Initiative for Policy Dialogue

IPD Tax Task Force

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The Brazilian Tax Structure

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1. A Brief Description, some Remarks and Issues

The Brazilian tax system is the result of a (bad) evolutionary process that began im 1967 (our last comprehensive reform) and gained a definitive configuration when, in 1988, our new Constitution was enacted.

This tax system can be considered very productive since it diverted 37% of GDP in 2004, from private hands to governmental use. (Federal, states and municipalities)

This level of fiscal extraction was achieved in a short period of time. In the early 80's it was around 20%, moving to 30% in the late 90's and has been growing since then to (37% in 2004).

Tables 1 and 2 (attached) offer a breakdown of the main sources of revenue by level of government and categories of taxation. For my purposes deserve attention the following observations:

a) most of the revenue is collected by the federal government (69% of the total in 2003);

b) more than 50% of the federal tax revenue goes to social security;

c) ICMS, a value added tax (VAT), is the main source of revenue of the state governments (84% in 2003). It should be recognized, however, that Brazil possess a strong system of revenue sharing, which subtract resources from the federal government in favor of the states and municipalities and from the states in favor of the municipalities (Table 3).

d) Imports taxes are not important as a source of revenue (1,5% of total revenue) and, as a general rule, exports are not taxed.

e) The tax system has been relying, heavily, on indirect modes of taxation (47% of the total tax take) and on payroll (24% of the total). Considering the fact that our income distribution record is very poor, this must be a matter of concern.

f) Taking advantage of the work of Tanzi & Zee I constructed table 4. It suggests that Brazil has a tax extraction of a developed country and a tax structure that combines elements of a developing and of a developed country.

g) The so-called contributions (a disguise for earmarked taxes) based on payroll are significant, reflecting the (increasingly) heavy load imposed by social security on taxpayers.

h) Taxes (contributions) on payroll listed on table 2 do not represent the only economic impact that result from governmental intervention in the labor market in Brazil. Other legal provisions, associated with hiring (and firing) of workers are relevant for economic analysis.

In fact, payroll taxes represent only 35% of the total "tax" burden imposed by legal obligation on hiring workers. It is well known that the "tax" wedge that exists between take-home-pay and the wage-paid by employers is around 100%. It seems that Brazil is, by far, the county that imposes the heaviest load on hiring workers in the world. (see table 5).

According to Pastore (a labor market specialist) this contribute to increase informal labor relations (see below) and unemployment.

i) It is important to notice that Brazil has not one but four VATs. Indeed, that states have one of this kind and the federal government have three. One that taxes the industrial sector imports, and part of wholesale commerce (IPI) and two others recently converted contributions based on VAT: PIS and COFINS.

As it happens in other places, Wagner's law seems to be at work in Brazil. In other words, public expenditures have been growing in relative terms lately and this is due to two reasons: the construction of social protection net (expenditures on retirement, pensions, education, health, unemployment insurance, housing and sanitation) in the last twenty years or so (Fig 1); and due to interest payments of the net public sector debt (2/3 due by the federal government). Since1994 net debt in the public sector (mainly domestic) has increased almost twofold as a percentage of GDP. This ratio has moved from 30% of GDP in 1994 to 55,5% in 2002.

The main causes of this phenomenon are to be found in increases in interest rates increases commanded by the Central Bank (Figure 2) and by the devaluation of the Real, somewhat counterbalanced by GDP growth and by primary surpluses (Table 6).

Table 7 collects the tax rates of the must significant taxes in Brazil.

2. Issues

a) Most Brazilians consider the 37% tax extraction rate an abuse. Indeed, by the international standards it is very high. This sentiment is understandable when one consider the quantity and quality of public services rendered by the public sector.
The underlining cause for the deterioration of public services at the federal and state levels can be traced to the increase in current expenditures since the early 90's. Such increases are the result of social security concessions and of interest payments on net public debt that has increased twofold since 1994 (interest payments in 2004 represented 7,29% of GDP).

b) Complexity. The most common criticism one can hear in Brazil is that there are too many types of taxes, which is true, and that the taxes laws and regulations are complex and difficult to comply and to control (which is also true).

c) There is a great amount of earmarking embedded in the different taxes and contributions. In the case of federal government it is even worse. Despite the fact that the central government has unified budget it is partitioned into two sub-budgets each with its own sources of revenue (the so called fiscal and social security budget – see table 2).

d) The tax system is highly regressive and relies heavily on indirect taxes

e) Regulation of the labor market and taxes on payroll more than double the private cost of labor. This fact seems to explain a significant part of the informal sector.

3. Changes in Tax Policies

a) **Opening up to international trade.**
It is well known that Brazil has a long history in utilizing tariff and non-tariff barriers to promote its industrialization and growth. Strictly speaking this policy can be considered successful, given the creation of a broad and diversified industrial sector in the last fifty years and the growth rates of GDP observed in the same period up to 1980.
Despite these results, in the late 70's the social cost of protection appeared to analysts and government officials, based on short and long run considerations, unbearable. As a consequence legal and effective tariff rates have been substantially reduced since 1988. Average legal tariff rates where brought down from 55% in 1987 to 13,4% in 1998. The same path was followed by effective rates that were reduced from 67,8% in 1987 to its present level of 15%.
At first glance the process of eliminating trade barriers may be considered successful. The levels of imports and exports observed in 1987 (US$ 15,0 and US$ 26,2 billions respectively) increased fourfold by 2004 (US$ 62,7 billions and US$ 96,4 billions)

and there are some indications that imports of capital goods contributed to the modernization and productivity gains in the economy as a whole. Still there is a lot to be investigated in this area.

b) Transformation of turnover taxes into VAT's.

Beginning in January 2002, a federal contributions (turnover) known as PIS was converted into VAT. As a turnover it had a 0,36% rate and was substituted by a 1,65% VAT rate. Given this experience, in 2004, the federal government transformed COFINS, also a turnover, into a VAT with a 7,6% rate.

c) The move to reform ICMS (the state VAT).

After a frustrated attempt to create a single VAT that would bunch together most of the indirect taxes in the country, the call for simplification of the tax system was directed to create a single VAT legislation in all states. At present Congress set the basic rules of the tax and the states have a high degree of autonomy in setting internal rates. Congress has been discussing a new legislation with far reaching implications. The most important of them is a provision that subtracts from the states, individually, the power to legislate and regulate de tax. If approved, the states, collectively, will set the rules and each state can only raise revenue within its borders.

4. Informal Sector

In 1997, IBGE - the Brazilian Institute of Geography and Statistics, conducted the first in-depth study on the subject.
Its declared objective was to understand how small (urban) units of production worked, how many people they employed and the total income they generated.
The survey sample covered all the states and metropolitan areas in the country.
The results showed that in October 1997 existed 9,4 millions informal businesses, mostly (86%) run by self-employed while the complement (14%) corresponded to "small employers", most of whom employed 1 individual (80%). In these activities nearly 13,0 million people were employed, about 17% of the total labor force.

The most important economic activities present in the informal sector in 1997 were commerce (26%) and repair shops (20%).

In 2004 a new survey was conducted by IBGE (a sample50.000 units) from a database of October 2003 and the results will be published shortly. Hence, very soon, it will be possible to learn how the informal sector evolved in the period 1997-2003.