and the need for increased funding for it as a precondition of development.

In sum the political market has been very competitive and, equally important, elections have been clean. The redistributive outcomes are consistent with theoretical expectations about competitive democratic elections in contexts of high

[20] Authors calculations from IDEA database.

[21] Cornia (2011) ranks Brazil in the social democratic cluster of countries and distinguishes it from the populist left.

exclusion, inequality and poverty. Because the median voter income in Brazil in the 1990s is two thirds of the mean income, strong pressures for redistribution followed. Electoral institutions with integrity and political competitiveness are prerequisites for the political intermediation of these demands. If the system is competitive, received theory expects that politicians converge to politically serve the interests of the median voter. [22]

Following the transition to democracy in 1985, the demands for redistribution were especially strong due to the extreme income concentration in the country. In fact, in 1989 Brazil was the second most unequal country in the world second only to Sierra Leone (Ferreira et al. 2008). Income inequality was the most politicized issue during the period of military rule and was a central issue in the discussions during the workings of the constituent assembly in 1987-1988. Emblematic of the pro-redistribution public sentiment, the motto of the first democratic government in the new democracy - the Sarney administration 1985-1989 – was *Tudo pelo Social* .

Brazil in the 1990s was also the most polarized society economically, with an EGR polarization index of 1965 in 1990. [23] According to Gasparini et al., Brazil ranks "as the most polarized country in the region" (2006: 17) although it has low polarization in some dimensions such as the gender and area. [24] Public perceptions of redistributive issues can be gauged by attitudes towards redistribution. In the World Values Survey of 1990-91, respondents were asked to rate their answers in a scale from one to ten. One states "Incomes should be made more equal" whereas ten states that "We need larger income differences as an incentive." Of all Latin American countries with available data, Brazil had the highest share of respondents answering "one" to the question.

Perspectives of upward mobility in Brazil in the late 1980s and 1990s were much lower than in other countries in Latin America (Woolcock and Gacitua-Mario 2008). In the late 1980s and early 1990s, Brazil was one of the countries with the highest inequality of opportunity in Latin America. Of the six countries with very high inequality of economic opportunities "Brazil is by far the most opportunity-unequal country". Predetermined characteristics ("circumstances") explain up to 35% of earnings inequality according to the estimate in Ferreira and Gignoux (2008), with data for 1996. This is consistent with the predicted impact of upward social mobility

[22] The medium and long-term consequence of this convergence is that the process becomes path dependent. A large clientele of social security beneficiaries ranging from old age and survivors pensions to end users medical facilities that makes up a formidable interest group with much political clout.

[23] The intuition for polarization is that "given a relevant characteristic such as religion, income, race or education, "a population is polarized if there are few groups of important size in which their members share this attribute and feel some degree of identification with members of their own group, and at the same time, members of different groups feel alienated from each other". These three elements (group size, identification and alienation) produce social conflict.

[24] Along with inequality polarization has been declining – one of the few countries in Latin America where this has occurred mostly as a result of the rising middle class.

on preferences for redistribution. Actual mobility may conflict with perceived mobility but the available evidence suggests that the latter is also very high. In 1998, 64.3% of respondents said that their parents had a higher standard of living while 24.2% said that it was worse. This marked perception of low expected future mobility may have driven voters to support an interventionist state that seeks to equalize income via taxation and social spending.

Several authors have argued that party systems act as key intervening factors in processing demands for redistribution. By this measure, the prediction would be that in Brazil redistributive pressures would degenerate into clientelistic exchanges, an outcome at odds with the empirical evidence. The apparent party fragmentation in virtue of the very high effective number of parties (ENPP) would suggest a high low level of party system structuration. With a mean ENPP equal to 8.69 in the last 6 general elections (with standard deviation = 1.08)[25], Brazil has one the most fragmented party system in the world. Party system structuration in Brazil is very low. However, as Kitschelt et al. (2010) note, the existing methodologies downplay the extent to which the party system is structured along programmatic parties. The main reason is the adoption of open list proportional representation with high magnitude electoral districts in a large country. Despite the extensive legislative fragmentation, there are only two parties with effective potential to win the presidential race. Smaller parties coalesce around these two parties and, therefore, there are two discernable ideological camps, the left led by the Workers Party (PT) and the centre led by the Party of the Brazilian Social Democracy (PSDB).

Intense political competition between those two multiparty coalitions, which are led by two programmatic parties, have shaped redistributive outcomes in the way expected by received theory. Since 1989 – the year of the first presidential election – the country has elected 6 presidents, impeaching one in 1993 for corruption, and has witnessed peaceful power alternation at the national level. Two oversized coalitions have dominated the national political landscape. The crucial test for institutional stability was peaceful political transition following the election of President Lula da Silva of the Workers Party's (PT) in the presidential election of 2002. Another key factor explaining the sustainability of redistribution is political stability, as discussed in the previous section. Indeed this is as crucial as political competition in providing a stable institutional environment, in the absence of which policy reversals take place and policies and programs are discontinued. There was also significant policy continuity in macroeconomic management and social policy-making.

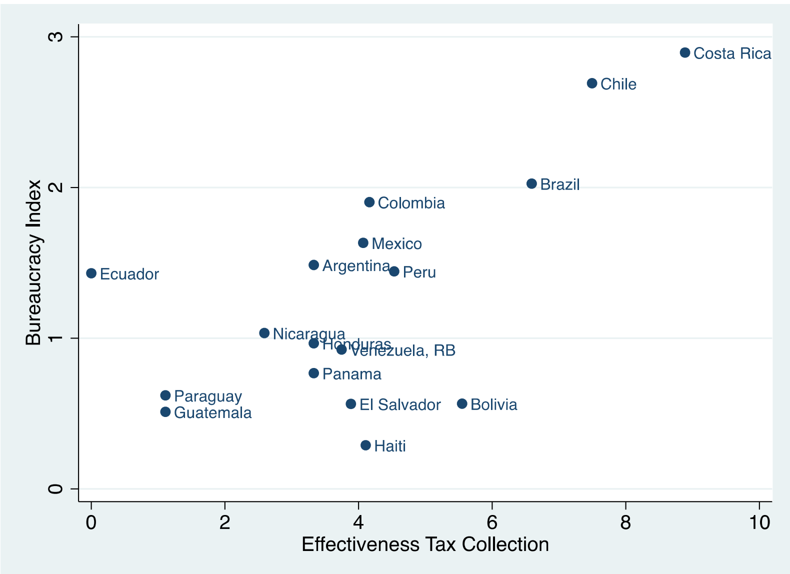
[25] Calculated for the last 6 legislative elections (1990-2010) with data from Michael Gallaher's Database on Electoral Systems available from : https://www.tcd.ie/Political_Science/staff/michael_gallagher/ElSystems/index.php

6. Institutional capacity and taxation

In this section we focus on Brazil's institutional capacity and its relation to taxation. Institutional capacity includes state capacity and political capacity. We show in this subsection that there is an element of path dependence in the explanation of tax administration effectiveness and that Brazil's has had strong capacity in the area of taxation. In addition, we show that the executive in Brazil possessed high political capacity, a topic we explore empirically in section 7.2.

State capacity is a necessary but not sufficient precondition for explaining Brazil's high taxation. Democratization and the fiscal crisis engendered incentives for expanding taxation but in the absence of institutional capacity to tax governments might resort to unorthodox tax instruments or *seignorage*. In the case of Brazil, as discussed in the previous sections, the public sector, in particular, had already reached a relatively high level of professionalization. In a study of the comparative evolution of state capacity in Latin America Geddes (1994) argues that Brazil was unique in terms of bureaucratic development. Vargas's comprehensive administrative reform during the Estado Novo period (1937-1945) paved the way to the creation of powerful and politically insulated sectoral bureaucracies (*ilhas de excelência*), which included the tax administration and social security administration. After the creation of the Secretaria da Receita Federal and the approval of a new tax code in 1967, 14 tax bureaucrats attended Harvard International Tax program (ITP).[26]

Figure 8: Quality of Bureaucracy and Tax Collection Effectiveness



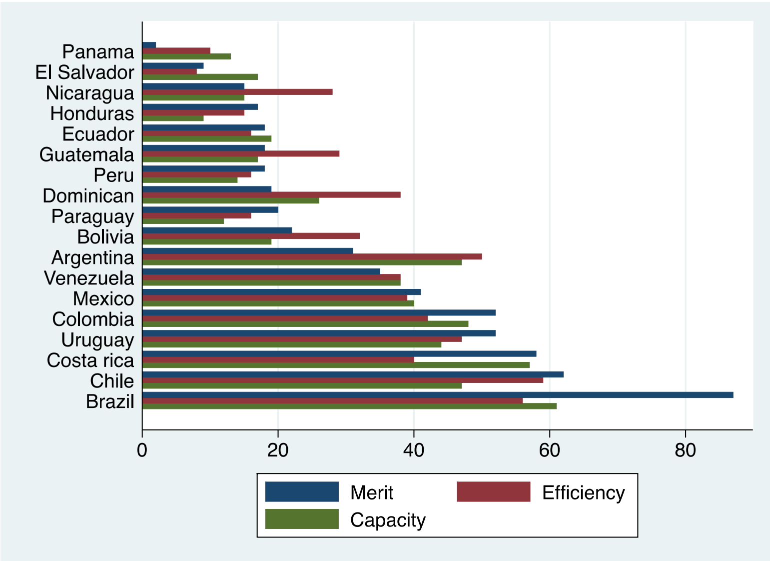
Source: Authors elaboration with data from State Capability Database: Franco and Scartascini (2013) [27]

[26] In terms of number of participants in the 1970s, Brazil was second only to Taiwan. The data comes from the obituary of the creator of the ITP, Oliver Oldman; see Alford (2009).

[27] *1. Tax collection Effectiveness*. Question rating the state's effectiveness at collecting taxes or other.

Figure 8 contains data for the perception of the effectiveness of tax collection in Brazil in the period 1990 to 2002 (average values) and the quality of the bureaucracy as measured by the bureaucracy index produced with data from the IDB's Political Institutions, State Capabilities, and Public Policy International Dataset.[28] Brazil is part of a cluster of countries with high bureaucratic capacity and effectiveness. In the study IDB conducted in 2005 Brazil appears as having the most professionalized bureaucracy in Latin America (Longo 2006, and see figure 9).

Figure 9: The Quality of Public Administration in LA



Source: Longo (2006)

forms of government revenue. Ranked from 0 (low) to 10 (high). Source: Columbia University State Capacity Survey; average 1990, 1999, 2000, 2002.

2.*Bureaucracy index* consists of 4 sub-indexes: a. Bureaucratic Merit Index: Question measuring the degree to which effective guarantees of professionalism in the civil service are in place and the degree to which civil servants are effectively protected from arbitrariness, politicization, and rent-seeking. Index on a scale of 0 to 10, with higher levels indicating more autonomous bureaucratic systems; b. Bureaucratic Functional Capacity Index: Question measuring the degree to which the bureaucracy has salary compensation systems and systems for evaluating the performance of public officials. Index on a scale of 0 to 10, with higher levels indicating systems with higher technical capacities and more incentives for good performance; c. Bureaucratic Efficiency Index: Question measuring the degree to which the bureaucracy is efficient in assigning human capital, given a fiscal policy constraint. Index on a scale of 0 to 10, with higher levels indicating more efficient bureaucratic systems. Source: Columbia University State Capacity Survey; average 1990, 1999, 2000, 2002. d. Bureaucratic Quality Index: High points are given to countries where the bureaucracy has the strength and expertise to govern without drastic changes in policy or interruptions in government services. In these low-risk countries, the bureaucracy tends to be somewhat autonomous from political pressure and to have an established mechanism for 24 recruitment and training. Countries that lack the cushioning effect of a strong bureaucracy receive low points because a change in government tends to be traumatic in terms of policy formulation and day-to-day administrative functions. Source: International Country Risk Guide 1990-2005. Average value on a scale of 0 (low) to 6 (high).

[28] For a description of the dataset see Franco and Scartascini (2013).

Institutional and organizational capacity in the area of taxation can be gauged from a number of organizational indicators ranging from very low turnover in the directorates of the federal tax agency SRF, meritocratic recruitment and very remuneration levels for tax auditors (IDB/IMF/CIAT 2012). Tax collection productivity was very high comparative to the region. The productivity rate of both income tax and the VAT was the highest in Latin America throughout the 1980s and 1990s, second only to Chile (Lora 2001: 40-41). Professionalization and bureaucratic insulation was high during the period of military rule and continued under the democratic administrations. One remarkable example of institutional stability in tax administration was the continuity in the top echelon of the Secretaria da Receita Federal (SRF) following the transition from the PSDB administration of Cardoso to the PT's administration of Lula. Lula's maintained the deputy director of SRF who had been appointed by his rival.

As expected in the literature independent tax administrations are public goods and their establishment require that political actors discount the future at low rates. Military rule in Brazil was very stable and the transition to democracy was protracted and much longer than in other countries in the Latin American region. Historically *seignorage* accounted for a small share of government revenue and hyperinflation kicked in the early 1990s institutional capacity was already strong (Melo 2005).[29] Brazil's high growth rates with import substitution industrialization from the mid-1960s to the late 1970s helped legitimize state intervention and the deepening of the country's extractive capacity (ibid).

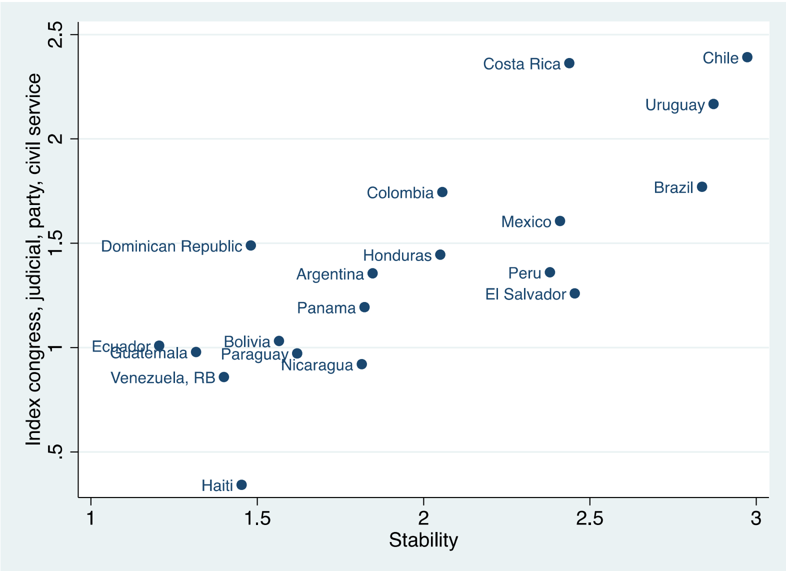
The professionalization of bureaucracies, in particular tax bureaucracies, is a component of state capacity, which encompasses other components, and is distinct from political capacity. The latter reflects the ability to pass legislation. Figure 10 provides information on state capacity in Brazil in comparative perspective. State capacity is the composite index created on the basis of partial indexes of judicial independence, bureaucratic capacity and legislative and party system capabilities. The index is an average for the period 1999-2010. Stability is an average of 4 indicators.

Using this metric, Brazil belongs to the cluster of countries that combine high state capability and high institutional stability. The executive ability to pass its agenda can be gauged by its host of prerogatives including the capacity to propose legislation and issue decrees, control the legislative agenda and require priority to presidential bills, powers of veto, exclusive powers to initiate legislation in a number of key issue areas such as the budgeting, administrative affairs, and taxation.

[29] The inflation tax in Brazil as a percentage of GDP was 5,2% in 1963-1973; 4,4% in 1973-78; 6,6% in 1978-83 and 8,2% in 1983-1987. In Argentina, by contrast, it reached 25,3 % in 1973-1978; 12, 04% in 1978-1983; and 22% in 1983-1987; see Melo (2005: 111).

The governments' political capacity in the democratic period was key for these developments and a fragmented party system was no obstacle for the approval of tax reform efforts. In Franco and Scartascini (2013) the index of policy capacity approximates what we call political capacity. Figures 10 and 11 show that Brazil belongs to the cluster of countries with high policy capacity. The Figures also contain information about institutional stability which the literature identifies as a precondition for tax capacity. Brazil similarly ranks in the top cluster of countries.

Figure 10: State capability and stability in LA

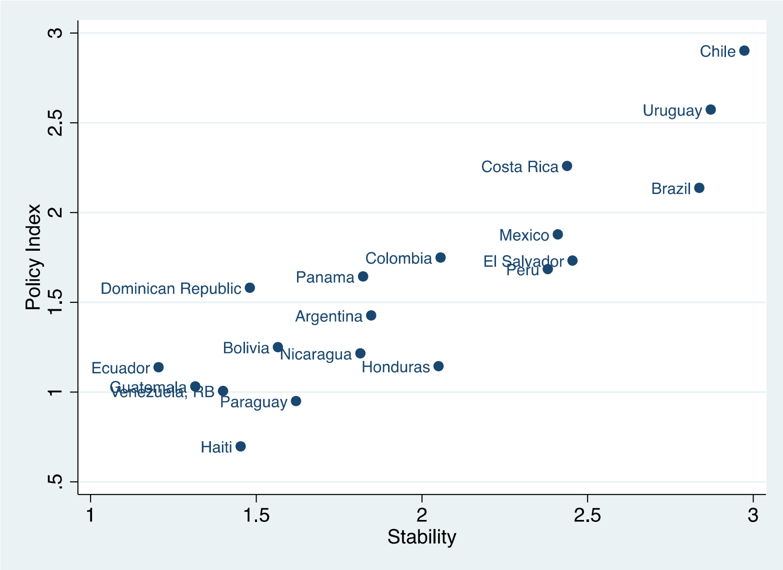


Source: Authors elaboration with data from State Capability Database (Franco and Scartascini 2013).[30]

In Figure 11, the policy index was created based on six variables: decisiveness, stability, coordination, implementation and enforcement, efficiency, and public regardedness.

[30] Notes. The stability index is based on 4 variables: a. standard deviation of the detrended Fraser Index: fraser1_all Source: Fraser Institute; 1999-2010. This variable had its scale reversed to compute the index. b. GCR Legal and Political Changes: Source: Global Competitiveness Report, 2002. Values and Details: This variable measures whether legal or political changes over the past five years have (1=severely undermined your firm's planning capacity, 7=had no effect). c. GCR Commitment: Source: Global Competitiveness Report; average 1998, 1999, 2000, 2002. Measures whether new governments honor the contractual commitments and obligations of previous regimes (1=not true, 7=true). d. Government Consistency: Source: Berthelier P., A. Desdoigts and J. Ould (2007). Experts evaluate the "Consistency and continuity of government action in economic matters", ranked 1 to 4, 4 being the highest score (high levels of capability, consistency, authority, rapidity, and confidence.

Figure 11: Policy capability and stability



Source: Authors elaboration with data from State Capability Database (Franco and Scartascini 2013).

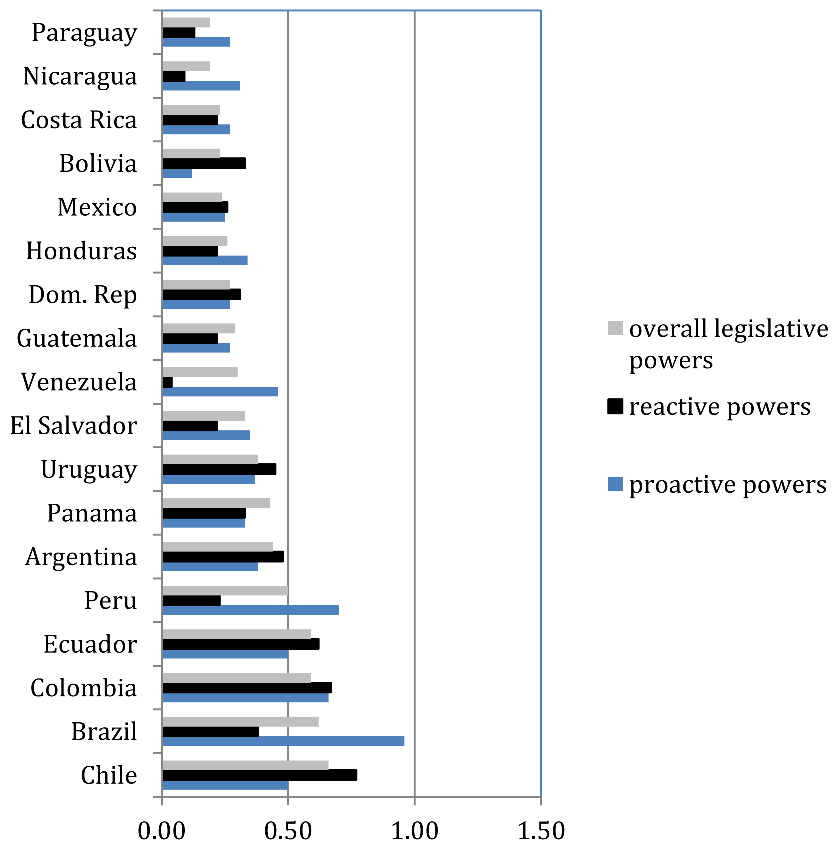
Of the political factors affecting tax policy outcomes, federalism has certainly played an important role. Contrary to theoretical expectations, federalism has not hindered taxation. On the contrary, in the case of Brazil, because there is no significant vertical fiscal imbalance, states have strong incentives to collect taxes. In the constitution of 1988, state political and economic elites have managed to secure an unusual favourable tax base (the state value added tax, ICMS). However, runway state finances created moral hazard and recurrent bail outs in the late 1980s and early 1990s exacerbated fiscal problems. The Cardoso government had both the incentives and the capacity to impose its preferences over the states leading to a significant recentralization in Brazil's fiscal federalism (Melo, Pereira and Souza 2010).

The capacity to pass an agenda of reform and institutional capacity to stabilize the economy is at the bottom of a great transformation in governance in Brazil in the 1990s (Alston et al. 2006; Melo and Pereira 2013). Figure 12 shows that Brazil has the second most constitutionally powerful presidency in the region. The chief executive in Brazil enjoys strong veto powers, as well as agenda powers and the ability to issue decrees with immediate legal effects.[31] The president has used his vast powers to implement reforms in a variety of issues areas and to impose costs on powerful constituencies. In fact, Cardoso presented a constitutional tax amendment in 1997 only to abandon the reform effort while the reform was being considered in Congress (this is discussed in detail in section 7.2). Rather than reflecting great resistance to the proposal this non-reform outcome can be interpreted as reflecting the executive preferences.

[31] Although Congress has the ultimate saying regarding such initiatives (the medidas provisorias), these measures create a de facto situation.

The Cardoso government in fact instructed party leaders of its coalition not to provide quorum for the vote of amendment. The government opted to maintain the status quo of an inefficient system that guaranteed high revenue over a streamlined one with uncertain future revenues. It opted for parametric gradual innovations over time. The executive ability to pass reforms can be found in various issue areas in the mid-1990s: it successfully passed 15 constitutional amendments, successfully approved and implemented the Real Plan and the Fiscal Responsibility Law (2000), and overhauled Brazil's fiscal federalism (Alston et al. 2006; Melo, Pereira and Souza 2010).

Figure 12: Constitutional powers of presidents in Latin America



Source: Inter-American Development Bank (2005)

In sum, bureaucratic capabilities, institutional stability and political capacity are factors that contributed to Brazil's high taxation since the nineties. This suggests that the lack of reforms in the last two decades is not causally related to inability to pass/implement complex reforms or because of resistance from interest groups. Non-reform outcomes result from the fact that governments have preferred the status quo over comprehensive reforms with uncertain future outcomes. We explore this question empirically in section 7.2.

7. What explains the recent tax/GDP rise?

In the light of the discussion in the previous sections what explains the degree of taxation and redistribution in Brazil over the last two decades? The theoretical and empirical insights emerging from the paper indicate strongly that correct answer to this question is unlikely to be a single causal factor. The main aim of this section is to pin down the main explanations emerging from the paper. The focus of the discussion here will be on assessing whether there has been a discontinuity in redistributive pressures and whether the absence of tax reform fits within a strategy for inclusion and a renewed social contract.

7.1 A discontinuity in redistributive pressures?

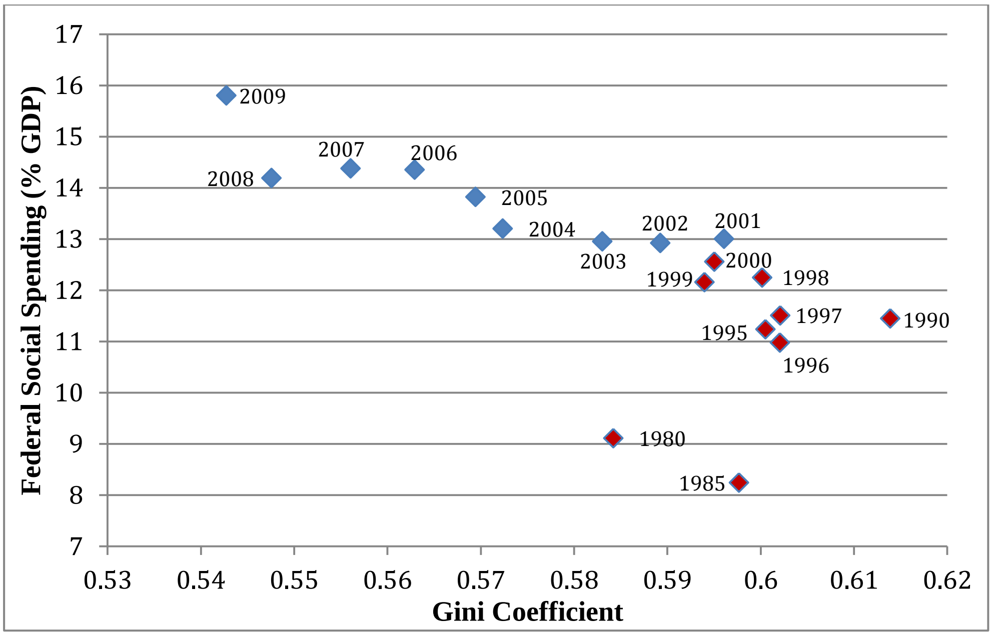
From a political perspective, the extent of redistribution must be explained ultimately by the incentives facing governments and by institutional capacities. In Brazil's case, political incentives for expanding taxation are associated with the strength of demand for redistribution that accompanied the transition to democracy. This is consistent with the predictions of median voter model. The expansion of the franchise in 1985 to incorporate a large share of the population in informal and low income employment shifted the median voters further towards groups with stronger primitive references for redistribution. This took place against a context of large polarization and vast inequalities. Redistributive pressures were encapsulated in the new constitution, which mandated fiscal decentralization and extended social rights. Most importantly, the Constitution set inclusion as the over-riding priority for public policy. These new priorities unleashed a programme of measures driven by a combination of territorial demands, reflecting the interests associated with states and municipalities, and pure redistributive pressures to redeem the so-called "social debt". The responses to these pressures caused a severe fiscal crisis which escalated into hyperinflation. It was left to left-of-centre parties to address the fiscal crisis.

However, the ramping up of social pressure was a necessary but not sufficient for sustained redistribution to occur. Fiscal sustainability and institutional capabilities were also fundamental component of the inequality reducing outcomes. The fallout of the trauma of hyperinflation was that beliefs about the value of social inclusion gave away to beliefs in social inclusion cum fiscal stability. As citizens became inflation averse, government responded with a stabilization plan to bring inflation down and reduce government deficit. The government had political and institutional instruments to pass legislation and to promote an array of economic reforms, most of which required constitutional changes. A crucial component of these reforms was fiscal reform. The rapid and sustained increase in taxation reflected the re-assertion of the authority of the federal government in fiscal affairs, including in federal-states relations. Unlike many countries in the region, the Secretaria da Receita Federal and the Ministry of Social Security were highly professionalized bureaucracies, which had the institutional capacity to further expand taxation. These bureaucracies did not need to be overhauled or reformed, as they already possessed the instruments – political insulation, technological capacity, and human resources - needed for expanding tax revenue collection. The existing tax system contained a host of inequities and inefficiencies and although a number of incremental changes were gradually made no major reform was implemented. Under Franco's (1993-1994) and Cardoso's (1995-2002) administrations, the governments initiated, but then abandoned, plans for comprehensive reforms. They opted instead to keep a highly inefficient tax structure with high extractive capacity over an efficient system with uncertain future revenues (Afonso 2013).

The new literature on redistribution and beliefs shows that redistributive outcomes do not inexorably follow from shifts in the median voter following democratisation (Benabou 2000; Alesina and Giuliano 2009). Multiple equilibria can emerge from similar conditions. In particular, shared beliefs mapping institutions to outcomes ultimately could determine policy. Alston, Melo, Mueller and Pereira (2013) argue that shared beliefs that redistribution is associated with superior societal outcomes can explain the policy options adopted by governments in Brazil since the mid-1990s.

Figure 13 plots federal social spending against the Gini measure of inequality for 1980, 1985, 1990 and 1996-2009. The data describes a shift from the southeast to the northwest, consistent with a discontinuity in pressures for redistribution and their underlying sets of beliefs. The changes appear modest given the scale of the graph, but it is important to keep in mind that historically the Gini coefficient of income in Brazil has exhibited little change. The near doubling of federal social spending from 1985 to 2009 most probably underestimates government-led redistribution. A significant number of inclusive policies in Brazil work through regulation aimed at increasing access and participation and through the government payroll (Medeiros and Souza 2012). Nevertheless, the direction of change in the past decade is indicative that the shift towards a more north-westerly equilibrium has not yet been concluded. It is likely that pressures to reduce inequality and generate inclusion will strengthen further in the coming years.

Figure 13: Changing Combinations of Inequality and Redistribution over Time



Source: 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) and estimates of % federal in Ipea (2009: 42-44). Using the estimates in Ipea (2009) to calculate the spending for 1995 and 2005 matches closely the data in Ipea (2011) so the numbers for 1980-1990 seem to be reasonably comparable. Gini data from Ipeadata http://www.ipeadata.gov.br/.

Figure 13 also shows a break in the relationship between social spending and the Gini around the turn of the century. Changes in social spending similar to those recorded for the 1980s and 1990s are now associated with a strong and sustained reduction in the Gini. This break suggests a more structural change. The argument is that Brazil has changed its social contract. In the spirit of Bénabou (2000) and as illustrated by Alston, Melo, Mueller and Pereira (2013), the changes in Brazil's fiscal contract can be seen as a move from a low-redistribution/high-inequality equilibrium towards a higher-redistribution/lower-inequality equilibrium. The fiscal contract is part and parcel of an emerging new social contract. The conventional view dates the emergence of a new social contract to the return to democracy in 1985. But Alston, Melo, Mueller and Pereira (2013) identify a sharp change in beliefs towards in the mid-1990s, now combining social inclusion with financial responsibility. The figure suggests that the break in the relationship between social spending and the Gini can be tracked down to the turn of the century. It is consistent with the expansion of social assistance programmes and changes in the minimum wage, measures focused on low income groups.

Whilst it is possible to identify a discontinuity in pressures for redistribution and a renewed social contract, it might well be that a new equilibrium has not yet been reached and that the process of transition is still actively underway. On the one hand, redistributive social policies in Brazil continue to be a government priority. On the other hand, there are growing voices pointing out that social policy activist might have implied a trade-off between redistribution and other important areas of public policy, infrastructure investment for example. The recent slowing down of growth has brought to the surface the fact that consumption based growth will be increasingly constrained by infrastructure deficiencies and low productivity.

7.2 Why it is so difficult to reform taxation?

This section addresses the puzzle of the failure of tax reform in Brazil. As already pointed out, institutional change in Brazil has been incremental and no tax reform has been carried out since the promulgation of the constitution of 1988. This should not be taken to mean a shortage of proposals for tax reform. In fact there have been numerous initiatives for tax reform that never materialized. Many proposals are discontinued only to be resurrected with strikingly similar content at a later date. However this is not to say there has been no change. Using information from an inventory of reforms in taxation by Price Waterhouse, Focanti et al (2013: 12) found 23 minor changes and 7 major changes in tax legislation between 1990 and 2004, the highest number of reforms after Argentina and Mexico for the same period. What is surprising is that the basic structure of taxation has not changed. What is puzzling is that no comprehensive reforms have been implemented despite the massive increase in tax revenue from 1994 and 2003.

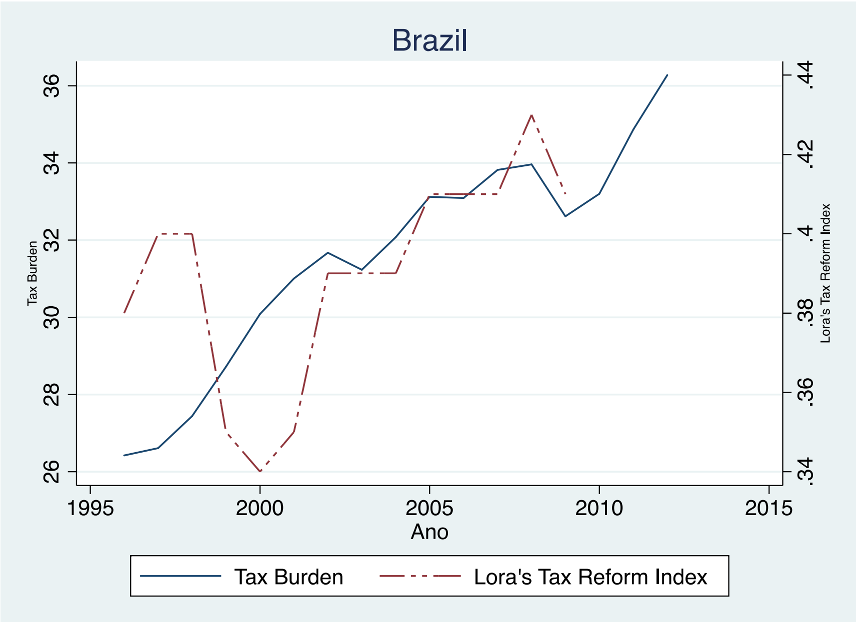
The other puzzle is that tax changes have primarily had the single objective of expanding revenue with no efficiency or redistributive considerations in mind. The current tax system has been described as highly inefficient and regressive but it is functional to governments because of the large revenue it generates. There is some support for the argument that policymakers and political actors have converged in the notion that redistribution is to be achieved primarily via social spending not taxation.

By virtue of the extensive constitutionalization of tax policy in Brazil (detailed in 17 articles of the constitution), comprehensive reforms would require changing the constitution. Over the last two decades two constitutional reforms proposals were discussed. The first, during the Cardoso government, was never passed or implemented, whereas the second, during the Lula government, was approved in 2003 (discussed in this section). Other minor reforms that did not require constitutional reforms focused on personal and corporate income taxation and marginally on VAT rates. In 1995 the government revamped the taxation of small business by introducing the so-called SIMPLES scheme, and implemented measures to close many loopholes in transfer pricing. In line with international trends, governments have lowered the top rates of personal and corporate income tax.[32] In

[32] The rates were reduced from 60% in 1985, to 50% in 1987, 25% in 1989, 35% in 1995, 25% in 1997, and 27.5% in 1999. These have become in force until late 2008 when a new rate scale was introduced consisting of 4 rates using the existing top and lower brackets .For business the corresponding rates

addition, changes were introduced to broaden the tax base. VAT rates rose marginally in the period. Figure 14 shows that there is no clear link between reforms and the tax burden: the changes in the reform index are modest ranging from 0.34 to 0.42 whereas the tax burden has risen by 7% percentage points between 1996 and 2010.

Figure 14: Tax burden and the Tax reform index



Source: Lora (2009) and OECD/CEPALSTAT

Many important changes, however, occurred by stealth. The share of the population paying income tax expanded considerably over the last two decades because the income threshold for filing tax returns has not been adjusted in line with inflation. Between 1996 and 2001, for example, the nominal value for income tax exemptions and the rate of income tax remained unchanged.

In line with trends elsewhere in Latin America in the 1990s, reduction to the rate of income tax on the profits of corporation was implemented. The withholding of tax on profits and dividends paid to individual taxpayers, set at 15%, was eliminated and law 9.249/95, art. 9º, introduced new deductions for interests on capital invested. In the mid-2000s the tax on profits from foreign investments in government bonds (law 11.312/06) was eliminated. The taxation of financial gains from stock market operations was reduced from 25% to 15% and that of government bonds from 22.5% to 15% according to the time frame of operations (Law n° 11.033/04).

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were reduced from 40% in 1985, to 30% in 1990, to 25% in 1995 and 15% in 1996 (but with a special additional rate of 10%).

The main focus of the tax reform agenda since the early 1990s, and which has remained in the agenda up to the current Lula's tax proposal, was not the taxation of income but the taxation of consumption. First, the most important proposal was the creation of a national VAT, by the fusion of the IPI, the federal VAT, and the ICMS, state VAT. Second, the conversion of the existing system into a destination VAT whereby tax is collected at the place of consumption rather than production of goods and services, thereby ensuring tax harmonization with other countries. Third, eliminating cumulative taxation particularly those associated with the social contributions. Fourth, eliminating the taxation of exports. Fifth, streamlining the system by making it simpler, while maintaining the level of revenues collected. The first two of these goals – the national VAT and the change in destination VAT failed. The third was partly attained although the achievements were modest. The fourth was fully accomplished. The last also failed despite the simplification of procedures in the taxation of small firms accomplished by the introduction of the SIMPLES mechanism.

Most legislative battles over the last decade and a half have involved tax and fiscal reform initiatives first proposed in the early 1990s. Under the administrations of President Itamar Franco and President Fernando Henrique Cardoso, a reform priority was the elimination of earmarking of tax revenues to support funds mandated for distribution with the states. This led to the Social Emergency Fund, later successively extended and renamed Fiscal Stabilization Fund in 1996, authorizing the untying of 20% of all federal taxes, over which the executive had full discretion. In 2000, it was reformulated and renamed DRU-(*Desvinculação de Recursos da União*), with its extension approved by Congress until 2015. By the same token, a tax on financial transactions (IPMF) was approved on a provisional basis (later renamed CPMF) and a comprehensive tax reform package was proposed in 1995.

The most important reform proposal of the last two decades was the Constitutional Amendment (PEC 175) presented by Cardoso's administration in 1995. The PEC 175 was relatively timid even by Brazilian standards where reforms are incremental. The central idea behind the proposal was to eliminate the Tax on Manufactured Products (IPI) which is levied at the federal level and changes the structure of the current state ICMS so as to create a single tax levied both at the federal and state levels. A single value-added tax to be collected by central-level authorities was a long-term objective of successive governments. In its first stage, a two-tier ICMS "would be introduced with two distinct tax rates, to be collected by federal as well as state administrations. The new ICMS rules defining permanent tax rates was believed to stop what has been dubbed a "fiscal war" among the states, since any companies benefiting from tax waivers in a particular state would undergo an increase in the federal rate by the same proportion.[33]

[33] States engaged in fiscal wars by reducing the rates of state taxes in order to attract investments

Another item in the reform proposal was the collection of the ICMS at the state of destination of products, not at the origin, thus substantially benefiting the poorer consumer states. Various versions of the proposal were discussed after amendments were incorporated in the Committee.

In 1998 the Ministry of Finance proposed a new draft of the amendment, which was viewed as an alternative counterproposal to that presented by the committee's *rapporteur*. The proposal called for the replacement of the ISS, IPI, ICMS, CSLL and the main cascading taxes, i.e. PIS and COFINS, with a single federal VAT, a state retail sales tax and a selective tax in place of the IPI. It was a more comprehensive proposal than that initially presented in PEC 175 but the government never mobilized its party leaders to put the proposal to a vote.[34] In fact, it actively worked to undermine the workings of the committee. Party leaders, for example, backing the government instructed party members not to be present so as that the committee would lack a working quorum (authors' interview with committee members). [35]

The early 2000s were marked by deadlock. Discussions were held around the same issues that had dominated the tax reform agenda for a decade. None of the proposals secured strong government interest. The only new development in 2001 was the creation of the CIDE contribution earmarked for the transport sector. This signaled that any attempts at comprehensive reform were abandoned in favour of sustaining tax revenue collection levels. In 2002, *Medida Provisória* 66 enabled the government to assemble an array of marginal changes in a symbolic mini-reform that could be called a reform proposal. With very limited in scope indeed, the reform was restricted to measures that could have been put in place by means of an ordinary law, hence avoiding the political stress involving the approval of a constitutional amendment. Basically, the COFINS was converted into a non-cumulative tax, an arrangement was created for the CIDE revenue sharing and the DRU and CPMF were extended. Other items on the reform agenda were tax relief for some economic activities, the simplification of procedures for small businesses taxation. An important efficiency enhancing and job generating proposal was replacing some payroll by turnover taxes. The government submitted a constitutional amendment for the creation of a federal VAT (PEC 383, of 2001), which was never put to a vote.

[34] During Cardoso's second administration the taxation committee worked on the proposal and approved a draft solution that was not supported by the government. The committee presented the proposal to the tax reform agenda as an informal contribution. The president of the Chamber of Deputies then announced that the government was not going ahead with tax reform.

[35] Many of the committee members had political links to business organizations. It is interesting to note that the proposal counted on the ample support in many sectors, particularly business. *Ação Empresarial*, for example, led by Jorge Gerdau – one of the most vocal representatives of business in Brazil and a global steel magnate embarked on a public campaign for the reform. The proposal was never put to a vote in the legislature 1995-1998, despite the fact that the *rappporteur* had prepared 3 reports.

Shortly after his inauguration, President Lula proposed the second important attempt at tax reform, also via constitutional amendment. Essentially the same issues of the reform agenda were resurrected. The proposal entailed limited changes in the tax structure. While it involved widening tax base and increasing rates, its net impact on the overall tax system was expected to be neutral across levels of government. The proposal called for a nationally unified legislation for VAT taxation by the 27 Brazilian states. A fusion was proposed of cascading contributions to form a new federal VAT. The COFINS should be transformed into a non-cumulative tax along with the PIS-PASEP. Taxes on companies' payroll should be scaled down, while the social security system should be financed in part by an extra turnover tax. A modified version of the initial proposal was thus agreed in Congress and approved as constitutional amendment number 44. The more controversial and radical changes would be considered separately in a new PEC. But this never materialized.[36]

Unlike the previous governments, the Dilma Roussef administration (2011-2014) has not presented any tax reform proposals. The only important change was the elimination, in September 2013, of the COFINS /PIS PASEP on a basket of goods consumed by the poor. [37]

Developments in the area of tax reform in Brazil, since the early 1990s, have a number of distinct features. First, there is a recurrent reform agenda that has never been implemented despite the Executive's enormous preponderance in its relations with congress, which are evident in other issue areas such as fiscal federalism and social security. In these areas the government was successful in implementing reforms that affected negatively the interests of the states and municipalities. Second, reform initiatives have been discontinued because the Federal government has opted for an inefficient system with high extractive capacity to an efficient system with uncertain future revenues.

As discussed before there have been numerous proposals that were never seriously considered by the government. Paradoxically, these include proposals that were presented by the government itself. The fate of the most important proposal presented in the last 15 years - PEC 175 - is illustrative of the logic underlying tax reforms. A substitutive proposal submitted by the committee came to light in September 1996, but was discontinued. The government refused to accept the *rapporteur's* substitute proposal and decided to stop negotiating the PEC 175. One

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[36] The government discontinued proposals for a major revamping of the tax system. However, in 2007, during Lula's second term of office, they resurrected as amendment proposal 31- a, also known as PEC 255. The aspects covered in the proposal are similar to those of previous reform proposals: uniform state VAT legislation all over the country to be created; turnover and cascading taxes (PIS/PASEP, COFINS) to be converted into a single federal tax; provisional contribution on financial transactions (CPMF) to be made permanent among others. At the time of writing, this bill has not been put to a vote.

[37] The proposal was enacted by Medida Provisoria 609 /2013 and finally approved as Law 12.860/2013.

possible - but misleading - interpretation is that the government was blocked in his proposals and therefore decided not to pursue the reform further. In fact, the payoffs of the reform game had changed as a result of the developments in run against the real following the Russian and Asian crises. Crisis inhibited reforms, particularly those geared towards efficiency gains as opposed to revenue boosting.

It became apparent for the key players that the federal government had in fact decided to abandon the reform due to the worsening economic conditions in the wake of the Asian and Russian crises and the subsequent run against the real. The government then pursued a strategy of passing ordinary legislation on specific aspects of taxation.

In sum, the fate of Cardoso's tax reform is associated with risk aversion and the uncertainty about the short-term impact in terms of losses and gains. One of the authors of the reform proposal repeatedly reminded his audience that good taxes are old taxes. The international crisis and the run against the real made economic policy-makers risk averse. They refrained from presenting a comprehensive reform of Brazil's tax system that might lead to less revenue. Passing such a reform would also have implied a nontrivial political cost due to the fact affected many interests, including business, regions and subnational governments. The government had the political clout to pass it but the game around reform changed.

Second, non-reform was also a product of the relative success in introducing incremental changes that did not require changing the constitution. [38] These included the extension of a temporary Tax on Financial Transactions (CPMF); the extension of the de-earmarking schemes; a simplified mechanism for taxing small businesses (SIMPLES); a specific proposal eliminating ICMS on exports (the so-called Lei Kandir; and the raising the rates for of a high yield social contribution, the COFINS). These marginal changes were instrumental in generating more revenue and at the same time made the system marginally less inefficient. As indicated before, the government preferred the status quo of a highly extractive inefficient tax system to an improved system with uncertain revenue outcomes.

In 2007, the ministry of Finance during Lula's honeymoon year after reelection for his second term of office presented a second constitutional amendment in the area of taxation. His proposal was comprehensive and called for the merging of social contributions (PIS PASEP, CSLL, COFINS) with IPI to form a new federal IVA. The proposal faced resistance from a wide array of institutional actors: 60 associations – including the National Council of Health (CNS) - called for the abandonment of the

[38] These included the extension of a temporary Tax on Financial Transactions (CPMF); the extension of the de-earmarking schemes; a simplified mechanism for taxing small businesses (SIMPLES); a specific proposal eliminating ICMS on exports (the so-called Lei Kandir; and the raising the rates for of a high yield social contribution, the Cofins.

proposal.[39] The fate of the reform was similar to that of the Cardoso's reform – the government instructed the party leaders not to present the proposal for the vote.

A third factor explaining non reforms is the emerging consensus around the view that that regressivity issues in the tax system were not a priority issue in the public agenda. Policy makers have converged on the view that redistributive objectives are best secured via spending (Afonso 2013; Melo et al. 2009). While the regressive effects of indirect taxation have not attracted great interest in the public agenda, some efficiencies issues have been addressed but no acted upon. Importantly, the main institutional actor in the decision-making arena of indirect tax policy, the states, face a prisoner's dilemma when it comes to eliminating VAT on the basic foodstuff because despite contributing to a what they perceive as national political issue they would see their revenue decrease.

Some major government reversals in taxation policy reflect an increasing reluctance to support further increases in the tax burden. An important example is the elimination of the tax on financial transactions (CPMF). Popularly called *imposto do cheque*, the CPMF was created in 1996 as a federal contribution applied to all financial bank transactions. Originally designed to be a temporary tax allocated to the universal health care system, the SUS, the CPMF lasted as a provisional contribution for about 12 years. It was finally taken off the books on 13 December 2007 when the executive's bill requesting its extension until 2011 was defeated in the Senate. It was a major upset because the executive's majority coalition was not able to obtain the necessary majority of 49 votes in the Senate, but just 45 votes. With this political defeat in Congress, one of the few examples of setbacks in political negotiations for the Workers Party governments, the government lost about R$ 40 billion in revenue. Without success, the government promised to allocate part of the CPMF to education. Anticipating that it would be defeated, the government, as a last resource, sent a letter signed by the finance minister promising that the CPMF would be entirely allocated to the SUS.

This episode represents a signal and a remarkable mobilization of several different sectors in the society (media, interest groups, business sectors, etc.) and opposition players that the leverage of the federal government to keep increasing the tax burden was running out (Kerstenetzky 2009). One of the most important criticisms the CPMF received from those sectors was the lack of transparency in its allocation. In fact, the CPMF was never fully allocated to the universal health care system as it was originally intended, as it contributed to financing other policies including the government's commitment to a primary surplus.[40]

[39] The CNS argued that the existing social contributions were earmarked for social security and health and this hardwiring protected these funds from being used for other purposes. (CNS 2008).

[40] The social movements against the CPMF, by the Industry Federation of the State of Sao Paulo – FIESP and composed by more than 200 unions and associations (http://www.contraacss.com.br/), was able to gather more than 1.5 million signatures all over the country against the CPMF and at the

Another example of a successful tax revolt in Brazil is the massive protest against the provisional measure MP 232 in 2005. A manifesto of the *Frente Brasileira contra a MP 232*, subscribed by 1,100 professional and trade associations of service providers including doctors, engineers, architects, journalists, led to the withdrawal of the provisional statute ("Entidades lançam manifestam contra a MP 232", *O Estado de São Paulo*, 15/02/2005).

8. How sustainable is the fiscal contract? Breaking the equilibrium

Per capita social spending has more than doubled in real terms since 1990 and inequality has declined significantly and almost monotonically since 1994 (Higgins and Pereira 2103). The tax burden has also shown a sustained increase since the mid-1990s. The issue to be discussed in this section is whether there are limits to further increases in the tax/GDP ratio and social spending, and whether maintaining existing levels of tax and spending are likely to threaten the fiscal and social contract.

In fact, there are signs suggesting emerging uncertainty in terms of the future political sustainability of the current social contract, which is crucially dependent on taxation and fiscal management. According to the received wisdom on taxation and social contracts encapsulated in the formula "no taxation without representation", taxation is intrinsically linked to democratic accountability. In what could be called an exchange theory of democracy, the latter emerges as a precondition for revenue extraction (Timmons, 2005). The assumption is that governments need the consent of citizens to collect taxes from them.

The current tax burden in Brazil is very high prompting concerns on the part of business elites about country's competitiveness problem (the so called "Custo Brasil"). This has generated business resistance and more generally elite's active mobilization against taxation. On the part of citizens, there has been great politicization of taxation issues. Breceda, Rigolini and Saavedra (2008) argue that Latin America faces political sustainability problems because taxation is concentrated in the elites. The authors extend a similar argument that was advanced for the analysis of the US and argue that in Latin America the political sustainability issues are compounded because income is very concentrated.[41] According to these authors in Latin America the share of taxation by the richest income quintile averages 61% - much higher than the share accounted for by the richest quintile in the UK (43%) and similar to corresponding share of the quintile contributions in the

same time supporting the idea of a comprehensive fiscal reform. Actually, this movement continues to be active as a kind of "vigilante" against any further government's attempts to bring the CPMF back in and mobilizing the society in opposition to additional tax increase.

[41] For a sample of Latin American countries, the rich were estimated to pay on average 82% of all income taxes while the poorest income quintile pay only 1.2% of total income taxes.

US United States (58%). By contrast, the poorest income quintile contributes pays 22 times less than the poorest quintile.

The upshot is that tax rates have to be significantly higher than the US and much higher than European countries to obtain the same absolute level of revenue. As a proportion of their income the rich do not necessarily contribute more than in in Europe, however, because of high-income inequality their contributions to tax revenues must be much higher than in Europe and, in the case of Brazil, the US. The dilemma is described as an inequality trap: "Latin American countries seem to be trapped in a vicious circle where high income inequality prevents increasing tax revenues, which in turn prevents the state to act as a provider of opportunities, and which in the long run keeps inequality high. How to induce the rich to contribute even more remains a serious challenges." (Breceda, Rigolini and Saavedra 2008: 14).

Raising additional revenue faces therefore increasing marginal political costs. In a context of rising expectations and severe unmet needs, the tensions might result in heightened political strife. Immervoll et al. claim that "no European Union country exhibits income taxes and contributions as concentrated on the better off as Brazil" (2009: 15). Daude and Melguizo (2010) in turn, argue that citizens may consent with taxation in return for improved services and more transfers. They argue that "the members of the middle quintiles have a 'dissatisfied customer' relationship with the state: while relatively supportive of taxation, they are not satisfied with the services they receive."(Ibid, p. 19). They argue optimistically that the middle sectors display higher 'tax morale' than other members of society. Using data from Latinobarometro surveys, the authors found that they are more likely to consider that citizens should pay their taxes, less likely to consider that taxes are too high, and less likely to justify tax evasion. At the same time, they are also less satisfied with the provision of public services.

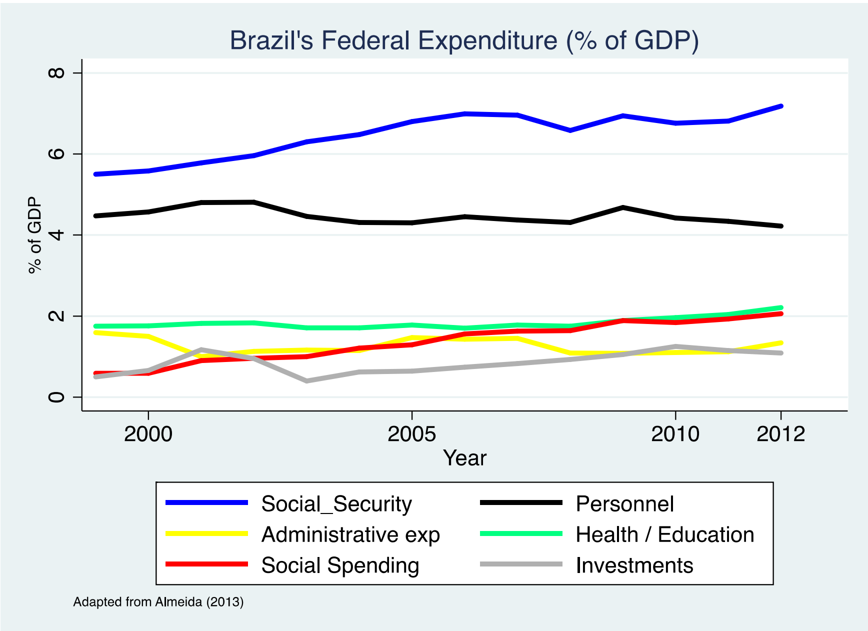
A less optimistic view is offered in Gaviria (2007) who argue that the negative views on social justice and equality of opportunities creates a high demand for redistribution and the weak support for market outcomes in Latin America in the late 1990s and early 2000s. For Daude and Melguizo (2010) risk aversion and the demand for social insurance against the risks of downward mobility or stagnation may dominate the POUM effect (an argument advanced in Benabou and Ok 2001).

Siqueira and Nogueira (2010) offer an even more pessimistic view. They argue that the coexistence of high tax burden and low redistribution in Brazil is puzzling and contradicts the predictions from median voter theory. In addition they claim that the coexistence of high inequality and heavy taxation is also puzzling in the light of theories of social contract. Specifically these authors argue that theory of fiscal illusion can account for the two puzzles: the lack of transparency in state financing – such as complex and indirect tax structures – creates a fiscal illusion that will systematically produce higher levels of public spending than those that would be observed had voters correctly perceived the 'tax-price' of public output. By heavily relying on the exploitation of fiscal illusions, the Brazilian state has been able to mobilize a huge amount of tax resources without the need of a broad social contract that could lead to more redistribution and better effective public services.

In Brazil the constraints to the fiscal contract are substantial (Pessoa 2011). Since the mid-1990s a succession of governments has managed to generate a fiscal surplus around 2 to 3% percent of GDP (except for the Rousseff government that has reduced the surplus to around 1%). Importantly, public expenditures have been stagnant or stable in key areas such as administrative and personnel expenditures. This suggests that the federal government has managed to keep these politically sensitive areas at bay and have insulated social expenditures from expenditure cuts.

Figure 15 shows that personnel expenditures declined from 4.3% to 4.2% between 2000 and 2012 while administrative costs (current outlays) declined from 1.8 % to 1.6% in the same period. By contrast (non-pension) social spending has increased monotonically since 2000: it jumped from 0.5% of GDP to 2.1%. Future social spending implies further tax revenues in a context where the current tax burden is already 36% of GDP and administrative expenditures and personnel are stagnant. More importantly, on the revenue side only 7% of the economic active population pays income tax and 97% of the income tax comes from the top income decile (Higgins and Pereira 2103; Afonso 2013).

Figure 15: Public expenditures by sector 1998- 2012



Is Brazil caught in a vicious circle and in an inequality trap, as argued by Breceda et al. (2008) and Immervol et al. (2008) for Latin America? First, this argument seems largely flawed because of its emphasis on direct taxation as a possible solution to the expansion of social spending. This argument rests on the assumption that redistribution can only be attained via taxation and overlooks the fact that redistribution can be achieved via social spending. In Brazil the early introduction of indirect taxation and the expansion of the extractive capacity of the state followed a path that is roughly similar to that of some welfare states in continental Europe. Building a comprehensive social security system with universal health care implies the introduction of tax instruments capable of generating massive revenues, and indirect taxation is one such instrument (Kato 2003). [42]

High inequality is indeed a formidable obstacle to expanding taxation but there are alternatives. The problem of revenue generation is compounded by the existence of a large informal sector – in the case of Brazil accounting, on average, for half of the labor market in the last decade or so[43]. Second, the inequality trap argument overlooks the extent of inequality reduction already attained, which is associated with consumption-led growth, and ultimately with more revenues. Redistribution has benefitted the mid quintiles which are net beneficiaries, particularly because pensions are concentrated in those mid quintiles.44 Third, fiscal illusion can explain part of the low visibility associated with the fiscal system. However, the recent politicization of tax issues has enhanced public perceptions of inequities in taxation. Taxation has become more prominent in public debates and is increasingly politicized. Because indirect taxes account for a large share of tax revenue, they are less visible. Although personal income tax is mildly progressive in Brazil, the harmonisation of personal and corporate income tax rates has meant that the rich can face lower average income tax rates than the middle classes. Tax incidence studies reported above show that the poorest two deciles pay proportionately more taxes and receive fewer public transfers than middle income groups who capture a significant proportion of social spending through generous pension benefits. This is because groups in the middle of the distribution are net beneficiaries of social security benefits, particularly old age pensions and unemployment benefits, and of government expenditures in education and health care. Over time the progressivity of education and health has improved significantly because the middle-income groups have opted out of public schools and the SUS.

Taxpayers have become increasingly disgruntled by high taxes. As figure 16 shows Brazilians agree that taxes are too high more than any other nationality in the region. Importantly the poor has become increasingly aware of high taxation – 66.7%

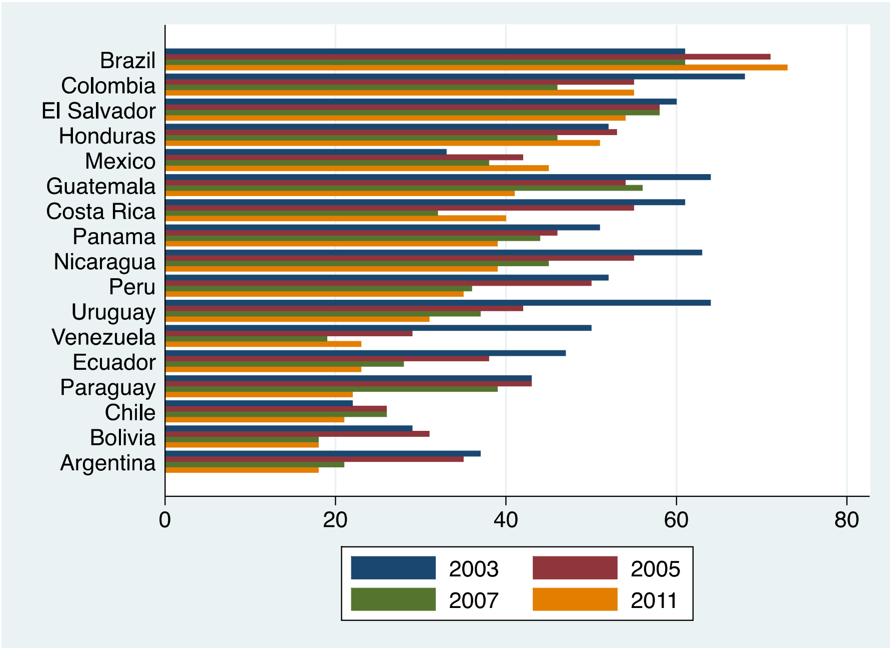
[42] Particularly in the context of low growth and high unemployment that have characterized OECD in the last decade or so.

[43] There has a notable reduction in the last three years, and in January 2014 it reached 32, 2 – historical low record according to IPEA, a government think tank.

[44] 85% of transfers are pension benefits and 94% of all benefits go to pensions. Indeed, redistribution is substantial if in kind services are considered. (Higgins and Pereira 2013; Higgins et al. 2013; Afonso 2013).

percent of respondents to the Latinobarometro concurred with the assertion that taxes were too high.

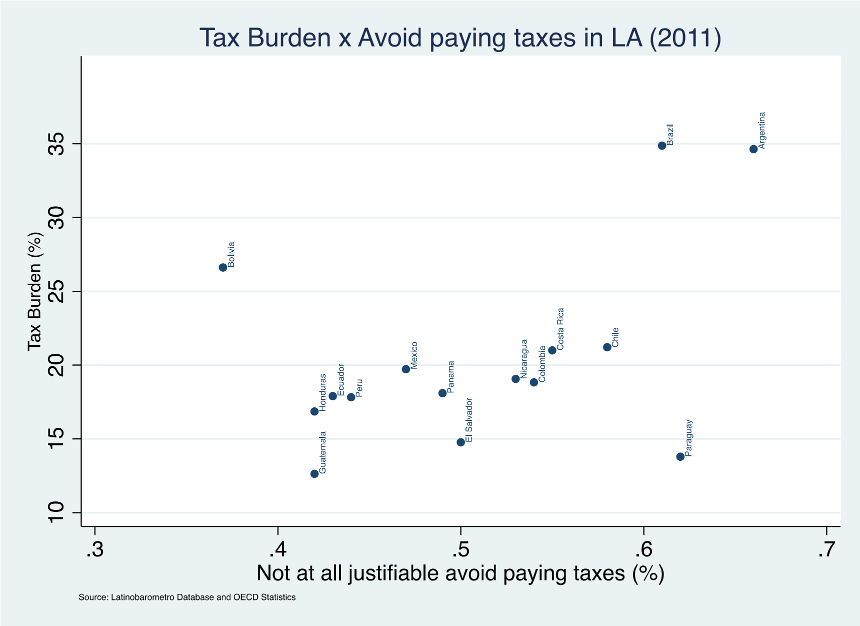
Figure 16: Public opinion and the tax burden
(% that agrees with statement "the taxes are too high")



Source: Latinobarometro

Interestingly, 82.4% of the individuals whose self-reported incomes were at the third decile of the income distribution agreed that taxes were too high – the highest percentages of all income groups. Importantly, the public sentiment that taxes are too high is not associated with low tax morale. As Figure 17 shows, the percentage of respondents that agree that it not at all justified avoiding taxes is the second highest in Latin America. Brazilians agree that taxes are very high but avoiding paying taxes is not justifiable.

Figure 17: Tax morale and tax burden



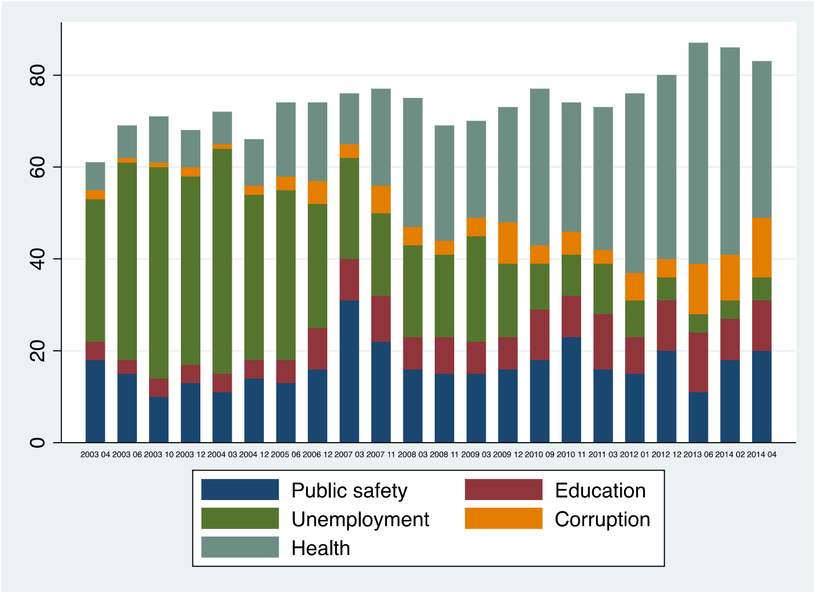
Source: Latinobarometro, OECD (2003)

We hypothesize that the social contract is currently affected by the new politics of tax accountability that have emerged in the last decade or so in Brazil. The new politics of tax accountability is the product of both macroeconomic changes and social inclusion. The key macroeconomic change was monetary stabilization and growth while increased social inclusion expanded the middle classes and reduced the group of extreme poor and moderate poor.

The second most important factor influencing policy priorities is social inclusion. The emergence of a new middle has increased the demand for publicly provided health care and education services. In addition to the consumers of such services, there is a crowding out effect on existing consumers because rising household income effect have led families to opt out of the public education and health care.

These developments raise the politicization of the social contract. The replacement of economic issues, unemployment and inflation, with public services as the most important policy priority, as Figure 18 denotes, has implications for political accountability and taxation.

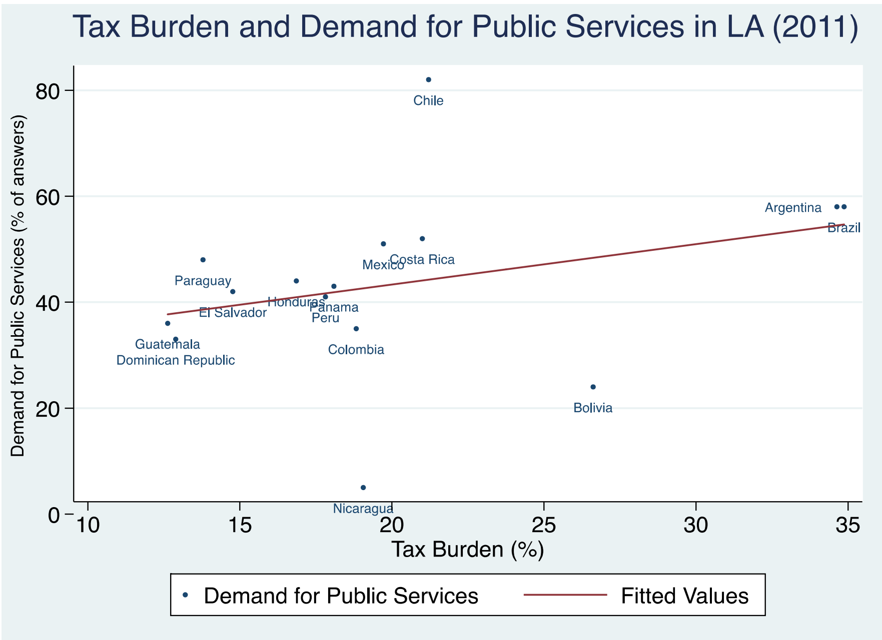
Figure 18: Citizens' perceptions of main challenges facing Brazil 2003-2014



Source: Datafolha

Whereas the former does not have a direct link to tax accountability issues, public services necessarily involve the notion of a balance between provision of quality services in return for taxation (see Figure 19). These developments seem to be important material underpinnings of the normative views of taxes and services identified by Daude and Melguizo (2010).

Figure 19: The demand for public services and tax burden in Latin America



Source: LAPOP

There are limits ahead for expanding taxation but they are not currently binding. But now we are facing a critical juncture. The very high level of taxation (i.e. the easy solution as business as usual is running out of gas), the politicization of the issue and the pressures for better quality in public services are engendering a strong basis for a new accountability pattern. In this pattern people demand less corruption and better services in exchange for tolerating high taxes.

9. Conclusions and implications for Africa

This section summarises the main conclusions, and considers the main findings of the paper in an international setting.

A political economy explanation of Brazil's rise in the tax/GDP ratio

The paper offers an explanation of the tax/GDP rise in Brazil from a political and political economy perspective. Longstanding features of the Brazilian economy and tax system provide the starting point. Brazil relatively closed economy and the absence of significant mineral resource wealth discouraged reliance on foreign trade taxes and on natural resource revenues which in other countries enabled elites to circumvent the need to negotiate taxes with their citizens. These two features encouraged early fiscal agreements with taxpayers and ensure a workable tax system. Historically, Brazil has had higher tax/GDP ratio than the rest of Latin America. In addition, bureaucratic capacity has ensured a relatively effective tax administration. The introduction of VAT in 1966 and improvements in tax administration by the military government are associated with the earlier step rise in the tax/GDP ratio and ensured a dominant role for indirect taxes in the tax mix.

The rise in the tax/GDP ratio under democracy has different features. It is not the consequence of significant tax reform or marked improvements in tax administration. Instead, it reflects an increase in revenue collection across the components of the tax mix, except for taxes on foreign trade, which are marginal in any case. The 1988 Constitution and the fiscal stabilisation in the mid-1990s led to the introduction of 'social taxes', presented as temporal tax components hypothecated to finance the expansion of social policy and to address acute inequalities and exclusion. Aside from 'social taxes', there has been no large scale reform to the tax code. The 'balanced' growth in tax revenues has meant no change in the neutrality of the tax system as a whole. Marginal progressivity in direct taxes is compensated by regressive indirect taxes.

Until the last few years, tax policy received very little attention in policy discussions. The implicit 'consent' for the rise in the tax burden by taxpayers, or perhaps more accurately the absence of 'dissent'[45] can be largely explained by the main elements of the emergent social contract. The paper discussed several elements with particular salience in the context of Brazil with implications for the level of support for redistribution.

First, the extension of the franchise in 1985, incorporating at a stroke the large illiterate population shifted the median voter towards lower income groups. As predicted by the median voter model, this extension strengthened popular support for redistribution from the 1989 election onwards, the first presidential election after the ending of dictatorship.

Increased political and programmatic competition has strengthened demand for redistribution. The Constitution and the public debate which accompanied it suggested that in addition to an electorate composition effect, a shift in preferences for redistribution took place. This shift responded to widely held perceptions of a social debt and greater urgency in addressing acute poverty and inequality.

Third, centre-left coalitions, which have ruled since the mid-1990s, have a commitment to greater redistribution, for ideological and electoral reasons. Fourth, the rapid expansion of social expenditure in the immediate aftermath of the 1988 Constitution was partly responsible, together with global crises, for a spiraling in government deficits and inflation. The process of fiscal stabilisation which began in 1994/5 with Cardoso led to an epistemic shift around fiscal responsibility and in practical terms to an increasing control of public finances under the federal government. Fiscal stabilisation strengthened the power of the executive in tax policy and expenditure. These elements, and their linkages, can explain implicit support for the tax/GDP rise, which are also the main components of fiscal and social contracts.

The demonstrations in June 2013 and the increasing prominence of both tax policy and service provision perhaps may be a signal for a ceiling to the tax/GDP ratio. If this is the case, conditions will become tougher for redistributive policies. It might become necessary to re-allocate expenditure, with implications for the broad political support government policies have enjoyed to date.

Brazil's fiscal contract in an international perspective

Locating the previous discussion within an international setting will help clarify the extent to which conditions in Brazil are exceptional.

[45] Fiscal illusion can work to lower the visibility of indirect taxes in particular.

High income countries

It is worth examining the elements of the social contract and the tax/GDP rise in Brazil against accounts of the evolution of redistributive (welfare) institutions in European countries. Received wisdom points to four main elements characterising social contracts in the 'golden age' of emergent welfare states: (i) tripartite corporatist agreement engaging government, business groups and trade unions; (ii) consent to financing the expansion of welfare institutions with direct taxes (social security contributions, personal income tax and payroll taxation); (iii) standard families; (iv) full employment; (v) coverage of life course and work related risks given full employment. These conditions change by the 1980s leading to a retrenchment in welfare states in Europe and a shift in financing to indirect taxes. The driving force behind the retrenchment is steep rise in the costs of the welfare state in a context of high, rising, and sustained unemployment following the oil crisis. Attention to the incentive effects of welfare state provision on incentives to work and save informs welfare state reforms (OECD 2003).

Kato (2003) argues that the early introduction of VAT and regressive taxation was a key enabling factor in the expansion of the welfare state in developed countries through the 1980s. The early reliance on direct taxation, and especially payroll taxes, to support welfare expenditure placed hard limits on their expansion. She argues that the timing of the introduction of VAT in high income countries explains a bifurcation between high tax/high expenditure and low tax/low expenditure countries. High tax /high expenditure countries managed to achieve this point because the early introduction of VAT enabled them to diversify the financing of welfare expenditure when it became no longer possible to support it through direct taxes. By contrast, low tax/low expenditure countries failed to diversify.

Beramendi and Rueda (2007) place this argument within a partisan frame. They argue that social democracy, in conditions where corporatism is strong, finds a limit to the expansion of welfare provision because workers and capital eventually become reluctant to support rising payroll and capital taxes respectively. Corporatism becomes a constraint on social democracy's support for an expanded welfare state. Recourse to regressive taxation provides a way out of this partisan bind. This explains the paradoxical link in advanced economies between social democratic governments committed to redistribution while at the same time reliant on indirect taxation. Beramendi and Rueda argue that the degree of corporatism is key to the observed separating equilibrium among developed countries into high tax/high transfers and low tax/low transfers.

Brazil's early introduction of VAT which established a strong indirect tax base is interesting in this context. It suggests a route to circumventing the political pressures arising from social policy expansion financed primarily from direct taxation. The mixed financing of social policies from direct and indirect taxes, especially the introduction of ‘social taxes’ in the mid-1990s, and improvements in social security contribution revenue from growth and formality in employment are also important here. The main point is that Brazil appears to have managed, arguably through serendipity, a financing mix for social policy that avoids the limits experienced by social democratic parties in a European context.

Africa

Given the objectives of the IRIBA project, it is appropriate to begin to make the connection to countries in Africa, in order to establish whether there are lessons from the rise of Brazil’s tax/GDP ratio and the political and political economy conditions identified in the paper.

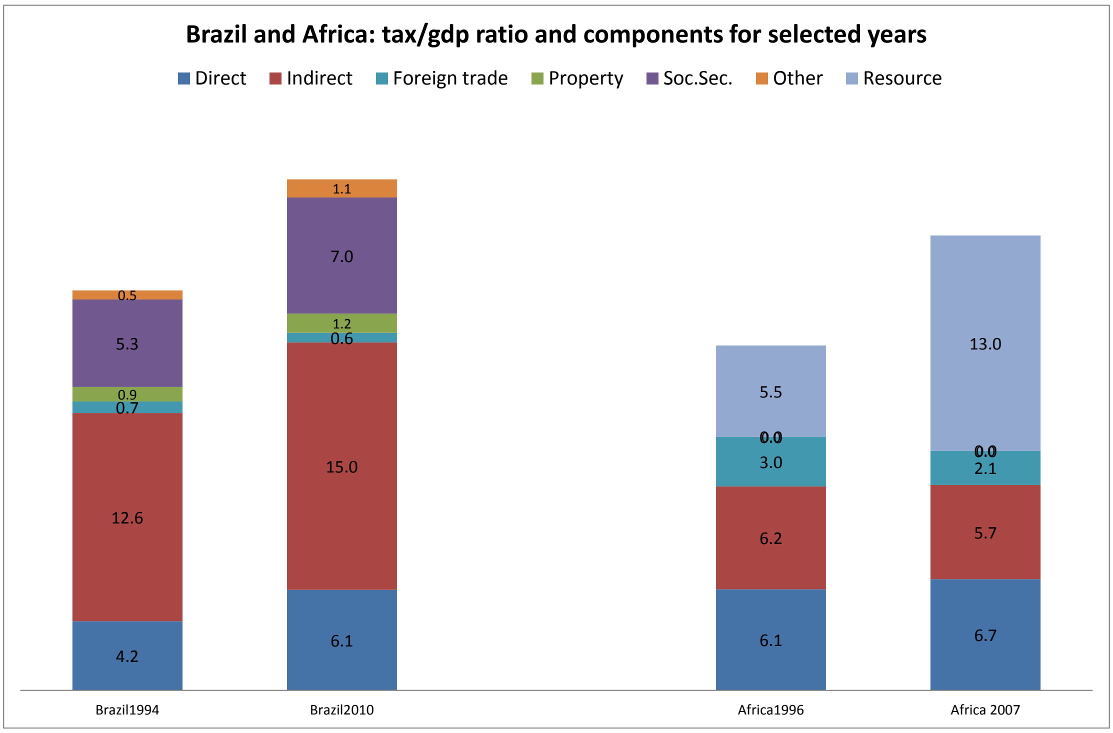
The discussion in the paper highlighted the fact that Brazil has enjoyed favourable conditions for the early emergence of an effective tax system. As discussed above, a relatively closed economy and the absence of substantive mineral resources forced elites to engage with potential taxpayers and to set in place an effective tax administration. The first rise in tax/GDP in the 1966-71 period under authoritarian rule firmly established this baseline advantage as regards the tax system.

In sub-Saharan Africa baseline conditions are very different (Acemoglu and Robinson 2014; Mkandawire 2010). With the exception of South Africa, the extractive capacity of governing elites has been very limited. In fact the reliance on trade taxes and revenues from mineral resources which characterises the economies in sub-Saharan Africa is almost the polar opposite of Brazil’s baseline conditions.

The rapid economic growth as experienced by Africa in the first decade of the 2000s, together with democratisation, have led to important improvements in the tax/GDP ratio in the region. From a political economy conditions, the fact that revenues from natural resources are the main driving force, especially as trade taxes have diminished in importance, is a key challenge. Figure 20 compares the tax/GDP ratio and components for selected years in Brazil and Africa.

As can be seen from figure 20, the dominant trend in the components of tax revenue is the growing significance of resources revenues, rising from 5.5% of GDP in 1996 to 13% in 2007. In fact, an important part of the increase in direct tax revenues as a % of GDP in the Figure reflects an increase in taxes on corporate income themselves associated with natural resource exploitation. In African economies, indirect taxes constitute a relatively small component and show a marginal decline from 1996 to 2007. African economies, with the exception of economies in North Africa, collect few revenues from property taxes and social security contributions.

Figure 20



Concerns with a 'resource curse' have a long history in development research.[46] To the extent that governments are less reliant on domestic tax revenues, elites can enjoy a measure of autonomy from the political processes associated with revenue bargaining, leading to weaker tax institutions and problems with government effectiveness and accountability (DiJohn 2010; Moore 2004). The confluence of short political cycles and uncertain non-tax revenue streams may encourage short term populist forms of social policy as opposed to long term institution-building. Countries relying largely on resource revenues, as most countries in Africa do, are likely to have fiscal contracts very different to that described for Brazil in the paper, and perhaps significantly more fragile and volatile.

[46] The literature on revenue bargaining in developing countries throws light on this issue. See Brautigam, Fjeldstad and Moore (2008) and Moore (2004).

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