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The Brazilian Tax System: A Diagnostic Review and Reform Possibilities

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Summary

This paper reviews the state of Brazil's tax system and discusses reform options that could raise additional revenue to finance social protection. It consists of three parts. The first part reviews the tax burden in Brazil and its impact on social spending, with particular attention to the identification of the most widespread distortions. The second part presents the analysis and the reform recommendations in detail, examining each individual component of indirect taxes on goods and services and direct taxes on payroll, income, and wealth. This section also includes a comparison of the estimated revenue losses or gains resulting from a set of reform measures with two primary objectives: correcting of current distortions and restoring tax progressivity. Finally, the paper briefly discusses issues related to the political economy of tax reforms.

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Aviso Legal:

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LIST OF ABBREVIATIONS

Table 1. List of abbreviations of countries or territories

Acronym	Description	Acronym	Description	Acronym	Description
ARG	Argentina	GHA	Ghana	NGA	Nigeria
ATG	Antigua and Barbuda	GNQ	Equatorial Guinea	NIC	Nicaragua
AUS	Australia	GRC	Greece	NLD	Netherlands
AUT	Austria	GTM	Guatemala	NOR	Norway
BEL	Belgium	GUY	Guyana	NRU	Nauru
BFA	Burkina Faso	HND	Honduras	NZL	New Zealand
BGD	Bangladesh	HUN	Hungary	OECD	OECD Average
BGR	Bulgaria	IDN	Indonesia	PAK	Pakistan
BHS	Bahamas	IRL	Ireland	PAN	Panama
BLZ	Belize	ISL	Iceland	PER	Peru
BOL	Bolivia	ISR	Israel	PHL	Philippines
BRA	Brazil	ITA	Italy	PNG	Papua New Guinea
BRB	Barbados	JAM	Jamaica	POL	Poland
BTN	Bhutan	JPN	Japan	PRT	Portugal
BWA	Botswana	KAZ	Kazakhstan	PRY	Paraguay
CAN	Canada	KEN	Kenya	RWA	Rwanda
CHE	Switzerland	KGZ	Kyrgyzstan	SEN	Senegal
CHL	Chile	KHM	Cambodia	SGP	Singapore
CHN	China (People's Republic of)	KOR	South Korea	SLB	Solomon Islands
CIV	Cote d'Ivoire	LAC	Latin America and Caribbean Average	SLV	El Salvador
CMR	Cameroon	LAO	Lao (People's Democratic Republic)	SVK	Slovak Republic
COD	Democratic Republic of the Congo	LCA	Saint Lucia	SVN	Slovenia
COG	Congo	LIE	Liechtenstein	SWE	Sweden
COK	Cook Islands	LSO	Lesotho	SWZ	Swaziland
COL	Colombia	LTU	Lithuanian	SYC	Seychelles
CPV	Cape Verde	LUX	Luxembourg	TCD	Chad
CRI	Costa Rica	LVA	Latvia	TGO	Togo
CUB	Cuba	MAR	Morocco	THA	Thailand
CZE	Czech Republic	MDG	Madagascar	TKL	Tokelau
DEU	Germany	MDV	Maldives	TTO	Trinidad and Tobago
DNK	Denmark	MEX	Mexico	TUN	Tunisia
DOM	Dominican Republic	MLI	Mali	TUR	Turkey
ECU	Ecuador	MLT	Malta	UGA	Uganda
EGY	Egypt	MNG	Mongolia	URY	Uruguay
ESP	Spain	MRT	Mauritania	USA	United States
EST	Estonia	MUS	Mauritius	VEN	Venezuela
FIN	Finland	MWI	Malawi	VNM	Vietnam
FJI	Fiji	MYS	Malaysia	VUT	Vanuatu
FRA	France	NAM	Namibia	WSM	Samoa
GBR	United Kingdom	NER	Niger	ZAF	South Africa

Table 2. List of other acronyms

Acronym	Description
ACE	Allowance for Corporate Equity
CBS	Contribution on Goods and Services
CIDE	Contribution of Intervention in the Economic Domain
CIT	Corporate Income Tax
Cofins	Social Security Financing Contribution
CSLL	Social Contribution on Net Income
FGTS	Guarantee Fund for Length of Service
GDP	Gross Domestic Product
GTB	Gross Tax Burden
IBS	Tax on Goods and Services
ICMS	Tax on the Circulation of Goods and on Services of Interstate and Intermunicipal Transportation and Communication
IOF	Tax on Financial Transactions
IPI	Tax on Manufactured Products
IPTU	Urban Real Estate Tax
IPVA	Motor Vehicle Tax
ISS	Municipal Services Tax
IS	Excise Tax
IT	Income Tax
ITCMD	Estate and Gift Tax
ITR	Rural Real Estate Tax
JCP	Interest on Shareholders' Equity
OECD	Organization for Economic Co-operation and Development
PIS	Social Integration Program
PIT	Personal Income Tax
RGPS	General Social Security System
RPPS	Special Social Security Systems
STN	National Treasury Secretariat
TJLP	Long-Term Interest Rate
VAT	Value-Added Tax
WIT	Withholding Income Tax
WT	Wealth Tax

1. INTRODUCTION

The assessment of tax systems - that is, the set of legal rules that govern the use of taxing power by various public authorities with respect to the taxes collected in a given country - is notoriously controversial. In Brazil, controversy is fueled by the fact that, according to the 1988 Federal Constitution, the gross tax burden (GTB) increased significantly, rising from 23.4% of gross domestic product (GDP) in 1988 to 33.5% of GDP in 2005. During this period, the burden increased at the expense of the tax system's efficiency and equity, mainly because it was driven by revenue pragmatism and often triggered by episodes of short-term fiscal adjustments, in which quality issues took a back seat. Since then, GTB has stalled its upward march. For a decade and a half, it has fluctuated at an average 32.6% of GDP, with latest estimates pointing to a burden of 32.5% of GDP in 2019 and 31.6% in 2020. Despite this period of stability, the quality of Brazilian taxation has continued to decline due to a profusion of tax incentives and poorly calibrated special regimes, and a dearth of significant and erratic progress on the reform agenda.

There have been many attempts to modernize the taxation of goods and services in Brazil. Since re-democratization, several reforms have made their way through the National Congress calling for a modern value-added tax (VAT) system to replace outdated and inefficient taxes. However, none has been politically successful, either because of conflicts within the federal government over revenue redistribution or because of opposition from social and congressional interest groups.

Following these successive failures, the impetus for reform has waned and split into three vectors of fragmentary change: i) the Union, attempting to update its taxation of goods and services, as in the Social Inclusion Program and the Contribution to the Financing of Social Security (PIS/Cofins); ii) the municipalities, introducing a minimum tax rate and diversifying the scope of services subject to the Municipal Services Tax (ISS); and iii) the States, seeking an as yet inconclusive agreement to settle the tax war and rectify distortions in the Tax on the Circulation of Goods and Services (ICMS). Recent progress has been based on one-off measures rather than far-reaching reforms. Distributional conflicts have limited the gains achieved after more than three decades of debate, and we are still saddled with a highly inefficient tax system.

But equally, if not more importantly, this impasse over the taxation of goods and services has monopolized the tax reform agenda, to the point of eclipsing other initiatives that might have made progress. Take income tax reform, which is essential to address the inequities and inefficiencies of the current model but has languished since the last reform in the mid-1990s.

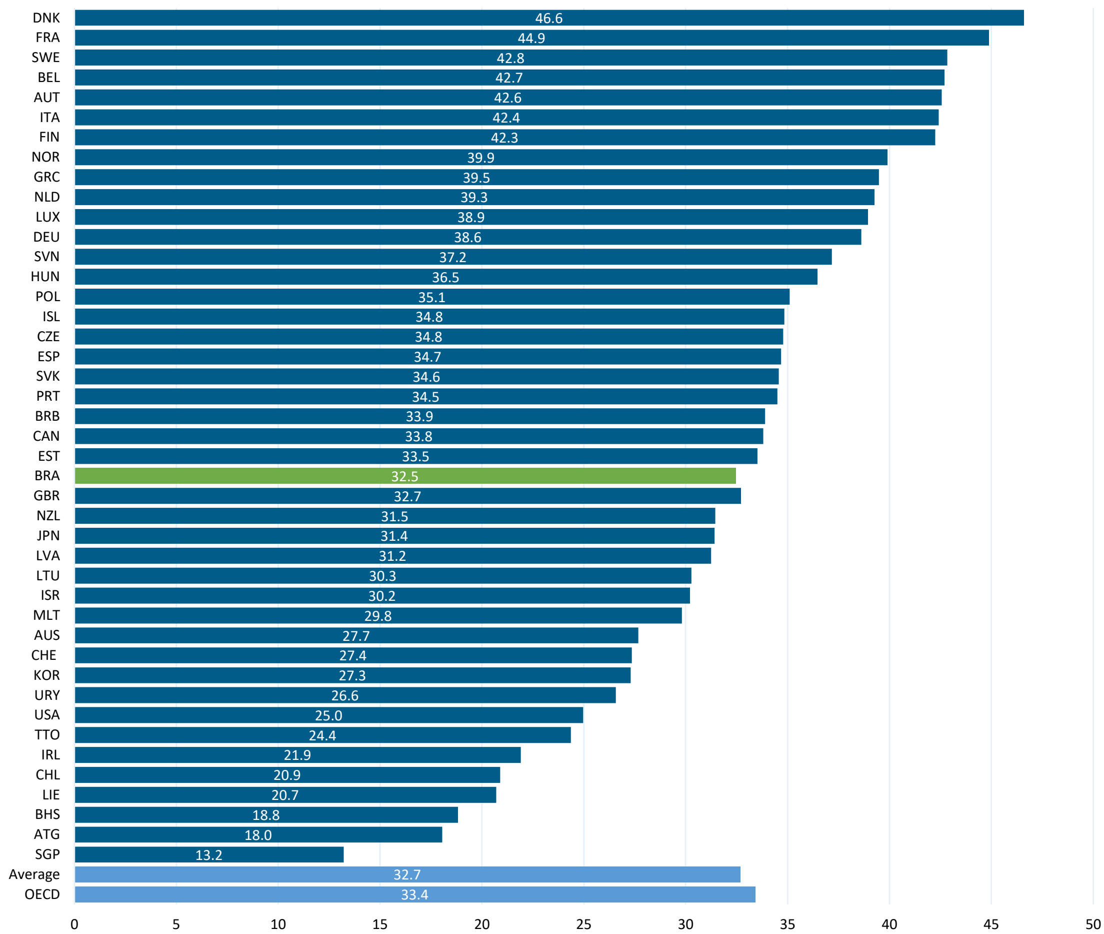
The Brazilian system is often described as a "tax madhouse". The fact is that it is difficult to justify maintaining such a complex, inefficient, and unfair tax structure. Change is not an easy task and will depend on political and federal agreements beyond the scope of this paper and that are mentioned in the conclusion. Nevertheless, updating an assessment of the issues at stake and of alternative solutions is a good starting point. In parallel, this paper examines the role of tax reform as a means to improve financing sources and to even channel additional revenues to social protection.

Following this introduction, the paper is presented in three sections. The next section provides an overview of the tax burden in Brazil and its impact on social spending, with a particular focus on identifying the most common distortions. The analysis and reform proposals are further developed in the next section, which analyzes each component of indirect taxes on goods and services and direct taxes on payroll, income, and wealth. At the end of this section, a balance is drawn with estimates of revenue losses and gains from a set of reform measures that have the twofold objective of correcting current distortions and restoring progressivity. The final section offers some final thoughts on the political economy of tax reform.

2. Overview of the tax burden, of its relation to social spending and of main distortions

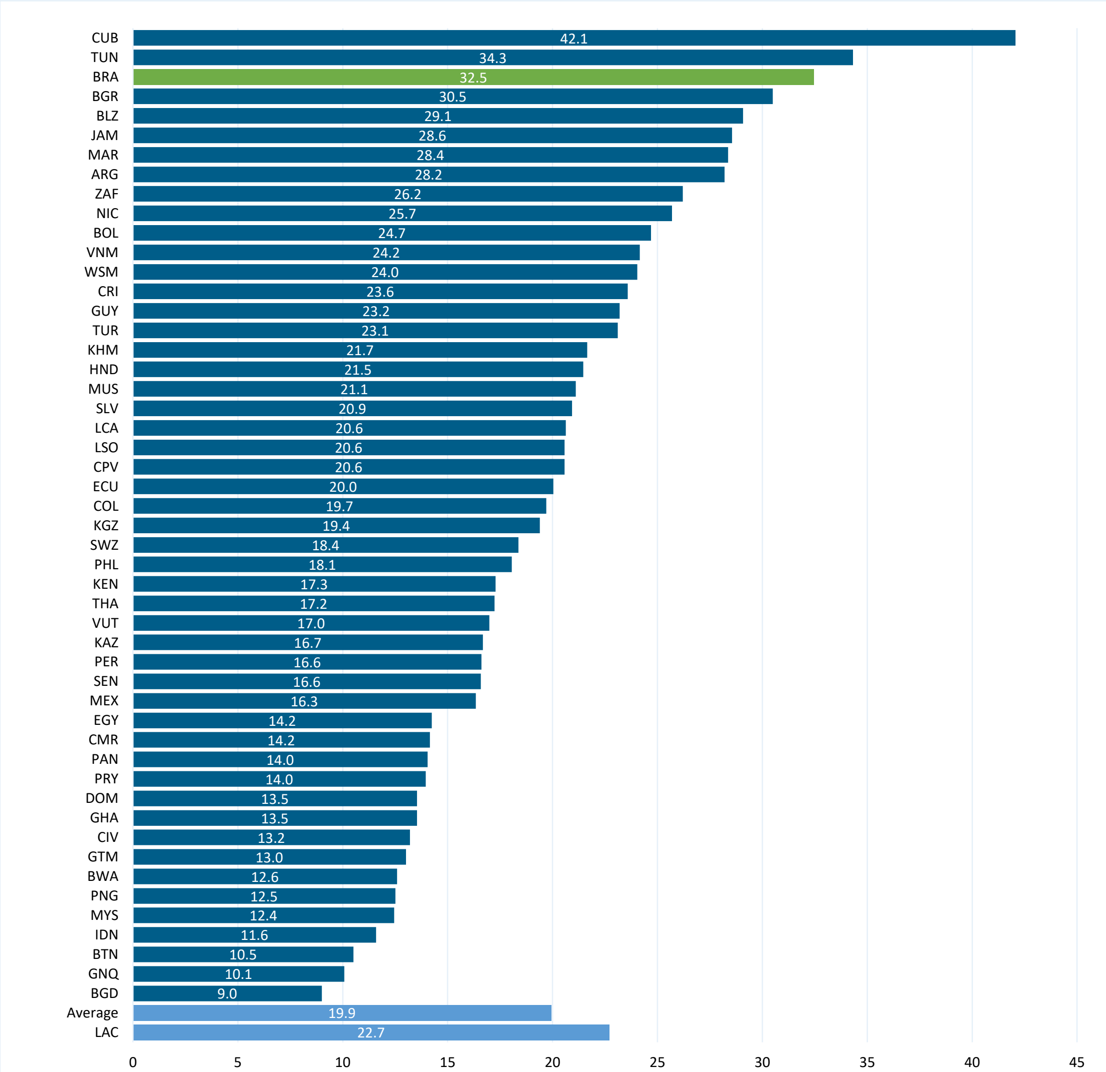
Brazil has a high tax burden compared to countries with similar income levels, approaching the average of high-income countries. In 2019, the burden reached 32.5% of GDP in Brazil, which is higher than the burdens of almost all other middle-income countries for which data are available in Graph 2 (except for two). This chart is only slightly lower than the averages in Chart 1 of 32.7% for high-income countries or 33.4% for members of the Organization for Economic Cooperation and Development (OECD). Conversely, Brazil's burden has not changed much in recent years, and this trend of stability differs from the growth trend that has prevailed in most countries. For example, among OECD countries, the average burden was almost one percentage point of GDP lower than Brazil's in 2005 (32.7 versus 33.5) and almost one percentage point higher in 2019 (33.4 versus 32.5).

CHART 1. Tax burden in Brazil and high-income countries - (2019) (Values expressed as % of GDP)



Source: Prepared by the author with information available in the OECD database. Note: Country acronyms are listed in Table 1.

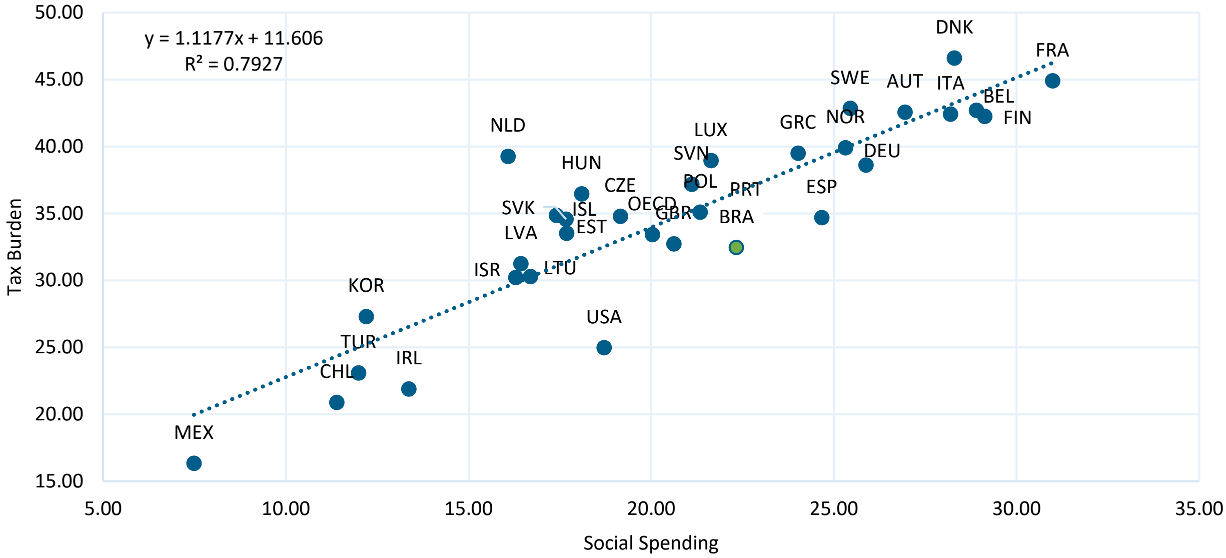
CHART 2. Tax burden in middle income countries - (2019) (Values expressed as % of GDP value)



Source: Prepared by the author with information available in the OECD database. Note: Country acronyms are listed in Table 1.

Another similarity with OECD countries is the level of social spending as a percentage of GDP. As shown in Chart 3, the level of social spending in Brazil is very close to the OECD average. Chart 3 also helps to understand differences in the level of the tax burden across countries. In general, there is a positive (strong) correlation between these two variables: countries with the highest social spending are those with the highest tax burden, and vice versa. On average, social expenditure represents 60% of the tax burden in OECD countries and exceeds 50% in almost all of these countries.

CHART 3. Tax Burden and Social Expenditure: Brazil and OECD countries – (2019)
(Values expressed as % of GDP)



Source: prepared by the author with information from available in the OECD database and own calculation for Brazil.
Note: country acronyms are listed in Table 1.

Brazil is hardly an exception to these broader relationships. It is one of the few middle-income countries where spending on social protection and public health reaches 22.3 per cent of GDP, plus another 4.5 per cent of GDP spent on public education (see Table 1). A significant proportion of social protection expenditure is attributable to contribution-based systems, in which contributions are levied from payrolls to cover social benefits. The most important examples are social security benefits for civil servants (Special Social Security Systems – RPPS) and private employees (General Social Security System – RGPS), plus withdrawals made by these employees from their mandatory savings fund (Guarantee Fund for Length of Service – FGTS), which amount to 15.0% of GDP and are (partly) financed by specific social contributions that represent 8.4% of GDP. The remaining social spending is largely financed by general taxation.

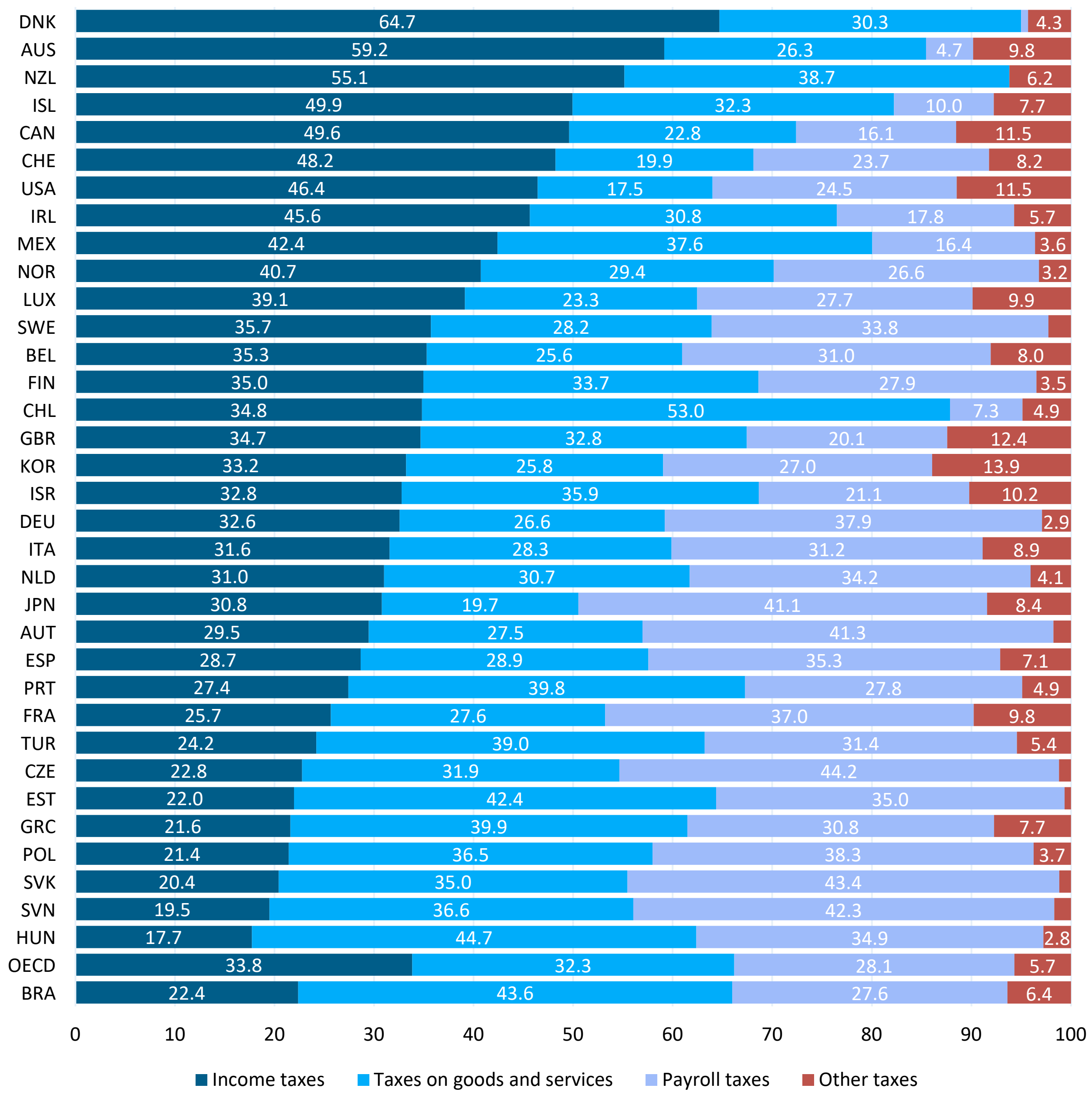
TABLE 1. Tax Revenue and Social Spending: Brazil – (2019).

Description	Amounts (billions of BRL)	Share (%) of GDP	Share (%) of GTB
Tax revenue			
Income taxes	537.9	7.3	22.4
Payroll taxes	664.7	9.0	27.6
Social contributions to the RGPS	395.9	5.4	16.5
Social contributions to the RPPS	92.9	1.3	3.9
Social contributions to the FGTS	128.7	1.7	5.4
Other payroll taxes	47.3	0.6	2.0
Property taxes	111.8	1.5	4.6
Taxes on goods and services	1,048.3	14.2	43.6
Other	41.4	0.6	1.7
Total	**2,404.1**	**32.5**	**100.0**
Social spending			
RGPS social security benefits	572.7	7.8	28.9
RPPS pension benefits	374.0	5.1	18.9
FGTS withdrawals	164.5	2.2	8.3
Assistance benefits - age and disability	58.5	0.8	2.9
Unemployment insurance	37.4	0.5	1.9
Financial aid to individuals and families	38.2	0.5	1.9
Other social protection expenses	102.9	1.4	5.2
Health	302.3	4.1	15.2
Subtotal	1,650.6	22.3	83.2
Education	333.2	4.5	16.8
Total	**1,983.76**	**26.8**	**100.0**

Source: prepared by the author with OECD and National Treasury Secretariat (STN) tax burden data and own calculation of social expenditure based on administrative data. Note: Does not include the employer's intrabudgetary contribution to the RPPS.

Against this backdrop, Brazil's inefficient and regressive tax structure is more worrisome than its high tax burden, which can be partly attributed to the welfare state agenda. Contrary to the typical OECD pattern, where income taxes are the main source of government financing, in Brazil almost half of tax revenues come from taxes on goods and services, and income taxes account for almost one-fifth of total revenues. Compared to the OECD average in Chart 4, the tax burden in Brazil proportionally telescopes on taxes on goods and services, concentrates less on income taxes, and reaches similar levels of concentration on payroll and property taxes. There are also asymmetries within these broad tax categories. With respect to income taxes, the tax burden in Brazil is similar to the OECD average for corporate profits (8.6% of the total, compared to the OECD average of 9.0%) and much lower for personal income (9.2% of the total, compared to the OECD average of 24.0%).

CHART 4. Tax burden composition in Brazil and OECD countries - (2019) (As a share of the total – %)



Source: prepared by the author based on information from the OECD. Note: Country acronyms are listed in Table 1.

In short, the Brazilian tax burden is characterized by relatively high levels of taxation on goods and services, wages, and corporate profits, mainly offset by the low tax burden on personal income. This low burden must be interpreted in the context of a middle-income country with high levels of inequality and informality, which limits the personal income tax (PIT) base. Nevertheless, there are a number of issues in the composition of the tax model that limit its revenue potential (and progressivity) and are likely to be priority targets for tax reform, as discussed in more detail in subsection 3.4.

How did this asymmetry arise and what are its main consequences for the tax burden structure? Its roots lie in a long historical process that has intensified in the last three and a half decades, reinforcing a structural framework that relies less on direct taxation of individuals, while concurrently, and contradictorily, striving to build a very substantial welfare state for an emerging economy. The centralized federal system of the military regime was followed by a period in which public services were decentralized and the social responsibilities of the State grew. Meanwhile, efforts to provide regional governments with a broader funding base were underway, prompting an increase in intergovernmental transfers and an endorsement of the unusual practice of delegating to the regional level the collection of a number of key taxes in the national tax system levied on goods and/or services (the state ICMS and the municipal ISS).

This contradiction created a dilemma in the financing of the state, because while the plan to build the welfare state through spending – whether on social and welfare benefits or on social services in health, education, and assistance – was advancing, the late Brazilian experience faced growing resistance to direct taxation of individuals. Indeed, the income tax was reformed in the 1980s and 1990s, limiting its degree of progressivity and its revenue potential, and it has changed very little since then. On the other hand, certain instruments that would enable increasing the progressive taxation of wealth have usually faced tougher political, legislative, and judicial hurdles.

The answer to the dilemma of government financing has consisted in pushing for legislative increases in the "less visible" elements of the tax burden (payroll, production, and corporate profits), with the added complication that they have often been triggered by short-term fiscal adjustment spurts. Such short-run episodes tend to limit the leeway of fiscal authorities by overly focusing on issues such as the most immediate revenue impact of tax measures and the feasibility of enacting them in a short period of time, to the detriment of more substantive issues of efficiency and equity. Short-termism also makes tax reform more difficult, as it requires lengthy legislative processes and agreements with stakeholders. As a result, the evolution of tax burdens in Brazil since the 1980s has been driven by one-off measures and revenue pragmatism, which have reproduced or even magnified many existing distortions, to the point where an asymmetric tax structure with high levels of taxation on production, salaries and corporate profits has become entrenched.

Concurrently, attempts to mitigate this process by means of ad hoc (rather than structural) solutions have been made, with a wide range of tax incentives and special regimes. While some were designed to relieve overtaxation bottlenecks, they have paved the way for others that lack technical justification and are more responsive to pressure from interest groups. The outcome is an increasingly arbitrary differentiation between taxpayers and economic activities and huge gaps in fiscal planning.

This tax system has its advantages, such as high fiscal productivity, which can finance a very dense social safety net for a middle-income country, and a measure of autonomy for regional government budgets. But it also harbors unnecessary complexities and inconsistencies, and its negative features are glaring. Some of these features are listed below.

Anti-growth bias

Brazil's tax burden structure runs counter to the findings of empirical studies such as Johansson et al. (2008). These studies suggest that tax structures with a heavier burden on corporate taxes are the most detrimental to economic growth, while those with a heavier burden on property taxes are more efficient. Evaluating tax systems based on these general categories is important, but these studies also suggest that additional aspects of the tax system should be considered. In particular, the inefficiencies that characterize the Brazilian tax system hinder productivity and economic growth (patchwork of taxes, complex legislation, lack of a coherent approach to the tax base, overlapping tax bases and cascading incidence, multiplicity of special regimes and tax incentives, high litigation and compliance costs, etc.).

Source of conflicts at the federation level

One of the core normative imperatives of fiscal federalism theory is that taxes levied on the most mobile economic bases should be under the jurisdiction of central governments.[2] The delegation of tax powers over mobile bases to regional governments creates conflicts on a federative level when it enables a non-cooperative game of tax wars through a predatory competition based on excessive tax breaks that local jurisdictions offer to attract each other's businesses, ultimately eroding everyone's tax base. This situation is very similar to the Brazilian experience, where conflicts over tax wars are widespread, leading to inefficiencies in resource allocation and aggressive tax planning practices by companies.

Volatile public finances

Tax collection from tax bases that are more sensitive to economic cycles, such as industrial production and corporate profits, typically impart a procyclical bias to fiscal policy. Periods of economic acceleration and disproportionate growth in tax revenues create fiscal slack for overspending during booms, while downturns produce sharp revenue declines that may require disproportionate spending cuts during crises. Brazil's asymmetric tax structure, which overburdens production and corporate profits, ultimately propagates volatility in the fiscal framework.

Regressive effect on income distribution

Direct taxes on individual income and wealth tend to fall more heavily on the wealthy, even in a tax framework like Brazil's, which makes very limited use of progressive tax rates. Conversely, indirect taxes on the production of goods and services, which impose costs on firms and are therefore usually passed on through their prices, tend to be regressive because they disproportionately affect people who spend a larger share of their income on consumption, i.e., the worst-off. The combination of low (and not very progressive) direct taxation with a high indirect tax burden makes the overall tax burden regressive. This situation is socially unjust, to say the least, because taxation increases income concentration in one of the most inegalitarian countries in the world, and it is counterproductive because it reduces the distributive impact of spending on public services.[3]

From this assessment of the most common distortions in the Brazilian tax system, we will now outline guiding principles for tax reform in the country. At the outset, we must acknowledge that we are operating with a high tax burden and high social spending compared to other middle-income countries. Considering this starting point, it does not seem reasonable to design a reform that would promote very substantial changes in these levels.

The same cannot be said for changing the structure of the tax burden and for redesigning the individual components of tax collection and social spending. There is ample leeway for reforms to cut high payroll and profit taxes at the corporate level, which in turn would imply compensations in individual income and asset taxation and/or in the taxation of goods and services, as many international experiences have shown. In Brazil, however, it is very difficult to achieve the taxation of goods and services, since they are among the highest in the world, and it is also undesirable because of the regressive effect on income distribution. Consequently, increasing the taxation of personal income and wealth becomes the primary choice. However, this alternative should be pursued with caution, based on guidelines that seek to balance or even combine equity and efficiency, and it should be coupled with changes in corporate taxation.

Moreover, any proposals to reform specific tax burden components need to be based on a more accurate assessment of the inconsistencies (and inequities) that should be addressed. This is the thrust of the next section, which looks in more detail at the breakdown of the assessment and reform proposals for each

2 According to fiscal decentralization principles outlined by Musgrave (1959) and Oates (1972).
3 For an assessment of the degree of regressivity of the tax burden and of transfers in Brazil, see Silveira and Passos (2017).

component while drawing a distinction between indirect taxes on goods and services and direct taxes on payroll, income, and wealth.

3. A detailed review of the analysis and of suggested reforms

3.1. Indirect Taxation: Taxes on Goods and Services

There are few issues on which tax analysts agree, and undoubtedly one of the most important is the recognition that the taxation of goods and services in Brazil is among the highest and most inefficient in the world. The 1988 Constitution ratified the practice of splitting taxes into a number of taxes under the jurisdiction of the federated Brazilian entities.

The largest single tax in Brazil is levied by state governments. The ICMS collects 6.9% of GDP, or more than one-fifth of the tax burden, as seen in Table 2. The ICMS is levied on trade in goods and certain services (telecommunications and interstate transportation) at rates that vary among the 27 federal entities (26 states and the Federal District). The most common are standard rates of 17% or 18% and special rates ranging from 7% for basic goods to 25% for non-essential goods.[4] The other major tax levied by the states is the motor vehicle tax (IPVA), which is classified by the OECD as a tax on goods and services because it is similar to a fee on the use of motor vehicles (0.6% of GDP).

In theory, the ICMS follows the VAT system. In practice, it is a "pseudo-VAT" because of the many difficulties that companies experience in claiming tax credits. In addition, the rates that are applied in practice are very different from the statutory or legal rates due to the discretionary power of state governments to grant tax incentives.

One of the main causes of this situation stems from a perverse incentive embedded in the very design of the tax system, which allows the state of origin to retain a percentage of ICMS revenues from interstate sales (as opposed to a modern VAT, where all revenues would benefit the state of destination). Suppose, for example, that a business makes all of its sales to a given locale, and that it achieves efficiencies by remaining there. Nevertheless, other locations still have an incentive to attract this company by offering ICMS benefits. If one succeeds, this location's interstate sales increase and it earns more than before. The trade-off is a loss of efficiency and tax revenue for the system as a whole. This design problem encourages states to offer excessive tax incentives to lure (or at least stem the flow of) business investment, even when there is no sound (social or economic) justification for doing so.

The ISS, which falls under the jurisdiction of Brazil's 5,570 municipalities, is the third largest tax on goods and services (0.9% of GDP, surpassed only by the ICMS and the PIS/Cofins) and faces similar problems. Composed of a minimum rate of 2% and a maximum rate of 5%, it applies to the sale of most services (except those subject to the ICMS). Thousands of municipal governments can decide how much to charge within this range. It is also unique in that it does not grant credit for the purchase of inputs. Therefore, the ISS is levied cumulatively (or cascadingly) through the entire production chain.

4 A distinctive feature that reinforces Brazil's lack of indirect tax transparency is that most tax rates are applied to the sales price of products through a so-called "tax gross-up", which adds the tax to its own tax base. For example, the standard ICMS rate of 18% is charged on the sales price of the product with tax (100%*18/100), resulting in a 22.0% rate on the price without tax (100%*18/82). This makes the "grossed-up" taxes appear lower.

This tax is a "mixed tax": it is subject to a law that specifies a list of services to be taxed at the place of destination (or where the service is provided), while the remainder are taxed at the place of origin (where the establishment supplying the service is located). Under origin taxation, some municipalities have enough room for maneuver to shrink the tax base and thus lower effective tax rates below the minimum level to encourage businesses to relocate. The central problem is that the lack of coordination between federal entities has unleashed a predatory war on ICMS and ISS tax incentive awards, which has skewed their selectivity criteria.

TABLE 2. Taxes on Goods and Services: Brazil – (2019).

Description	Amounts (billions of BRL)	Share (%) of GDP	Share (%) of total GTB
Taxes on goods and services	**1,048.3**	**14.2**	**43.6**
General taxes on goods and services	**881.4**	**11.9**	**36.7**
ICMS	508.8	6.9	21.2
PIS/Cofins	288.8	3.9	12.0
ISS	70.2	0.9	2.9
Others	13.7	0.2	0.6
Taxes on specific goods and services	**114.9**	**1.6**	**4.8**
Excise Taxes	65.3	0.9	2.7
IPI-Vehicles	5.6	0.1	0.2
IPI-Beverages	3.6	0.0	0.2
IPI-Tobacco	5.6	0.1	0.2
IPI-Others	37.6	0,5	1.6
CIDE-Fuels	2.8	0.0	0.1
Other excises	10.1	0.1	0.4
International trade taxes	42.9	0.6	1.8
CIDE-Remittances	5.1	0.1	0.2
Other taxes on specific services	1.6	0.0	0.1
Taxes on the use of goods and performance of activities	**51.9**	**0.7**	**2.2**
IPVA	46.2	0.6	1.9
Other	5.7	0.1	0.2

Source: prepared by the author based on OECD and STN data.

The complexity of the system is compounded by the existence of a second "pseudo-VAT" under federal jurisdiction: the tax on manufactured products (IPI), which also provides for limited (rather than extensive) use of tax credits. The IPI has variable rates, generally ranging from zero to 30%, depending on the type of product. The effect of this degree of flexibility is that the IPI operates, albeit imperfectly, as an excise tax designed to discourage the consumption of goods with negative externalities, charging higher rates on tobacco products (30%) and alcoholic beverages (between 13% and 19.5%, depending on alcohol content). However, the ability to discourage the consumption of goods with negative externalities is dispersed because the federal government collects another tax on fossil fuels, the Contribution of Intervention in the Economic Domain (CIDE), which overlaps with ICMS differential rates. From a tax collection perspective, the IPI (0.7% of GDP) is significantly more important than the CIDE-fuels, which has become irrelevant since 2012, when its rates were zeroed and then restored to very low levels (BRL 0.10 per liter of gasoline and BRL 0.05 per liter of diesel) to dampen the inflationary effect of fuel prices.

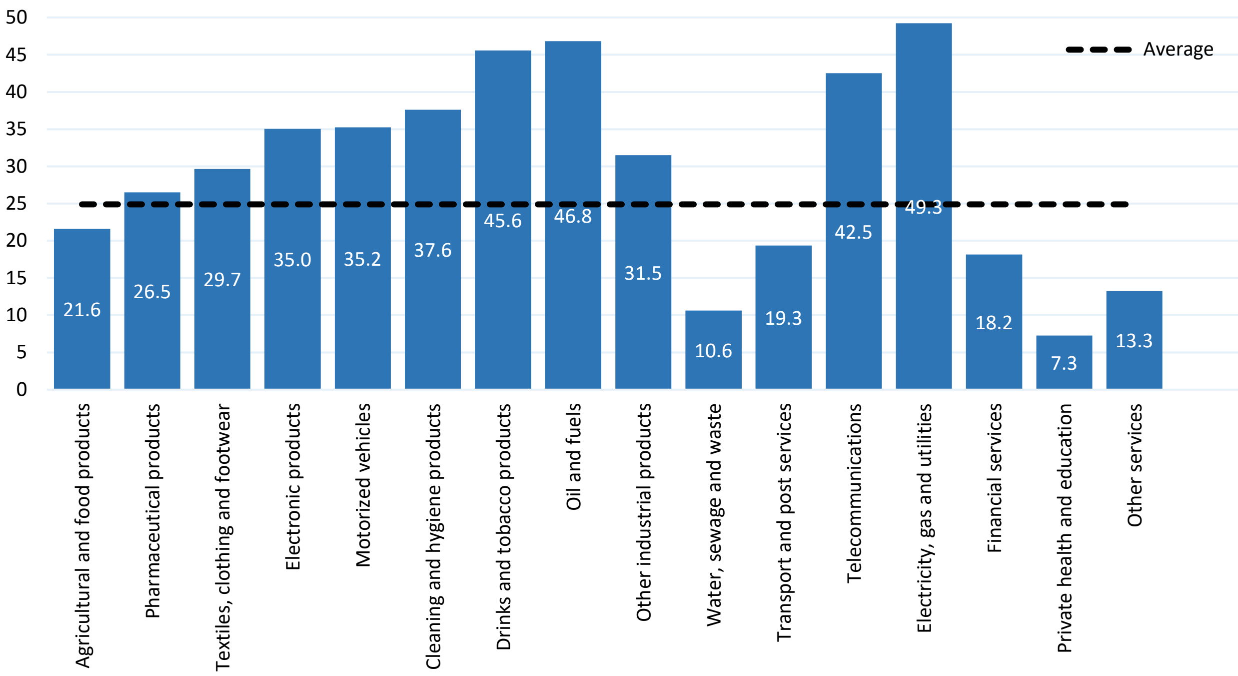
PIS/Cofins are also a federal responsibility and represent a much larger share of tax revenue (3.9% of GDP, or more than one-tenth of the tax burden). Originally, PIS/Cofins were levied cumulatively on the gross income of companies. Currently, two tax base calculations coexist, one cumulative and the other non-cumulative. The standard rate under the cumulative regime is 3.65%, which is levied on the company's income without the right to offset any credit for purchased inputs. In other words, it is a cascade tax that is levied on all stages of the production chain. The non-cumulative system, with a standard rate of 9.25% on value added, was introduced between 2003 and 2004 and only allows companies to deduct taxes paid on the purchase of inputs that are directly consumed in the production process. The service sector has remained in the cumulative system, while the long chain industrial sectors have moved into the non-cumulative system. The new system is still partially cumulative, however, because it is based on a narrow (physical) credit concept that precludes the offset of taxes paid on the purchase of inputs that are not directly consumed in production. For example, business office expenses are not eligible for credit and are ultimately levied on a cumulative basis throughout the production process.

In essence, indirect taxation in Brazil is characterized by the juxtaposition of cumulative taxes and "pseudo-VATs" (ICMS, ISS, IPI, PIS/Cofins and Cide, among other minor taxes), which do not grant tax credits or cause difficulties in the use of tax credits. All these taxes end up being more or less cascading, and there are countless differences in the way goods or services, economic sectors and regions of the country are taxed. As a result, it is very difficult to determine how much of the taxes that add up at each stage of production are borne by companies themselves or are passed on to the final consumer, and to determine the actual tax rates on each good or service.

Chart 5 shows estimates for average tax rates based on National Accounts data, under the assumption that companies pass on the cost of taxes to consumers in the retail price of goods. This estimate shows a significant imbalance in tax rates. The effective tax rates on industrial goods (excluding food and pharmaceuticals) and services subject to the ICMS (telecommunications and electricity) are always higher than the world average, approaching 25%. The opposite is true for other services, where the average rates are always lower.

From a distributional point of view, it is important to note that the advantages of reduced rates for food and medicines are neutralized in the typical consumption basket of poor households as a result of the over taxation of industrial goods and certain services (electricity, telephone, personal hygiene products, clothing, etc.). This is the opposite of what happens in the typical consumption basket of the well-off, where the proportion of services is generally much higher and that enjoys low taxation. As a result, rate differentiation ultimately reinforces the regressive nature of indirect taxation on income distribution, as shown by Orair and Gobetti (2019).

CHART 5. Average rates on goods and services (In %)



Source: prepared by the author with data from IBGE[5]'s National Accounts and Cornelio et al.'s tax incidence matrix (2022).

This fragmented system involving many different regimes is enough to make taxation extremely complex. When the specific problems associated with each tax are added, there are so many taxes that it is almost impossible to make a comprehensive assessment of the shortcomings of the taxation of goods and services in Brazil. Some of these problems are summarized below:

» The limited (and insufficient) use of credits in taxes subject to a non-cumulative regime, such as ICMS, IPI and the non-cumulative PIS/Cofins regime, which in practice causes their cascading (i.e., the pseudo-VATs).

» The juxtaposition of cumulative taxes and regimes, such as ISS and the cumulative PIS/Cofins regime.

» Jurisdictional conflicts (for example, between ICMS and ISS, and IPI and ISS) due to fiscal fragmentation into multiple tax bases.

» Fiscal wars of regional jurisdiction taxes, for example, the supply of intermunicipal services taxed at origin by the ISS, and especially in interstate transactions subject to the ICMS where a hybrid of origin and destination principles apply.

» An excessive number of tax rates, exemptions, and non-taxation, which makes coordination difficult, increases the cost of tax administration and creates opportunities for abusive tax planning.

» Excessive complexity and unjustified arbitrariness, leading to high litigation and compliance costs.

» Skewed tax selectivity criteria that exacerbate the regressive nature of the taxation of goods and services.

5 [Translator's Note: Brazilian Institute of Geography and Statistics]

Given these and many other problems, it is almost needless to emphasize the importance of reforming the taxation of goods and services in Brazil. The juxtaposition of several indirect and cumulative taxes clearly makes taxation less than transparent and, in this sense, takes on a utilitarian dimension, allowing collection of one of the highest tax burdens on goods and services in the world (14.2% of GDP) with little public opposition. Despite this, high tax productivity does not seem enough to justify such an inefficient and unfair tax system.

The academic literature also widely agrees that the solution to many of the above problems lies in promoting a modernizing reform that replaces several of the current taxes (at least ICMS, ISS, IPI and PIS/Cofins) with a new system based on two pillars: a VAT and an excise tax (IS) whose design is consistent with international best practices. Namely, a VAT at destination with full crediting, a comprehensive base (including all goods and services, tangible or intangible) and the avoidance, as far as possible, of differential rates; complemented by an excise tax with a non-fiscal or regulatory purpose (rather than a revenue-raising purpose) to discourage harmful practices to health and the environment.

To this end, there are currently two main proposals before National Congress: Constitutional Amendment Bill n. 45 of 2019 (PEC 45/2019) and Constitutional Amendment Bill n. 110 of 2019 (PEC110/2019). Both pragmatically address some of the distributive conflicts by providing for long transitions, both in the implementation of the new taxes and in their distribution across federal entities. They have the potential to make the Brazilian tax system more equitable and efficient.[6]

The main difference between them lies in PEC 45/2019's more inflexible approach, which establishes a single VAT system called the Tax on Goods and Services (IBS) and disallows differential rates. According to the proposal, the new IBS is to be governed by a committee of representatives from the three federal entities, each of whom will retain the autonomy to set its own rate, as long as it is consistent for all goods and services consumed in that locality. This is an ingenious solution to ensure the budgetary autonomy of the federal entities: the three will share the tax base, which will be uniform throughout the nation, but each one will determine its own tax rate according to their specific laws. Compared to the current framework, the difference would be that autonomy would be exercised exclusively in the management of the tax rate and no longer for granting tax benefits.

PEC 110/2019 is more flexible in two ways. First, it provides special rates for a limited basket of goods and services (basically staple foods, medicines, public transportation, education, and health services). In addition, it proposes a dual VAT system that retains the federal breakdown into two taxes with the same tax base: the contribution on goods and services (CBS), to be controlled by the Union, and the subnational IBS, to be controlled by a committee of state and local government representatives. This alternative also preserves the autonomy of each federated entity to set its own tax rates.

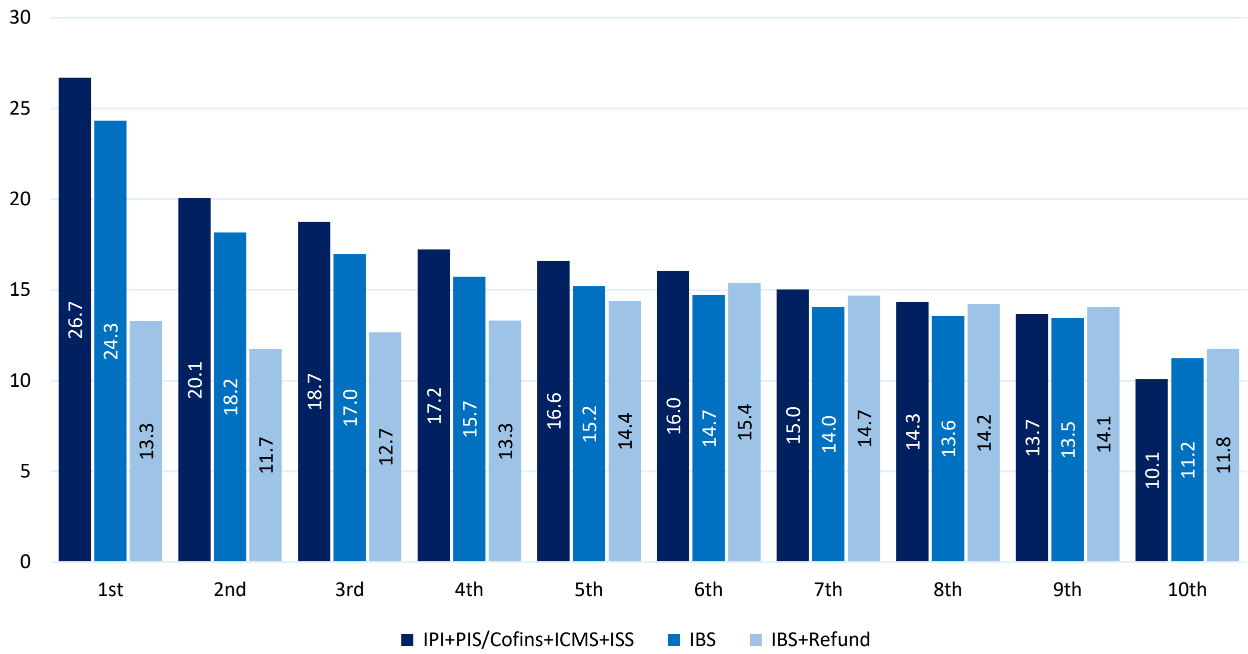
The transitional provisions of both tax reform proposals were designed to avoid increasing the tax burden. This was considered the best way to allay taxpayers' reluctance to accept tax increases, while ensuring that there would be no loss of revenue shares for social spending or revenue shares earmarked by the Union and all states and municipalities. This means that updating the taxation of goods and services is to be pursued without increasing or decreasing tax revenues as a percentage of GDP.

Nevertheless, the estimated standard reference rate for the new IBS, which would be necessary to replace revenue losses from the abolished taxes (PIS/Cofins, IPI, ICMS and ISS), would be close to 25% after the transition period, a rate that is virtually unparalleled worldwide. Brazil would still be one of the countries with the highest taxes on goods and services, but the potential to increase economic growth would be higher due to the efficiency gains from the new tax, which would be exempt from cumulative taxation and tax benefits, easier to manage, fully computerized and fully integrated throughout the national territory.

6 See Orair and Gobetti (2019) for an assessment of the design and impact of the two tax reform proposals.

A further limitation is that the progressive gains tend to be modest. Chart 6 shows the results of a counterfactual simulation by Orair and Gobetti (2019), that is, a recalculation of the tax burden on household income if differential rates were replaced by a uniform rate that yields the same level of tax revenue. As demonstrated, the current tax system with differential rates is regressive: the burden is proportionally higher for the most disadvantaged, starting at roughly 27% of income for the first decile of this distribution and then gradually decreasing to 10% of income for the most affluent decile. When simulating a uniform tax rate, the tax burden continues to decrease as we move from the bottom to the top of this distribution: from 24% of income for the very poorest decile to 11% of income for the wealthiest decile. It turns out that this burden is slightly lower in the first nine deciles of the distribution, the only exception being the richest decile, which is taxed slightly more.

CHART 6. Tax burden of current taxes with differential rates (IPI, PIS/Cofins, ICMS and ISS) and the new IBS with a uniform rate and individual refunds, by deciles of per capita household income distribution. (In %)



Source: Orair and Gobetti (2019).

This finding supports international evidence that differential tax rates are not only inefficient, but also regressive in the sense that they benefit rich households more than poor households (e.g., OECD and KIPF, 2014). Nevertheless, the modest progressivity gains from unifying tax rates should be recognized, as should the fact that analyzing averages obscures the risks of negative effects on the purchasing power of many low-income households. In an effort to increase these gains and minimize these risks, the two tax reform proposals (PEC 45/2019 and PEC 110/2019) provide, among other guidelines, for the creation of a mechanism to refund taxes collected from low-income taxpayers.

This transfer can be targeted to families that have been categorized as priority in the federal government's social program registry, but it does not have to be limited to these families. The amount to be transferred can be determined by cross-checking the registration data provided by taxpayers at the time of purchase, which is already being done in ICMS refund programs in several Brazilian states, or, even more simply, by estimating the amount of tax in an average family consumption basket.

This tax refund mechanism can significantly mitigate and, in the best scenario, neutralize the inherent regressivity of indirect taxes (see Chart 6), depending on its design and the size of the transfers. Given the reform's assumption of tax burden neutrality (net of tax refunds), increasing the volume of refunds would imply a higher standard rate for the new IBS, which would be more likely to elicit popular opposition. Section 3.6 presents estimates of the potential revenue that this instrument would raise.

3.2. Direct taxation: payroll taxes

Payroll taxes in Brazil are high by international standards. The employee's social security contribution is a progressive tax of between 7.5% and 14.0% levied on wages up to BRL 5,645.80 (in 2019), not including that portion of wages exceeding this amount, which represents the maximum social security benefit under the General System (RGPS). Employers will still have to cover the following costs for a typical private sector employee: i) social security contributions at a linear rate of 20% on the full wage, including the amount that exceeds the maximum social security benefit; ii) occupational accident insurance, of between 0.5% and 6% depending on the risk associated with the activity; iii) 8% for the FGTS, which is a mandatory fund that opens a savings account in the employee's behalf, the funds of which can be withdrawn upon termination of employment; iv) The "Education Allowance" (Salário Educação), where 2.5% of wages goes to finance basic public education; and v) "The 'S' System" (Sistema S), a 2.5% levy on wages in the industrial, commercial and transport sectors, which quasi-governmental entities that deliver educational and social services. When this set of taxes is added to other smaller levies, the payroll tax reaches 9.0% of GDP (see Table 3), which is not very different from the average of 9.4% of GDP in OECD countries.

The Salário Educação and the Sistema S illustrate the practice of using payroll taxes to cover expenditures that are not linked to contributory benefits. In contrast, there are no mandatory payroll taxes for unemployment insurance or for health insurance in Brazil. Unemployment benefits are mainly financed by a tax on goods and services (i.e., the 60% of PIS revenues earmarked for this purpose). The cost of universal public health care, on the other hand, relies on a basket of taxes with multiple incidence brackets. At the federal level, health costs are part of the social security budget, which depends on the dedicated revenues of two general taxes: the Cofins and the Social Contribution on Net Income (CSLL). At the sub-national level, the main mechanism is to establish minimum thresholds of tax revenues and transfers received that must be spent on health (12% in the states and 15% in the municipalities).

TABLE 3. Payroll Taxes – Brazil – (2019)

Description	Amounts (billions of BRL)	Share (%) of GDP	Share (%) of total GTB
Payroll taxes	**664.7**	**9.0**	**27.6**
Employees social security contributions	149.4	2.0	6.2
Employers social security contributions	332.0	4,5	13.8
Social contributions to the FGTS	128.7	1.7	5.4
Education Allowance	22.0	0.3	0.9
"S" System	20.5	0.3	0.9
Other	12.1	0.2	0.5

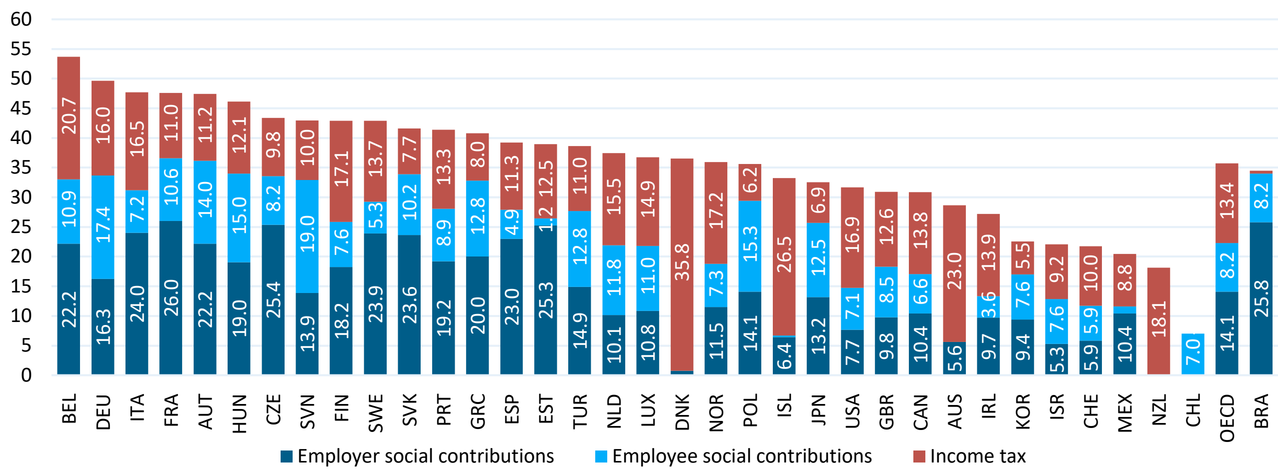
Source: prepared by the author based on OECD and STN data.

The tax wedge indicator is a synthetic way of assessing the comparative tax burden on wages, representing taxes as a percentage of total wage costs for a typical worker in the country. This indicator integrates all taxes levied on wages, namely: employee and employer social contributions, other payroll taxes and the PIT on earned income. The main limitation of this indicator is that it equates taxes with social contributions, which differ in that they entitle the worker to a social benefit. Nevertheless, this indicator

Chart 7 shows the tax wedge indicator for each OECD country. In Brazil, the estimates are based on the average wage of a single worker without children employed in formal economy, using standard income tax deductions.[7] The chart shows that taxes account for 34.5% of the wage costs of a typical worker in Brazil, which is very close to the OECD average of 35.7% is useful for a comprehensive view of the cost of payroll taxes.

The main difference is the composition of the tax wedge. In most OECD countries, the tax wedge is fairly homogeneous, with roughly two-thirds coming from payroll taxes and the remaining one-third from personal income taxes. The most important exceptions are countries with payroll-based tax systems (Denmark, New Zealand, Australia, and Iceland) and Chile, where the tax wedge consists entirely of payroll taxes. In Chile, the typical formal sector worker is exempt from personal income tax due to the combined effect of low average wages by OECD standards and an exemption threshold that limits tax collection to the top of the distribution. The same reasoning helps explain why the tax wedge in Brazil is almost entirely made up of payroll taxes (and only marginally of the PIT). Nevertheless, the high payroll tax wedge in Brazil is striking and finds few counterparts even among OECD countries.

CHART 7. Tax wedge: Brazil and OECD countries, burden rate in the wage cost for an average worker, 2017. (In %)



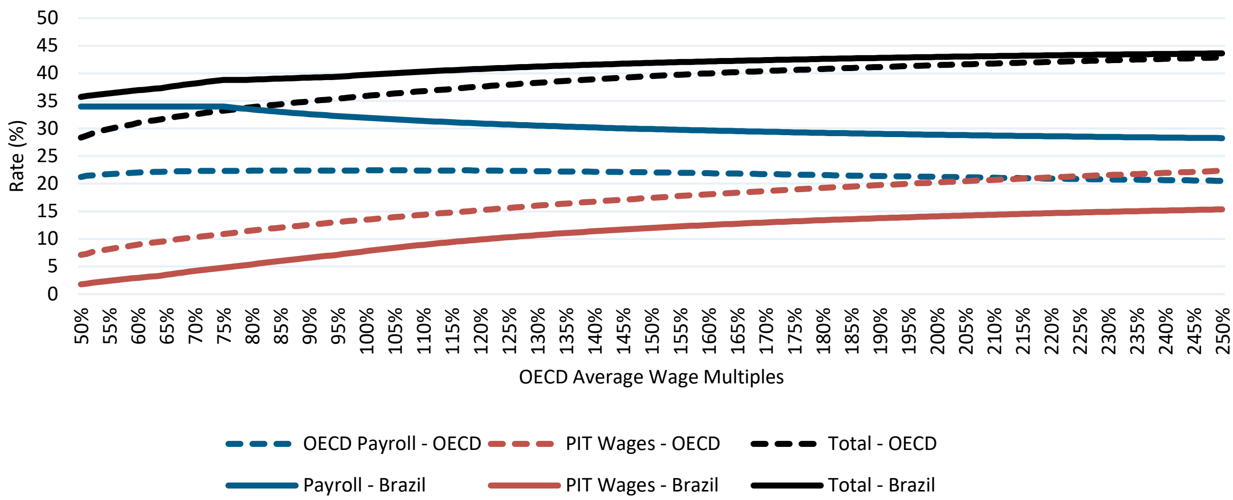
Source: Prepared by the author with information from the OECD database and based on own calculation for Brazil.

Note: Country acronyms are listed in Table 1.

7 The Brazilian tax wedge is calculated using the average salary from RAIS (Annual Report of Social Information). The relevant taxes include the employee's social security contributions, the employer's tax package (social security contributions, FGTS, Education Allowance (Salário Educação), occupational accident insurance of 1% for low-risk activities, contributions to the S System (Sistema S), Sebrae (Brazilian Service of Support for Micro and Small Enterprises), and Incra (National Institute for Colonization and Agrarian Reform) of 2.5%, 0.6%, and 0.2%, respectively, and the PIT on the wages of taxpayers who do not have dependent family members and have opted for the simplified tax filing model. According to this model, the PIT is calculated by a standard deduction of 20% of the gross income. This is different from the full model, where the employee must declare all expenses that are deductible from the PIT (health expenses, education expenses, contributions to private pension plans, etc.). The PIT is discussed in more detail in section 3.4.

The unusual nature of the Brazilian and Chilean cases illustrates yet another limiting aspect of relying on labor cost measures that are, typically, employed in countries with widely divergent average wage levels. To address this factor, Chart 8 draws a comparison of Brazil's tax wedge with the OECD average for comparable wage levels. Brazil has a higher wedge from the outset, and the size of the gap increases as wage levels decrease. The narrowing gap with respect to wages is due to the structure of the tax wedge: the burden in Brazil is proportionally higher in payroll taxes, with a roughly linear incidence across wage levels. It is lower in the progressive PIT, which spares the lowest wages and imposes a proportionally higher burden on the highest-paid.

CHART 8. Tax wedge: Brazil and average OECD countries, burden rate in the wage cost for an average worker, 2017. (In %)



Source: Prepared by the author with information from the OECD database and based on own calculation for Brazil.

In short, Brazil's tax wedge is not only high compared to other countries, but also not very progressive, meaning that the tax burden rises as wage levels decrease. This has adverse effects on domestic production competitiveness and encourages labor market informality and tax avoidance practices.

A case in point is the so-called "pejotization"[8] (*pejotização*), i.e. a process whereby parties choose to hire the worker as a service provider, owner or partner of a corporate enterprise that falls under a special tax regime for micro and small enterprises (Simple Method) or medium-sized enterprises (Presumed Profit), instead of entering into a conventional employment contract. Chart 9 shows that, at its most extreme, "pejotization" can bring the tax wedge down from an average of 44.1% to an average of 17.5% or 10.2%, depending on the type of special regime.

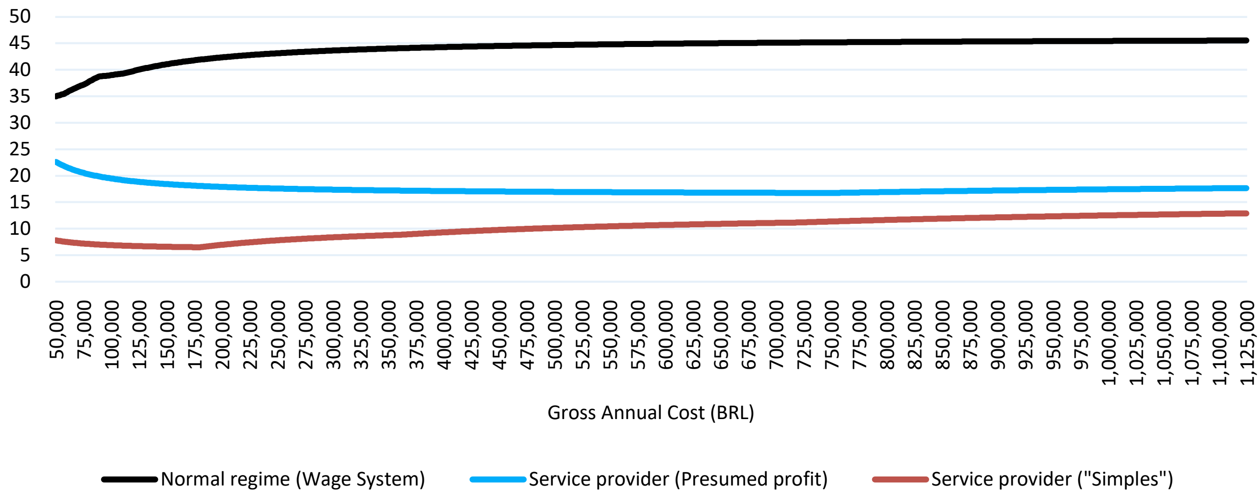
On one side, this arrangement benefits the business, which is exempted from the bulk of payroll taxes and other labor obligations. On the other side, service providers also enjoy tax benefits, since they are not subject to the 27.5% PIT rate on labor income, but to the lower rates from special regimes, with no additional liability upon distribution of such income to themselves, given that current Brazilian legislation exempts dividends and profits distributed to individuals. All they have to do is set their compensation as a partner in the business, namely "compensation for work" ("*pro-labore*"), at the minimum threshold – for instance, at a threshold that

8 [Translator's Note: "Pejotization" (from the Portuguese acronym P.J., meaning "Pessoa Jurídica". In English, "legal entity") is the process of firing your current employees and re-hiring them to do the same work, only this time as service providers. Although this is a common practice among Brazilian companies, it is neither legal nor does it prevent the risk of an employment contract.]

would still allow PIT exemption and the lowest social security contribution – and then distribute the remainder of their income to themselves as exempt dividends. In fact, this exemption actually restricts income tax progressivity in Brazil, as will be discussed in more detail in section 3.4.

In theory, organizing production linkages via more flexible service provider arrangements is not a problem in itself. The difficulty arises when tax system parameters are poorly calibrated and produce arbitrary effects that distort business organizational decisions, as illustrated by the artificial transformation of labor income (overtaxed) into capital income (undertaxed). The other problem associated with "pejotization" is that it erodes the tax revenue base, both for payroll taxes (especially social security contributions) and for income taxes.

CHART 9. Tax wedge according to type of employment contract: Brazil, burden rates on gross costs in 2017. (In %)



Source: Prepared by the author with information from the OECD database and based on own calculation for Brazil.

At least three sets of measures are needed to address such problems. First, an income tax model that integrates taxation at the corporate and individual levels on a more consistent basis should be introduced. Second, poorly calibrated special regime parameters need to be rectified. These two points are directly related to income tax and are discussed in the next two subsections. It should be noted, however, that these two measures would not overcome the problem.

The third set of measures involves reducing the payroll tax burden using two approaches. The first is to eliminate contributions that do not concern the employee's social security benefits from the payroll. This includes mandatory levies on corporate payrolls payable to private organizations that comprise the "S System". Their financing could be converted into discretionary contributions from businesses and/or subsidized spending by the government itself. The "Education Allowance" is also an example. It could be incorporated into the general tax framework, in connection with the new IBS or the income tax. These are some instances of important schemes from the mid-20th century which can be reconsidered in today's context.

In the same vein, the 20% employer's contribution on wages over and above the social security cap bears the hallmarks of a general tax that collectively and complementarily channels resources to the social security system as a whole. It is different from contributions below the cap, which are directly offset by the employee's right to social security benefits. Moreover, any exemption on surplus payroll contribution is a step in the direction of a model in which payroll contributions and contributory benefits are more closely aligned. It also frees up resources and would ideally be combined with more progressive taxation of the PIT, which would replace the supplementary sources of financing social spending.

Ultimately, the priority line of action is to exempt a portion of workers' earnings/wages from social security contributions. The amount to be exempted is equivalent to the minimum-wage and corresponds to the lowest level of social security benefits. In Brazil, the low-income elderly population receives a wide range of social benefits that are indexed to the same threshold. While such non-contributory benefits may have the merit of providing social protection to a significant number of vulnerable people, they have the adverse secondary effect of discouraging participation in the formal labor market and in the contribution system.[9] One possible option for redesigning this system would be a universal benefit for seniors funded by taxes in general, and exemption from social security contributions up to the amount of this benefit. This would convert the contributory system into complement to the universal benefit.

Such reforms must be carried out carefully to avoid jeopardizing the sources that finance social spending. Consequently, the ideal approach would be to begin with a partial exemption from social security contributions, offset by a more progressive taxation of individual income. For example, employee tax rate would be cut from 7.5% to 3% and the employer's tax rate would drop from 20% to 6% incident on a portion of the employee's wage that is equivalent to a minimum wage. This minimum-wage tax exemption measure offers the highest potential for stimulating economic growth while promoting formalization and extending the contribution system's coverage. Accordingly, it is included among the priority measures for tax reform in section 3.6, which outlines its budgetary impact.

3.3. Direct taxation: corporate income tax

Income taxation in Brazil is compositionally asymmetric, with high levels of corporate income tax and low levels of personal income tax. While the tax burden on corporate income is very close to the OECD average (2.8% in relation to 3.0% of GDP), the tax burden on personal income is well below half (3.0% and 8.0% of GDP, respectively). In part, this asymmetry can be explained by the fact that Brazil is a middle-income country with high levels of inequality and informality, which narrow down the PIT revenue base. Nevertheless, there are a number of distortions in income tax structure that compound such asymmetries.

TABLE 4. Taxes on income, profits, and capital gains: Brazil - (2019).

Description	Amounts (billions of BRL)	Share (%) of GDP	Share (%) of total GTB
Income tax	**537.9**	**7.3**	**22.4**
Personal income tax	221.8	3.0	9.2
Corporate profit tax	207.5	2.8	8.6
CIT	127.1	1.7	5.3
CSLL	80.4	1.1	3.3
Not Allocable	108.7	1.5	4.5
WIT-Remittances	39.3	0.5	1.6
WIT-Capital	57.2	0.8	2.4
Other	12.2	0.2	0.5

Source: Prepared by the author based on OECD and STN data.

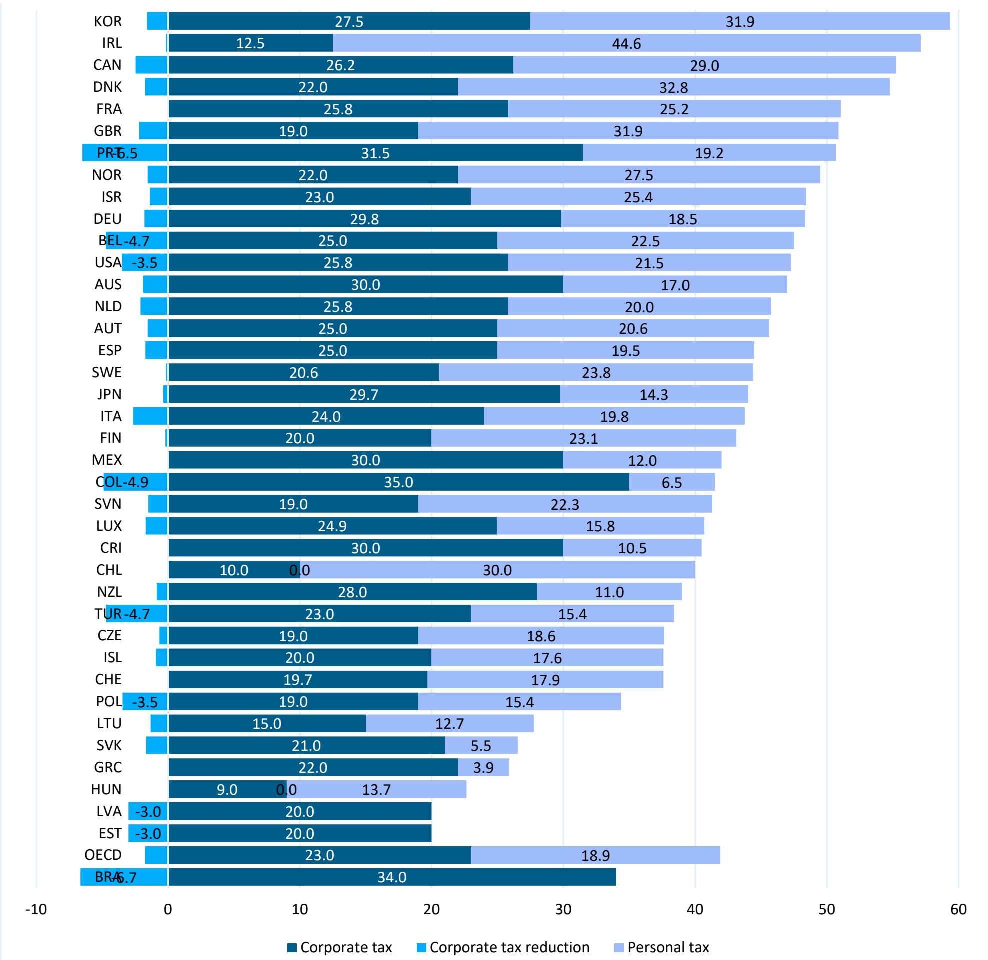
9 See Firpo and Portella (2021) for a more detailed assessment of the relationship between social protection systems and informality of low-skilled workers.

Brazil has a peculiar system for taxing profits and dividends. Corporate profit from companies in general (except for the financial industry and special regimes) is taxed at one of the world's highest statutory rates - of up to 34%, adding the 9% CSLL rate to the CIT rate of 15% of the basic rate and 10% of the surplus tax rate on profit above BRL 20,000 per month. These rates have remained unchanged since 2000 and disagree with an international downward trend. Among OECD countries, for example, the average rate fell from 31.7% to 23.0% in the 2000-2022 period and only two countries still had rates higher than 30% (Colombia and Portugal).

Brazil, in contrast, has a large number of mechanisms that keep effective tax rates well below statutory rates (base exclusions, tax incentives and benefits, special regimes, etc.). Chart 10 compares the effective tax rates typically levied on profits from new investments in Brazil and in OECD countries. From this information, it is clear that the practice of granting a special mechanism to decrease the effective tax rate is very common in these countries. However, no country offers higher relief than Brazil, where the 27.3% effective tax rate is almost 7 percentage points lower than the statutory rate.

Being one of the few countries that fully exempts dividends paid to partners or owners of businesses at the individual level is also distinctive to Brazil. Coupling corporate profit taxation with personal dividend taxation, the Brazilian effective tax rate of 27.3% is well below the OECD average of 40.2% (see Chart 10).

CHART 10. Maximum composite tax rate on profits and dividends: Brazil and OECD countries – (2022). (In %)



Source: Prepared by the author with data from the OECD database.

Note: Country acronyms are listed in Table 1.

The most widespread practice among OECD countries is to tax dividends on the PIT but apply some kind of double taxation relief mechanism – either by tax base deductions, by credits to offset taxes that were already incurred at the corporate level, or simply with special tax rates. Brazil is different in that it has a hybrid system of profit and dividend taxation.

This system is backed by two mechanisms: i) full PIT exemption for conventional dividends; and ii) a variant of CIT with an equity deduction (Allowance for Corporate Equity – ACE) called Interest on Shareholders' Equity JCP). This is determined by applying the long-term interest rate (TJLP) to the company's equity. It is deductible from the CIT/CSLL tax base, up to 50% of annual profits as reported in the annual statement (or retained earnings).[10] These JCPs are exempt from corporate income tax, subject to a withholding tax of 15% when distributed to owners or partners. In turn, any surplus profits in excess of the JCP deduction is subject to CIT/CSLL tax rates of up to 34%. When it is distributed to partners or owners no additional tax is levied at the individual level.

In other words, profits are taxed only once: up to half can be distributed as JCP and taxed at a withholding rate of 15%, while the remainder is taxed at rates that may reach 34%. In the absence of other methods of lowering applicable tax rates, the total tax rate will range from 24.5% to 34%, depending on the extent to which the JCP deduction margin is used, which in turn is determined by how the business is organized.

A leanly organized group has an incentive to maximize the benefits of a 15% differential tax rate by distributing profits up to the JCP deduction cap to its individual shareholders, investment funds or foreign companies. More complex corporate structures are disadvantaged by this mechanism. If profit is distributed as JCP to another company in Brazil, it is considered financial income, taxed at the PIS/Cofins rate of 9.25%. Therefore, the tax rate becomes 24.25% (15% + 9.25%) if a controlled company distributes profit as JCP to its parent company, or 33.5% (15% + 9.25% + 9.25%) if the latter distributes it to a holding company. In most situations, exclusions from the tax base and other tax benefits make the CIT/CSLL option preferable[11]. Consequently, the extent to which JCPs are used differs substantially depending on business group makeup.

An important distinction is that JCP differs in design from a typical ACE-type CIT model. The basic ACE rationale is to encourage neutrality in a company's selection of the financing sources at its disposal, insofar as it strives to balance the tax treatment of debt financing of investments (company's equity), which generates future interest expenses that are deductible from the CIT tax base, and financing through direct contributions from partners and owners (owner's equity), by granting a deduction equal to the notional interest rate applied to owner's equity.

This is not applicable to JCP, which stipulates that profits must be distributed to partners or owners in order to qualify for the deduction. That is, undistributed profits cannot be deducted from the CIT/CSLL tax base. This prerequisite for deduction has the undesirable property of encouraging distribution (rather than retention and eventual reinvestment by the company). Another difficulty with JCP is that its design is such that it will only benefit lean corporate groups, while clearly discouraging more sophisticated corporate arrangements. In fact, the original reason behind the creation of JCP in 1995 was mitigation of the impact of inflation on dividend yields of business partners or owners, as a proxy for the monetary adjustment of the balance that took place during a prior high-inflation period. Ex-post rationalization led to its association with ACE.

10 The most frequently used mechanism for ACE is an average of long-term government bond rates. Brazil, on the other hand, uses the TJLP, which is an official rate published by the Central Bank that is calculated using projected inflation and risk premiums that capture the basic cost of long-term financing in Brazil.

11 Two examples of these CIT tax benefits are the accelerated or incentive depreciation mechanisms, which allow deductions or deferrals of the tax base for businesses that have made qualifying investments, and tax breaks for businesses that operate in strategic regions (Northeast or Amazon).

This profit tax system in Brazil is unique compared to any international experience, despite similarities with some OECD countries. We can draw a certain analogy with the ACE-type CIT models of countries such as Italy, Turkey, and Belgium. The fact is that they all pay dividends to PIT, which discourages companies from not reinvesting profits. In addition, ACE mechanisms have recently undergone reforms that eliminated or restricted them to new investments (rather than to all of the company's assets) to allow for reforms that lowered CIT rates. The main arguments for these reforms are that ACE, despite its positive effect in cutting corporate leverage, does not have the expected impact on investment, its tax cost is high, and/or it generates leeway for abusive tax planning practices.

An additional analogy is the Corporate Income Tax (CIT) model adopted by Estonia and Latvia, the only OECD countries to fully exempt distributed dividends. These countries, like Brazil, do not practice double taxation. Under this model, retained earnings are not taxed until they are distributed to partners and shareholders, at which point they are taxed only once at a withholding rate of 20% on CIT.

Regardless of whether these countries exempt dividends or associate the ACE mechanism with dividend taxation, companies are incentivized to retain and reinvest their profits (rather than distribute them) under the expectation that doing so will foster economic growth. This is the exact opposite of the Brazilian model, which encourages the distribution of profits through JCPs to take advantage of the preferential 15% tax rate as long as the corporate group is lean; and is neutral with respect to excess profits, which are taxed at rates of up to 34% regardless of whether they are distributed or retained (and eventually reinvested) by the company.

The JCP is but one of several mechanisms that arbitrarily depress effective tax rates in Brazil. Special tax regimes for micro, small and medium enterprises are also of particular note. In the "presumed profit" regime, which is prevalent among medium-size companies, legislation presumes that profits are equivalent to a percentage of business revenues, from 8% for industry and commerce to 32% for services. The CIT/CSLL is then determined on the basis of this presumption, which leads to a maximum rate of 2.7% or 10.9% of turnover (8%*34% or 32%*34%). For the services industry, after adding all the other taxes determined by the simplified system, the overall taxation of businesses will be between 13.7% and 19.5% of turnover if they are included in the presumed profit regime, and from 4.5% to 28.5% if they are covered by the "Simples" regime for micro and small businesses.

The major problem is that parameters for simplified regimes are poorly calibrated, resulting in a host of arbitrary rules. First, there are many situations where the presumed percentages significantly underestimate corporate profits. This leads to arbitrarily low effective tax rates because a large share of profits is not taxed, whether at the corporate level or as distributions to individuals. Tohelp put these figures in perspective, the estimated average tax rates on corporate profits under special regimes range from 6.1% ("Simples") to 19.9% (Presumed Profit, "*Lucro Presumido*"), well below estimates for the general regime (Actual Profit, "*Lucro Real*"), which vary between 23.8% and 29.0%, depending on the corporate profile.

Secondly, limits have relaxed over time, broadening the special regime scope to include businesses that do not qualify as small or medium-sized under strict criteria. Currently, businesses with revenues below BRL 4.8 million can choose "Simples" and those with revenues up to BRL 78 million can choose the Presumed Profit option. Loopholes in tax planning that favor large business groups persist, such as concentrating costs in the head office, which operates under the general regime (Actual Profit, "*Lucro Real*", and shifting profits to subsidiaries, which are undertaxed under the special regime (Presumed Profit, "*Lucro Presumido*").

Despite the fact that the statutory tax rate levied on corporate profits is among the highest in the world, there is a wide array of mechanisms (exclusions from the tax base, tax incentives and benefits, special regimes, tax planning loopholes, etc.) that under most circumstances significantly undercuts effective tax rates and creates arbitrary tax treatment across businesses of all sizes and industries. Indeed, it is hardly a coincidence that the estimated (average) effective tax rate for businesses overall is 23.4%, or just over two-thirds of the statutory tax rate of 34%.

The international trend towards lower corporate tax rates, coupled with assessments that the Brazilian model of taxing income in general and profits in particular does not meet the minimum requirements of fairness and efficiency, suggest that sooner or later Brazil will have to address these problems through tax reform. Adjusting the statutory tax rate closer to international standards and compensating for this movement with measures to broaden the tax base is the logical course of action. The statutory rate could, for example, be raised to 25%, which would move it closer to the OECD average of 23%, provided that the window of opportunity offered by rate cuts is used to review tax benefits, other exclusions from the tax base and special regimes, and to introduce a package of anti-avoidance measures. Estimates of revenue losses and gains from these proposed changes to the corporate tax rate and tax basis are given in Section 3.6. Further offsetting measures are needed to expand the taxation of income to the individual level, including dividends, ideally under a PIT model that allows for more consistent treatment of different sources of income, as discussed in the next subsection.

3.4. Direct taxation: personal income tax

While it is indeed true that there is room for improvement in taxation of individual income, such efforts should ideally not be driven solely by revenue goals. The following is a brief list of inconsistencies that could be mitigated by a reform of the PIT:

» The maximum personal income tax rate (27.5%) is low by international standards. Additionally, the tax base is limited by the large volume of exemptions and deductions, many of which lack sound (social or economic) justification. This restricts the degree of tax progressivity and leads to horizontal inequalities between taxpayers at the same income level.

» Horizontal inequalities are compounded by asymmetries in the treatment of small businesses and the self-employed vis-à-vis employees. Poorly calibrated parameters in the special regimes for small and medium-sized businesses, coupled with the exemption of dividends and high payroll taxes, create incentives for "pejotization", whereby individuals artificially become partners or owners of businesses for tax avoidance purposes. Indeed, in some extreme cases of highly personalized activities with low operating costs, the tax wedge of more than 40% under the conventional wage regime can be reduced to 10.2% on average under the "Simples" regime and 17.5% under the Presumed Profit regime, which violates the basic principle of horizontal equity.

» The degree of progressivity is also curtailed because only a very small share of the income of the very rich is subject to the PIT progressive scale. Their primary source of income is capital income, which enjoys special treatment, such as exempt dividends and financial investments that are exempt or taxed at a special withholding rate. This differential treatment of capital income is the main reason why there is a break in the progressive scale of the PIT at the very top of the distribution, which violates the basic principle of vertical equity.

» The distinctive profit taxation model in Brazil, which concentrates tax collection at the corporate level, further hampers progressivity. When taxes are levied on the firm, there is a higher probability that they will be passed on to consumers or workers by way of higher prices for goods and services or lower wages, weakening the progressive potential of taxation. On the other hand, if tax is levied directly on dividends, it is more likely to have an economic impact on the shareholder's income and, given that dividends are a source of income that is highly concentrated at the top of the distribution, ensure tax progressivity.

This list, which is far from comprehensive, merely illustrates some of the inconsistencies and inequities that limit the tax collection potential and the progressivity of the income tax. This lack of PIT progressivity is mirrored in the income distribution average tax rates by strata shown in Table 5 and Graph 11.

In simple terms, the bulk of PIT in Brazil is collected from 26.7 million taxpayers with income above BRL 25,100, who represent less than one-fifth of the 158.3 million adults in the country. The semi-dual model treats capital income, which is mostly exempt or subject to tax withholding at different rates, differently from labor income, which is subject to progressive taxation. Progressive taxation is levied on taxable income, and on roughly half of the income subject to tax withholding, both of which are mainly wage-related. Four tax rates are applied to incremental bands of the tax base (after legal deductions of at least 20% of income), between 7.5% and 27.5%, beginning at the exemption threshold of BRL 22,900. Therefore, the average tax rates on taxable income are much lower: they begin at zero in the first income bracket in Table 5 and reach 21.8% in the last bracket.

TABLE 5. PIT: Number of Taxpayers (in thousands), Per Capita Income Amounts, Deductions and Tax Base (in BRL thousands), and Average Tax Rates (%) by Income Brackets, Calendar Year 2020.

Income Brackets	Taxpayers	Taxable income				Income subject to withholding tax		Tax-exempt income	Total income	
		Income	Deductions	Tax base	Average rate	Income	Average rate		Income	Average rate
Up to BRL 25.1 thousand	4,937.9	10.1	-1.9	8,2	0.0	0.4	6.8	1.5	12.0	0.3
From BRL 25.1 thousand to BRL 37.6 thousand	5,014.8	27.1	-6.0	21,1	0.3	2.0	11.9	3.0	32.1	1.0
From BRL 37.6 thousand to BRL 62.7 thousand	8,263.0	39.0	-9.4	29.6	2.0	3.7	14.1	6.4	49.2	2.6
From BRL 62.7 thousand to BRL 87.8 thousand	4,316.9	57.0	-14.3	42.7	5.0	6.0	15.5	11.4	74.4	5.1
From BRL 87.8 thousand to BRL 125.4 thousand	3,219.1	77.4	-18.3	59.0	8.9	9.1	16.2	18.4	104.9	8.0
From BRL 125.4 thousand to BRL 188.1 thousand	2,526.2	106.8	-22.2	84.6	13.1	14.0	16.7	32.0	152.8	10.7
From BRL 188.1 thousand to BRL 250.8 thousand	1,167.2	141.5	-27.2	114.3	15.7	21.3	16.9	53.6	216.5	12.0
From BRL 250.8 thousand to BRL 376.2 thousand	1,073.9	183.6	-34.1	149.6	17.5	31.9	17.0	87.1	302.6	12.4
From BRL 376.2 thousand to BRL 501.6 thousand	462.1	239.2	-43.6	195.7	18.8	48.4	17.2	140.3	428.0	12.4
From BRL 501.6 thousand to BRL 752.4 thousand	340.8	277.4	-48.5	229.0	19.5	77.0	17.2	236.4	590.8	11.4
From BRL 752.4 thousand to BRL 1,003.2 thousand	118.0	298.3	-48.1	250.3	20.2	126.9	17.2	408.9	834.1	9.9
From BRL 1,003.2 thousand to BRL 2,006.4 thousand	122.6	343.6	-50.1	293.5	21.1	212.1	17.1	732.3	1,288.0	8.4
From BRL 2,006.4 thousand to BRL 3,009.6 thousand	30.8	454.8	-66.9	387.9	21.7	403.8	17.2	1,421.7	2,280.3	7.4
From BRL 3,009.6 thousand to BRL 4,012.8 thousand	13.6	573.4	-86.4	487.0	22.0	635.1	17.2	2,025.2	3,233.7	7.3
More than BRL 4,012.8 thousand	28.0	1,272.5	-233.3	1,039.3	21.8	3,350.6	17.0	7,508.8	12,132.0	7.0
Total	**31,634.8**	**62.4**	**-13.3**	**49.2**	**10.4**	**12.5**	**16.5**	**31.2**	**106.2**	**8.0**

Source: Prepared by the author based on SRFB[12] data.

12 [Translator's Note: Brazilian Federal Revenue Office]

However, the main constraints on progressivity are related to the taxation of capital income. Slightly over one-half of the income subject to exclusive taxation comes from capital ownership, which is typically taxed at linear (neutral) rates that are lower than progressive rates. Besides, most of the income from capital ownership is tax exempt at the personal level, especially dividends and distributed profits.

Given that the weight of capital income increases as one moves along the income distribution, the PIT model ends up creating a paradoxical situation: the average rate on total income rises to a maximum of 12.4% in the intermediate strata of taxpayers that earn between BRL 250,8 thousand and BRL 501,6 thousand, while the main source of income is still taxable (wage). From then on, we see an inflection in rates, which drop to 7.0% for those with incomes above BRL 4.0 million due to the predominance of capital income (exempted or taxed at lower linear rates). For instance, in this last stratum of the best-off in Brazil, whose average income is BRL 12.1 million, almost two-thirds of income is exempt, and a scant quarter is subject to withholding tax, while only a tenth of income is taxable (on average BRL 7.5 million, BRL 3.4 million and BRL 1.3 million, respectively).

The disruption in the distribution of the degree of progressivity is more clearly seen in Chart 11, which shows estimates of the average tax rates applied to the entire income distribution (and not only to those who file income tax returns). The progressive nature of the PIT, which is levied almost entirely on the income of the best-off 10% of the country, is evident. In the worst-off 90%, a vast majority is exempt and only a minority pays taxes at an average rate of 0.4% of their income. However, the average tax rates for the wealthiest 10% are relatively low (between 3.3% and 13.0%) and cease to increase at the very top of the distribution, which severely limits its degree of progressivity.

CHART 11. PIT: average tax rates by income distribution strata. (In %)

Source: Prepared by the author with information from SRFB and IBGE.

From this brief examination, it appears that there is scope for increasing personal income tax revenue potential and its progressivity, provided that caution is applied to avoid replicating or intensifying current distortions.

Increasing personal income tax progressivity is usually associated with limitations on deductions and/or higher marginal tax rates. In Brazil, however, the PIT structure means that such isolated measures would have very limited redistributive and collection effects, as they would only affect income that is treated as taxable, which does not include dividends nor income from financial investments – the main income sources for the very rich. This burden would be largely borne by wage-earners and would also be somewhat counterproductive, in that the "pejotization" effect, i.e., the artificial transformation of labor income (taxable) into capital income (exempt from income tax), would be fostered.

Conversely, a mere refund of the tax on dividends would not solve the problem either, for it would preserve the imbalance between tax rates, the disincentive to invest in productive assets and the loopholes for tax avoidance. For instance, if dividends were subject to the progressive PIT scale, their impact would be partly neutralized because companies would be encouraged to use alternative mechanisms to pay partners and owners, such as share buybacks taxed at a special capital gains rate or disguised dividend payments.

Additionally, the maximum statutory tax rate on dividend income, which comprises corporate and individual taxation, would not meet international standards. In other words, if profits were taxed at the corporate level at a rate of up to 34% and the remaining 66% at a rate of up to 27.5%, the maximum tax rate would amount to 52.2% (34% + 0.66*27.5%), only lower than that of four OECD countries shown in chart 10. The OECD average is split evenly between 23.0% at the corporate level and 24.5% at the personal level, to a maximum of 41.9% (23% + 0.77*24.5%).

These observations strengthen the argument that, instead of adopting simple measures, the best approach would be to shift to a more coherent model consistent with international practice. This implies following a set of guidelines that include: i) more equitable tax treatment of income from work and of income from shareholders or business owners (including small businesses); ii) more equitable taxation for different sources of capital income (dividends, financial investments, or capital gains); and iii) the introduction of a consistent mechanism that integrates income tax at the personal and corporate levels, at rates that would not differ from international standards.

There are several alternative models that have been discussed in literature. The first consists of introducing the required procedures for implementing a comprehensive income tax, in which all income is subject to a PIT progressive scale, regardless of whether it comes from labor or from capital ownership, which is integrated with the CIT. This approach is intended to ensure that the progressive taxation of increases in purchasing power of the taxpayer's assets is operated in compliance with the original principles of the comprehensive income tax model. Since all income, without exception, is included in the tax base, subject to progressive tax rates, this approach ensures consistent treatment across different income sources. The drawback is that the required procedures are difficult to implement, and, in practice, no country has been able to do so fully. This model entails, for example, the establishment of monetary correction mechanisms to ensure that only real gains on financial investments are taxed, and of a credit system to offset the corporate tax that businesses already pay against the PIT on dividends.[13]

A second alternative, which is more feasible from an operational point of view, is to rectify the PIT dual model by rebalancing tax rates and reviewing exemptions and deductions. This option would preserve the differential treatment enjoyed by labor income, which is subject to the progressive PIT schedule, and capital income, which is broadly taxed at the same linear rate. This would be a simpler (and imperfect) solution to mitigate the effects of inflation adjustment and double taxation of profits. Nonetheless, it raises the issue that differential treatment of capital income narrows the degree of PIT progressivity at the top of the distribution, which is an especially sensitive concern for an inequality-laden country such as Brazil. These constraints justify bolstering the dual PIT model with a tax levied on net worth (i.e., the wealth) of the best-off, if achieving greater progressivity is desired, as opposed to the comprehensive model, which at best can even dispense with this type of tax.

13 In general, these include: i) applying the criterion of shareholder income competence, changing the applicable criterion to that of imputed income (regardless of whether the profit has been retained or distributed as dividends), to overcome the problem of lock-in profits; ii) introducing a credit system to ensure full integration with the CIT by offsetting against the tax already paid by the company (i.e., CIT is treated as an advance that generates credits to be offset in PIT); iii) monetary correction mechanisms for taxing only actual gains from financial investments; and iv) mechanisms for monetary correction and retroactive calculation of the tax due upon realization of the capital gains, avoiding the problem of lack of liquidity when these gains are taxed on an accrual basis.

Other alternatives for reforming PIT include subjecting capital income to progressive taxation, albeit on a separate basis, with lower rates than for wage income. This is a middle way between the dual and the broad models, in which operational feasibility and progressivity are combined. Section 3.6 presents estimates of revenue gains from possible changes to the PIT, including the creation of a new marginal tax rate of 35% and a specific progressive schedule for capital income, and a series of reconsiderations of exemptions and deductions from the tax base.

3.5. Direct taxation: property tax

The property tax burden in Brazil, at 1.5% of GDP, is not very different from the OECD average of around 1.8% of GDP. However, its breakdown is very different, as is the structure of rates and exemptions.

Most notably, the weight of taxes on financial and capital transactions is slightly higher in Brazil (0.7% vs. 0.4% of GDP). This is due to the fact that the tax on financial transactions (IOF) has shifted from its primary regulatory (extra-tax) purpose to become a tax collection instrument. The IOF is levied on a wide range of financial transactions (credit, foreign exchange, insurance, and real estate securities) by individuals and companies, with a standard rate of 0.38% on domestic transactions and rates between 1.1% and 6.38% on international transactions. After the IOF is deducted, revenue from real estate taxes is nearly halved. There is greater untapped revenue potential.

Brazilian real estate tax collection is relatively low by international standards (0.7% of GDP, compared with an OECD average of 1.0% of GDP). Besides increasing tax rates, tax revenues could also be increased by reviewing the system for estimating and updating the tax base and by improving collection mechanisms.

The major problem with the Rural Real Estate Tax (ITR) in Brazil is that rural landowners under-declare values and there is no effective verification mechanism. The Urban Real Estate Tax (IPTU), on the other hand, faces an additional hurdle: municipal legislators must approve any adjustment to real estate assessment scales, which poses a political constraint on municipalities that want to apply a valuation basis that is closer to real estate market value. As a result, the amount set by municipalities for levying the Real Estate Conveyance Tax (ITBI), which is based on the market value of conveyed real estate, is usually far higher, and often doubles or even over doubles the amounts that are used as reference to determine the IPTU.

This inability to estimate and update real estate values renders the application of the principle of progressivity ineffective and contributes to low tax collection. We should also mention the high level of IPTU arrears, which is partly explained by weak mechanisms for recovering tax debts in municipalities. To avoid political fallout, these mechanisms ultimately encourage taxpayers to fail to comply with their tax obligations on a regular basis.

Apart from the aforementioned adjustments to the IPTU and the ITR, two other proposals to increase tax collection are often put forward in public forums: the first, an increase in Estate and Gift Tax rates (ITCMD); and the second, the creation of a Wealth Tax (WT), which was provided for in the 1988 Federal Constitution but has never been enacted.

TABLE 6. Property taxes: Brazil – (2019).

Description	Amounts (billions of BRL)	Share (%) of GDP	Share (%) of total GTB
Property taxes	**111.8**	**1.5**	**4.6**
Recurrent taxes on real property	49.7	0.7	2.1
ITR	1.6	0.0	0.1
IPTU	48.1	0.7	2.0
Estate and Gift Tax (ITCMD)	8.6	0.1	0.4
Taxes on financial and capital transactions	53.5	0.7	2.2
IOF	40.9	0.6	1.7
ITBI	12.6	0.2	0.5

Source: Prepared by the author based on OECD and STN data.

In the former scenario, however, it is important to recognize that Brazil's inheritance tax collection (0.12% of GDP) is not much lower than the OECD average (0.14% of GDP, or 0.20% of GDP for the 24 member countries that apply this type of tax). This is explained by the fact that although the ITCMD tax rates are low, capped at 8%, the exemption band is also low. Consequently, while it is desirable to reform the Brazilian inheritance tax to make it more progressive, it seems unreasonable to imagine that a change that would significantly increase tax revenue would be possible. The best option is to address the distortions of the current inheritance tax through a combination of better designed brackets and higher rates applicable solely to the estates of the very wealthy.

As for the second possibility, a recurrent wealth tax (WT), it is important to understand that this is a proxy for taxation of income and capital gains. This type of wealth tax has attracted increasing interest in recent years because of renewed interest in the role of taxation in controlling income and wealth concentration at the top. This echoes recent developments in the international context of growing inequalities and the advancement of the global tax transparency agenda, which has ushered in new tools to prevent offshore concealment of capital income and wealth, curbing the extent to which these taxes are distortionary.

However, the same revenue objectives can be achieved either by levying a wealth tax or by adjusting income taxation. There are pros and cons to both alternatives, and a combination of the two may be desirable under certain conditions. Where a dual income tax model that does not progressively tax capital income is in place, and/or where there are many exemptions, deferrals, and loopholes for tax avoidance, it makes more sense to opt for increasing taxes on the wealth of the best-off - as opposed to a comprehensive model, which taxes income broadly and progressively, and therefore can do without such a broad scope for this type of tax.

Theoretically, income taxation seems more appropriate, but sometimes the difficulty of tapping certain incomes (e.g., land and property owners) justifies a complementary wealth tax. For these reasons, it has been included in the list of measures with the potential to increase revenues that is shown in the next subsection.

3.6. An assessment of the reform proposals: estimates of revenue potential

The estimated revenue losses or gains from the set of reform measures in the preceding subsections are summarized in this subsection. This assessment is presented in Table 7 under the simplifying assumption that all measures would take effect immediately in the year following their implementation. This assumption is made simply to allow comparison between estimates and results should be interpreted with caution, since some measures would require longer transitional arrangements than others.

TABLE 7. Assessment of tax reform measures. (Estimated values in BRL in 2023)

Measures	Amounts (billions of BRL)	Share (%) of GDP
Tax refunds for low-income families	-26	-0.25
Additional IBS rate (0.5%)	26	0.25
Payroll exemption up to the benefit floor (9%)	-78	-0.75
Payroll exemption above the benefit ceiling (10%)	-4	-0.04
Additional PIT rate (35%)	7	0.07
Review of PIT deductions and exemptions	29	0.28
Reduction of CIT /CSLL rates (25%)	-98	-0.95
Expansion of CIT /CSLL base and change in special regimes	40	0.39
Progressive taxation of capital income in the PIT (up to 22.5%)	107	1.03
Review of benefits and unification of the form of taxation of financial investments	32	0.31
Wealth Tax	31	0.30
Revenue expansion measures	272	2.63
Revenue reduction measures	-206	-1.99
Total	**66**	**0.64**

Source: Prepared by the author.

The first measure in Table 7 is the mechanism for refunding the goods and services tax to low-income households. Orair and Gobetti (2019) estimate that it would take a return of about 2% of the IBS revenue, corresponding to an updated amount of BRL 26 billion (or 0.25% of the projected GDP of BRL 10,339.8 billion in 2023), to transform the IBS incidence profile into near-neutral in terms of income distribution. Given the basic assumption of a constant level of tax collection on goods and services (after refunds to the worst-off families), which is stated expressly in the two reform proposals currently before Congress, the corresponding chart for this measure would be an additional rate of 0.5% of the new IBS.

The next two measures shown in Table 7 are payroll tax cuts. The priority measure is the cut in social security contributions levied on the pay component corresponding to the social security floor (minimum wage), which is estimated at BRL 78 million (0.75% of GDP) if the employee's rate is pared from 7.5% to 3% and the employer's rate from 20% to 6%. As discussed in subsection 3.2, this kind of tax relief should be coupled with an increase in personal income tax. Indeed, it can be regarded as a preliminary step towards a universal benefit scheme for senior citizens which would be funded by taxes in general.

Decreasing the employer's social security contribution above the social security benefit cap is also a measure that leads to a model where contributions and benefits are more closely aligned. This measure should also be envisaged in tandem with the reform of the income tax system. Table 5 shows an estimated impact of BRL 4 billion should the rate be cut from 20% to 10% only on wages above BRL 30,000.

If this were associated with a new marginal PIT rate of 35%, i.e., higher than the current 27.5% for the calculation base above BRL 35 thousand, the estimated BRL 7 billion gain would more than offset any initial losses. In Table 7, also looking at the PIT, the estimated revenue gains from measures to broaden the taxable income base are as high as BRL 29 billion (0.28% of GDP)[14].

It is important to bear in mind that such measures to broaden the tax base and the rate of the progressive tax scale would, in isolation, have limited redistributive and tax collection effects under current PIT configurations in Brazil. As discussed in subsection 3.4, they would only affect income classified as taxable, which does not include dividends or income from financial investments, which are the main sources of income for the very rich. As such, its burden would be largely borne by wage earners and to a certain extent it would be counterproductive, because it would still foster “pejotization” by artificially converting earned income (taxable) into capital income (exempt from the PIT).

For that reason, Table 7 includes a number of measures that require a comprehensive reform of the income tax model. One such measure is the adjustment of statutory corporate tax rates, which would align Brazil with international standards by cutting statutory corporate tax rates from 34% to 25%, with an estimated revenue loss of BRL 98 billion (0.95% of GDP). The window of opportunity offered by this rate cut could be used to advance measures to broaden the CIT/CSLL tax base, including a readjustment of the special tax regime parameters (“Simples” and Presumed Profits), with an estimated revenue gain of BRL 40.0 billion (0.39% of GDP)[15].

Increasing capital income taxation at the personal level is another possibility for compensation. Table 7 shows potential gains of BRL 107 billion (1.0% of GDP) could be obtained from a progressive scale with rates of up to 22.5%, which would be levied on a wide range of capital income whenever the sum of such income exceeds an annual threshold of BRL 180 thousand. The progressive scale would replace the current model, which exempts dividends and subjects the bulk of financial investments to exclusive withholding tax rates, usually linear. Additionally, the progressive taxation of capital income could be diversified to include types of financial investments that are currently exempt or that allow deferral.[16] Reviewing these tax benefits and unifying taxation of financial investments would generate an estimated additional revenue of BRL 32 billion (0.3% of GDP).

The last measure is regulation of the wealth tax (WT). There are a number of possible designs for this tax, and, for the sake of simplicity, the simulation presented in Table 7 is based on the thresholds and rate bands adopted in Spain, where progressive rates from 0.2% to 2.5% are applied to the worth of assets above the exemption threshold of €700,000 (or BRL 2.5 million at the average 2017 exchange rate of BRL 3.61). When applied to the data available for Brazil, this tax would affect 240.7 thousand taxpayers, who are essentially clustered in the stratum of 0.16% of adults with the highest income levels in Brazil, owing to the high correlation between income and wealth distribution according to Paiva et al (2021). From a tax collection point of view, the simulation suggests revenues of about BRL 31 billion (0.3% of GDP) from wealth tax.

The concluding balance in Table 7 suggests that the estimated revenue-raising measures could reach 2.6% of GDP, partly offset by revenue-losing measures of 2.0% of GDP, with a net gain of up to 0.6% of GDP. These figures should be taken as potential maximums and are dependent on a number of political obstacles to approval, which are briefly addressed in the concluding remarks.

14 More specifically, the estimates involve the introduction of caps on the deductibility of health care expenses and the exemption of income for pensioners with severe illnesses, as well as a change in the treatment of severance pay for income received cumulatively.

15 These include: a reform of the JCP; the creation of a minimum tax rate of 15% on corporate accounting profits; and a change in the profit presumption system to a percentage of net sales (after deducting payroll expenses, taxes, and estimated expenses for inputs). It also includes a set of anti-avoidance measures whose impact on tax collection is difficult to quantify.

16 This means the end of exemptions for financial securities in the real estate and agribusiness sectors (LCI, LCA, CRI, CRA, FII, etc.), the expansion of the system of regular tax anticipation (“come-cotas”, i.e., mandatory withholding of income tax) to closed-end funds and the taxation of income held offshore.

4. Final considerations

This paper presents an assessment of the major distortions of the Brazilian tax system and outlines a number of possible solutions. If fully and immediately implemented, these tax reform measures would potentially raise additional revenues estimated at up to BRL 66 billion, or 0.64% of GDP.

The assumption of immediate effectiveness in the year following the full application of the set of measures is, evidently, not realistic. It is only intended to simplify the comparison between impact estimates, and results should be treated with a modicum of prudence, since some measures would require transitional arrangements with lengthier timescales than others. In addition, some tax reform measures will face greater political opposition and will tend to wither or die in the course of legislative process.

From a pragmatic point of view, it makes more sense to pursue a process of gradual change or "piecemeal reform" rather than a radical reform that would be difficult to implement. The caveat is that the notion of piecemeal reform implies a certain conception of a tax system that would be achieved in the future but will be implemented piecemeal to ease transitions and allow for course corrections.

Irrespective of the chosen pace, it is essential that tax changes are not treated in isolation, but rather as part of a coherent whole, or a destination point, which presupposes a comprehensive reform of the tax system. This reform will not only entail the reformulation of specific tax collection components to address their respective inequities and inefficiencies, but also a change in the configuration of the tax burden to decrease the high levels of taxation on wages and profits at the corporate level.

The other dimension of a change in the structure of the tax burden is the need to offset it with higher taxation on individual income and wealth and/or taxation of goods and services, as many international experiences have done. In Brazil, however, the option of taxing goods and services is more problematic because this is already one of the highest in the world, not to mention that it is undesirable because of its regressive effect on income distribution. Consequently, the main thrust of this paper has been directed towards measures to increase taxation of individual income and wealth. Nevertheless, this alternative should be pursued with caution, following guidelines that blend equity and efficiency concerns, and it must be combined with reforms in taxation at the corporate level.

With regard to the taxation of goods and services, the scope of the discussion was restricted to the reforms that are currently before National Congress, which envisage replacing the current basket of inefficient taxes with a modern system based on two pillars (IBS and IS) following a transitional period, without raising nor lowering the burden. Under this approach, Brazil would still be one of the highest taxing countries for goods and services but would have greater potential to boost its economic growth through efficiency gains from the new system.

A reform that updates taxation of goods and services is a rare opportunity to combine gains in efficiency and equity for the tax system. Contrary to what common sense preaches, the introduction of uniform tax rates, coupled with the tax refund mechanism for low-income families, would mitigate and possibly eliminate regressivity in the taxation of goods and services in Brazil.

The quandary is that the size (and nature) of the redistributive impact would depend on the volume of targeted refunds and the reference rate for the new tax (IBS). The larger the volume of refunds, the higher the tax rate needed to balance collection (i.e., to keep it constant in net terms after refunds to the worst-off) and, consequently, the greater the political pushback from the non-beneficiary population. Lastly, while it is true that transparency is a desirable feature of this modern tax, since it is explicitly shown on the final consumer's bill, visibility does have the side effect of making it unpopular. There is also the usual rejection of tax reform, for instance by representatives of certain states and municipalities, who are opposed to a loss of autonomy to grant tax incentives, and by companies and industries that currently enjoy tax privileges. It is interesting to recall that many industries opposing reform have a common trait of being labor-intensive, such as service providers. This is why concurrent payroll tax relief could be used as a tool to circumvent opposition and allow approval of the goods and services reform.

Naturally, this is neither the sole nor the main objective of payroll tax relief. The set of measures discussed in this paper reflects two broader and interlinked objectives: i) transition to a contributory system where contributions are more directly related to social benefits; and ii) the effort to transfer funding sources of other social policies (universal or targeted) to general taxes. The implicit assumptions are that meeting this dual objective can foster participation and regularization of the labor market, stimulating economic growth while extending the welfare system's coverage to a larger contingent of the population.

Needless to say, this type of payroll tax relief reform should be implemented with caution, to avoid jeopardizing current sources of social expenditure funding. Its obligatory counterpart is evolution in individual income (and eventually wealth) taxation, which tends to meet with strong opposition from segments at the top of the distribution. A comprehensive communication strategy on the broader objectives of the reform is needed to overcome such obstruction by showing that it is not just a matter of raising revenue.

This is why it is important to pinpoint the current inefficiencies and inequalities (horizontal and vertical) as priority targets of a possible income tax reform. On one hand, the goal was to draw attention to the creation of a model that matches a broad decrease in corporate income tax rates. The window of opportunity offered by lowering tax rates should be used to rethink specific tax benefits that are recognized as inefficient, in particular those that currently hinder businesses from reinvesting. As follows, lower rates at corporate levels would be applied to broader tax bases.

On the other hand, with regard to personal income taxation, a model of tax reform primarily aimed at broadening the tax base by reviewing deductions, exemptions and special treatments is proposed. In other words, the expected gains in tax collection and progressivity would hardly derive from an increase in the maximum tax rate, but rather from equalizing the treatment of different sources of income and taxpayers by broadening the tax base and closing loopholes for tax planning. As a matter of fact, the reference model under discussion envisages no more than a moderate increase in the maximum PIT rate to a level that is low by international standards (from the current 27.5% to 35%) and retains a separate scale for capital income (progressive rates of up to 22.5%).

These features limit the degree of progressivity of the PIT and warrant rethinking in the context of a possible reform. If progressivity at the top of the distribution should be increased, a complementary proposal for a tax on the wealth of the very rich has been included in the list of measures with the potential to increase revenue. This becomes a viable alternative if the PIT reform agenda is stymied by legislative gridlock or otherwise becomes dispensable. Ultimately, the progress of the reform agenda as a whole depends on the interplay of political forces, bargaining power, and social preferences. This paper does not purport to deliver a definitive answer to these questions. It is purely a contribution to debate.

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