

Tax System

Shortcomings and policy recommendations 



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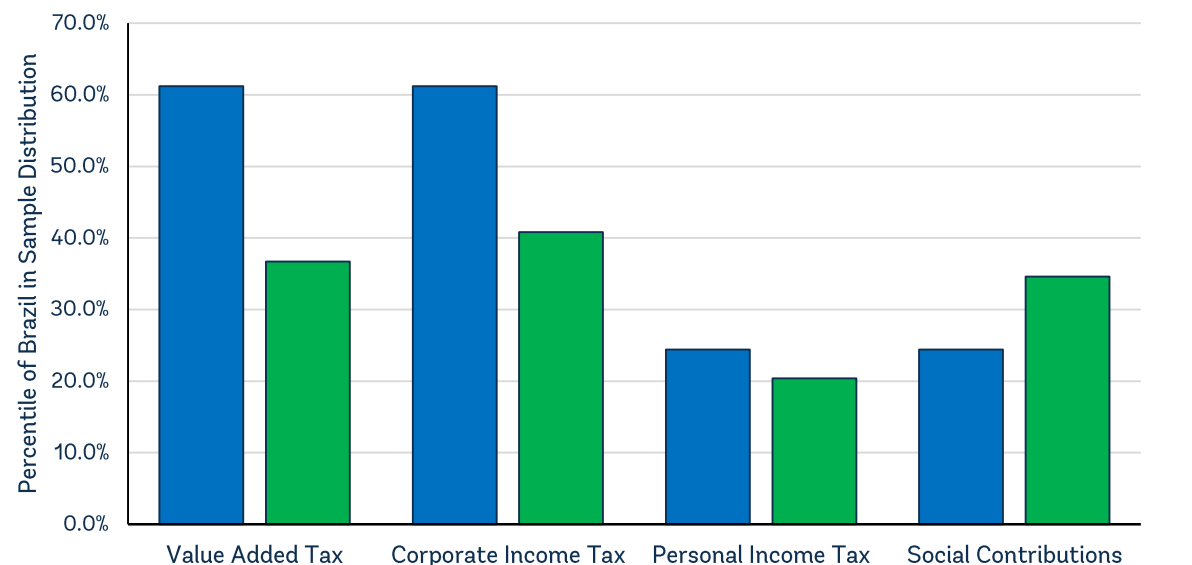
I. Key Sectoral Challenges

Tax revenue is high despite moderate rates

- **Brazil has strong VAT and CIT revenues**, despite rates being lower than in over half of peer countries.
 - Challenge is not about tax system efficiency but about the effective burden and incidence on tax payers
- **For personal income tax, Brazil's revenue and rate place it at the 20th percentile of peer countries**, though the low rank is driven by a comparison with OECD.
- **Brazil raises more personal income tax revenue than most peers in Latin America and other emerging markets.**
- **Social contributions are where Brazil underperforms**, given relatively high rate.
 - Reflects informality and large tax exemptions in payroll since 2012

Revenue from indirect taxes (% of GDP) - 2016

Figure 1: Tax Revenue in Brazil and Peer Countries*



Source: IMF WRL Survey (2014) and USAID (2013)

■ Revenue as % of GDP ■ Tax Rate

*The peer countries include Latin American countries, Emerging Market Countries, and OECD countries.

I. Key Sectoral Challenges

Distortionary turnover taxes

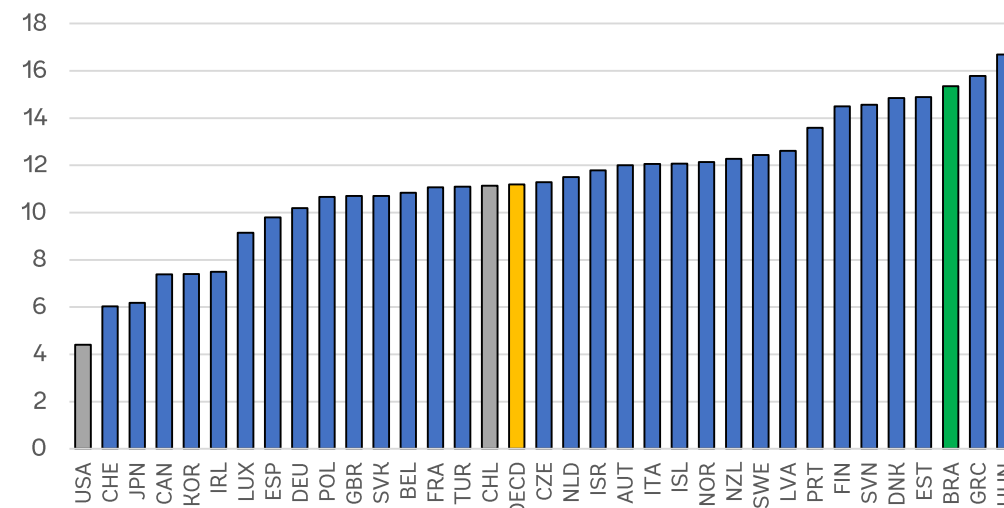
- **Taxes at the federal, state and municipal levels compound on each other.** This is because the taxes are applied to final sales price of goods (including taxes), rather than to the pre-tax sales price.
- **Multiple taxes levied on firms are levied on the same basis: revenues. This includes the SIMPLES, the ISS or the PIS/COFINS, IRPJ and CSLL when the firm opts for the presumed profits regime.**
 - Taxes at different levels of government compound on each other; and
 - Deducting input cost is often difficult in practice (admin cost, delays).
- **Turnover taxes in Brazil have several economic Implications:**
 - Turnover taxes cascade through the production chain - leading to higher effective tax rates for downstream firms compared to upstream firms, especially in long production chains;
 - This distorts firm's decisions on inputs, leading to vertical integration and market segmentation - hampering horizontal equity as firms in different sectors are taxed at different effective rates - thus reducing efficiency of production in the economy.
 - These differential tax rates add to the distortions directly created by the tax system when imposing different taxes on goods and on services.
 - An estimate of the extent of distortions (and hence the economic losses) requires access to micro data.

I. Key Sectoral Challenges

Limited progressivity

- The Brazilian tax system is regressive because it relies mainly on indirect taxes;
 - Indirect taxes are regressive because the poor use a larger share of their income for essential goods consumption.
 - Indirect taxes are important in Brazil, accounting for 15% of GDP in 2016, against an average of 11% in OECD;
- Furthermore, high-income earners have part of their income untaxed;
 - Average effective income tax rates increase until the 99th percentile of income distribution up to 12.3%, but then fall to 7% for the richest 0.05% of the population;
 - A loophole allows income shifting from the personal to the corporate tax base (*pejotização*), mainly for rich professionals who benefit from lower effective income tax rates.
- As a result, Brazil's tax system contributes little to reducing inequality;
 - Considering all taxes and all direct and indirect transfers, Brazil reduced inequality in 24%. This compares to over 30% in European countries, and 41% and 34% in Argentina and Russia, respectively.

Figure 2: Indirect Taxes Revenues (%GDP) - 2016



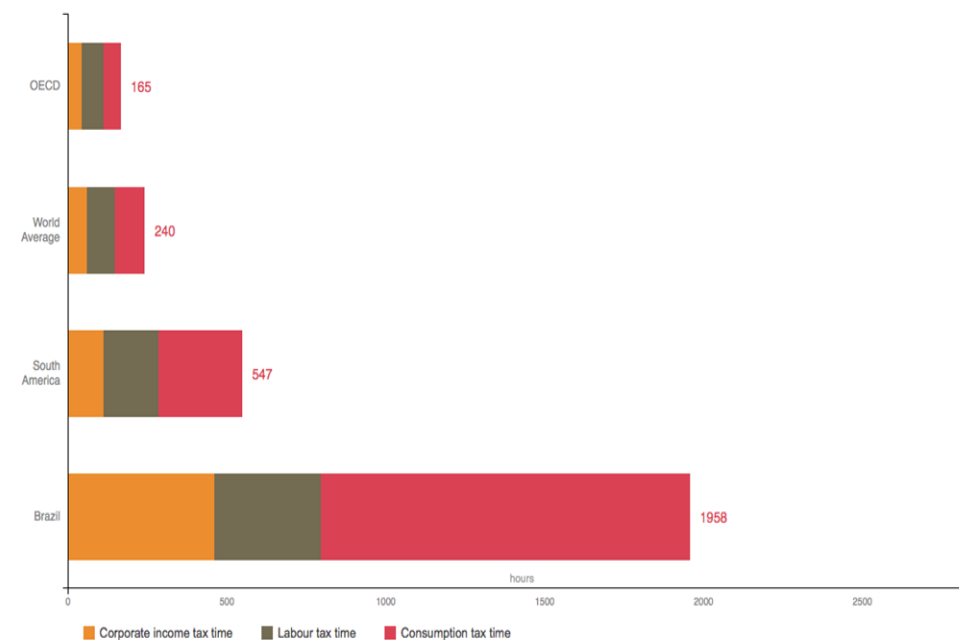
Source: OECD and Brazilian Federal Revenue.
Note: Tax revenue on good and services.

I. Key Sectoral Challenges

High tax compliance costs

- Brazil’s tax system imposes exceedingly high compliance costs on taxpayers.
- Taxpayers in Brazil spend almost four times as much time to comply with their tax obligations as do taxpayers in other Latin American countries, and over ten times as much time as taxpayers in OECD countries (Doing Business 2018; PWC 2018).
- The costs are due to:
 - Complex structure of taxes and the combination of state, federal, and municipal taxes with different collection agencies for each;
 - Frequent legislative and regulatory changes, which mean taxpayers have to periodically check tax system parameters and are subject to uncertainty; and
 - Burdensome reporting requirements.

Figure 3: Time to Comply with Taxes



Source: *Paying Taxes (2018)*

I. Key Sectoral Challenges

Tax competition and the ‘fiscal war’

- **Fiscally constrained states compete for mobile tax bases.**
 - Taking advantage of the freedom to set rates, state governments implement lower ICMS rates and discounts for mobile economic activities to attract them to their states.
 - The result has been a race to the bottom, which is referred to as the “fiscal war” between states, and has reduced aggregate state revenues.
- **“Winner” states in the “fiscal war” may gain in tax revenue and job creation, but at the expense of the country as a whole .**
 - This process creates significant distortions: There are different tax rates for different sectors, and different rates for the same sector in different states.
- **In addition, ICMS design favor production states over consumption states.**
 - VAT with destination principle would avoid this.

II. Policy Recommendations

Reforming indirect taxes

- Objective should be to simplify and reduce distortions in indirect taxes
- Reform proposal by CCiF (Bernard Appy) for federal VAT:
 - Replace several turnover taxes with VAT;
 - Follow best practices (destination principle, invoice-credit method, broad base, etc.);
 - States could diverge from reference rate;
 - It envisages a ten-year transition period for the full implementation of the new model, which seems long and may pose risks to the reform;
 - It also envisages a new revenue distribution mechanism to become fully operational over 50 years.
- Reform proposal by Dep. Haully:
 - Includes state-level VAT and federal excise tax on industrialized products;
 - It is less detailed than CCiF proposal;
 - It envisages a shorter transition period of 5-15 years (in two phases).
- An estimate of the extent of distortions (and hence the potential gains from the reforms) requires access to micro data.

II. Policy Recommendations

Reforming direct taxes

- Beyond reducing distortions in indirect taxes there is a need to increase the progressivity of income taxation
- Broaden the income tax base by:
 - Including all forms of capital gains;
 - Eliminating regressive deductions; and
 - Reinstating dividend taxation.
- Harmonize income tax rates on different bases to reduce income shifting.
- The implementation of a dual income tax as in Scandinavia and Chile would eliminate tax difference between capital and labor earnings.

III. Main Messages

1. The tax system generates **production inefficiencies**:

- Recommendation to replace turnover taxes by a federal VAT.

2. The tax system is **not as equitable** as it could be:

- Recommendation to reinstate dividend taxes, and consider a dual income tax.

3. Tax **compliance costs** are exceedingly high:

- Recommendation to simplify filing requirements, and automatize filing.

	Low Impact	High Impact
Easy implementation	<ul style="list-style-type: none">• Simplify specific filing requirements• Eliminate regressive PIT exemptions	<ul style="list-style-type: none">• Reinstatement of dividend taxation• Include all capital gains in PIT base• Facilitate analytical work using micro data
<ul style="list-style-type: none">• Difficult implementation	<ul style="list-style-type: none">• Implement tax simplification process (see other policy note)	<ul style="list-style-type: none">• Replace indirect taxes by VAT• Harmonize tax rates on labor and capital income/create dual income tax



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