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# Perspectives on tax reform in Brazil

*Marc Morgan, World Inequality Lab, Paris School of Economics and L'Ecole des Hautes Etudes en Sciences Sociales*

**There is no question** that the salience of tax reform in Brazil is high. It has become common to point out the country's low quality of public services and high level of taxes. In this context it would be desirable to introduce new ways of thinking about matters related to government policy generally, and tax policy more specifically. By understanding the function and potential of taxes, as well as their links to inequality and economic development, the seed can be planted for deep change. Once we conceptualise the potential of certain policies, momentum can be garnered to fully realise them if they are desirable to a majority of the population.

Taxation is an economic issue that is most often clouded by emotional thinking based on opaque reference points of judgement. Everyone is inclined to generalise from their personal situation without much regard for society as a whole. But regard for the whole is crucial to achieve some sense of equity.

In a new paper, Morgan (2019) attempts to examine the design of a tax system that would better serve the principles of equity and efficiency for Brazil and make the country a global leader in progressive tax policy.

Two broad purposes can be associated with taxes. The first is to redeem public spending already made by a currency-issuing government so that price stability is maintained. By taking money out of circulation, taxes can control inflation. The second function of taxes, by modifying prices, is to encourage or discourage particular behaviours of individuals, whether they be through income or wealth taxes, or consumption taxes. In relation to the former, they can regulate the amount of income received or property controlled by individuals. Thus, taxes can define the bounds of a socially acceptable and economically desirable schedule of income or wealth, making socially excessive and economically unproductive incomes or portfolios costly to sustain.

In the case of Brazil, the lack of tax neutrality between different categories of income is manifest, with income from capital gains and financial investments being subject to a separate, lower tax schedule than labour income, and in the case of dividends, no personal tax schedule at all. This partly explains the substantial income differences persisting in the country—a notable case of high income inequality coexisting with a weak regulatory personal income tax. The challenge is to design an income tax system that encourages real productive investment over profit withdrawals or financial asset purchases.

The link between inequality and taxation can also be made from a more macro perspective. The concentration of income at the top of the distribution can have adverse demand effects for the economy as a whole, since it increases savings (higher-income households have higher saving rates) and increases the volatility of expenditures (these savings will not be automatically channelled to real investment due to the lure of capital gains and returns in financial markets). Therefore, a more progressive tax system could tap into the high saving propensities of richer households to divert private resources to much-needed public investment projects, as well as incentivising private corporate investment.

By taxing more the individuals who consume a relatively small share of their income, and expanding the income of those who consume a higher fraction of their income (directly through transfers or indirectly through investment and more inclusive labour/corporate governance laws), the government could provide a dynamic stimulus to the economy. Otherwise, the excess savings will create a vicious cycle, going into financial markets, increasing the share of the financial sector and financial incomes, thereby increasing inequality further, which increases household saving further, and so on. A similar stimulus could come from taxing less the firms that reinvest a larger share of their profits into fixed or human capital formation.

The author presents a rough blueprint for a more progressive tax system for Brazil considering the taxation of income and the taxation of inherited property.

Regarding income tax, it is argued that the current personal income taxes (*Imposto de Renda de Pessoa Física*—IRPF) could be replaced with a new income tax, which would replace a number of existing ones including social contributions and other levies. This new tax would be levied at source on labour and capital incomes, according to a progressive scale. The author also argues for a greater link between the new personal income tax and a revised corporate income tax (*Imposto de Renda de Pessoa Jurídica*—IRPJ).

Conversely, given that much of private wealth is collectively determined, it makes sense to tax wealth, especially when it is passed through generations. Inheritance can be a powerful accelerator of unearned inequality and a destructor of meritocratic values. In Brazil, the inheritance and donations tax (*Imposto sobre Transmissão Causa Mortis e Doação*—ITCMD) derives from the 1988 constitution and is a state-level tax, levied by each state government according to distinct discretionary schedules. The only common feature is that the maximum marginal tax rate is around 8 per cent, which is very low by current and historical standards. The author argues for a reform of the ITCMD in the direction of a universally progressive lifetime capital receipts tax.

Ultimately, inequality depends on factors that are 'chosen', but the solution is by no means easy. The good news is that Brazil already has a relatively high degree of administrative capacity (a well-paid and knowledgeable civil service, counting on the latest tax assessment techniques). The issue going forward is to improve tax enforcement, by tackling tax avoidance and evasion, which have been a prevalent feature of economies such as Brazil's. A further factor inhibiting development on this front has been informality. Characteristic of the region, close to one third of the country's workforce is in the informal sector and, therefore, excluded from much of the tax and benefit system. However, the proposal made for the new personal income tax could entice more workers to enter formal jobs.

*Reference:*

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

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