The tax burden and our dilemmas

The tax burden in Brazil rose from 26% of GDP in 1995 to 36% in 2008, after an expansion of the state that was essentially characterized by increased spending on services and social benefits. That increase in the tax-to-GDP ratio is commonly seen as a negative point in the country's recent economic development because it reduces incentives to both work and save — in other words, it hampers growth.

This assessment, however, may not be the best way to understand the reality and to help envisage more appropriate alternatives for the future because it disregards some essential aspects of that reality. The expansion of the state has not occurred in a vacuum; it is part of a historical process of sociopolitical choices by the society, starting with Brazil's re-democratization. This means that the tax hike is related to the expansion of social benefits and public services, such as health and education. Obviously, much depends on the efficiency of the increases in such spending. Only when that is clear is it possible to carry out a comprehensive cost-benefit assessment of the state's involvement in the economy.

The redistributive role of the state — Economic theory identifies the elements that leads a country to choose a higher tax burden. The French economist Roland Bénabou has sought to disentangle the relation between equity and the size of the welfare state.[1] Bénabou suggests that the degree of distributivism of a country's fiscal policy is very high in egalitarian societies (where there is little income inequality), it is reduced as income inequality worsens, and it increases again when income inequality widens excessively.

In egalitarian societies whose populations are fairly homogeneous in terms of education and income, citizens tend to understand taxes and public expenditure as an insurance system to support those facing adverse situations. In those countries, the egalitarian socioeconomic structure tends to be reinforced through state mediation, but strictly speaking

there is no redistribution through taxes and public spending because there are no massive transfers from the wealthy to the poor — conforming to the insurance rationale described, most transfers occur between individuals with relatively similar socioeconomic profiles.

In more unequal societies high-income groups feel that the taxes they pay outweigh the public services they consume. Those groups are also in a better position to influence political decisions in order to avoid tax redistribution. Thus, the wealthier succeed in preventing tax increases that would finance the expansion of the welfare state, which perpetuates inequality. A study by Bartels[2] shows that the higher the income of their constituents, the more the votes of US senators serve those interests.

In a third situation, income becomes so enormously unequal that the number of supporters of redistribution grows to the point that they become politically more powerful than the wealthy. In this case, the tax burden tends to be increased to finance services and programs that transfer income from the wealthier to the poorer.

Income redistribution, distortions, and tax burden — The improvement in income distribution in Brazil in the last 20 years is good news, but we are far from the ideal situation of egalitarian societies with a high tax burden and high public spending, where voters support an active public sector that acts more as an insurer than as an agent of redistribution. This is evidenced by a 2006 World Bank study of 126 countries in which Brazil ranks 116th with regard to income distribution.[3] In other words, only 10 countries in the sample had worse income distribution than Brazil. Thus Brazil clearly belongs in the third group of countries where inequality is so high that not even the traditional interests of the wealthy can prevent the state from carrying out redistributive policies through high taxes and increased public spending.

However, the Brazilian formula of redistribution is based on heavy income transfers that are only marginally focused on the poor or the reduction of educational inequality — the exception is Bolsa Família (Household Grant). A prime example of the type of inefficient redistribution that worsens income inequality is the payment of pension benefits resulting from death.[4] In 2006 these benefits represented 3.2% of GDP. The figure is high in international terms. In a study of countries where the proportion of the population about to retire is similar to that in Brazil, they were found to spend approximately 0.2% of GDP in pension benefits resulting from death. Even more striking is that on average the mostly rich nations of the Organization for Economic Cooperation and Development (OECD) spend only

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0.8% of GDP on such benefits. These examples underline the peculiarity of the Brazilian case.

Another factor that calls into question the efficiency of the redistributive role of the Brazilian state is the evidence that the increase in the tax burden was unusually regressive. According to Zochun and others (2005),[5] the burden of direct and indirect taxes on the income of households earning up to twice the minimum wage rose from 28.2% in 1996 to 48.8% in 2004 — an increase of 20.6 percentage points. In contrast, for households earning over 30 times the minimum wage, the tax burden in the same period rose from 17.9% of income to 26.3% — a substantial increase of 8.4 percentage points, but less than half the cost to poorer households. Zochun and colleagues point out that between 1996 and 2004 the tax burden declines consistently as income increases.

There are no ready and well-defined institutional models to help a country develop.

Institutional approach — In analyzing the tax burden it is appropriate to revisit studies conducted on how institutions — particularly the extent and quality of state action — affect development. Research on the role of the institutions in development concludes that there are no ready and well-defined models that apply to all countries. Djankov (2003) and Rodrik (2008) suggest that the institutions that work in developed countries are not necessarily the best option for developing countries.[6] An example that had great historical impact is the transition to capitalism experienced by Russia and other former Iron Curtain countries. In the case of Russia, the most representative example, Western consultants were behind extremely rapid changes to the institutional environment, particularly a broad but hasty privatization process and an attempt to create a new class of entrepreneurs overnight. As a result, state companies ended up in the hands of oligarchs, which caused serious damage to the reputation of capitalist institutions in the country and precipitated a return to a more state-controlled and authoritarian model. Transition to capitalism in China took place much more slowly, with incremental changes introduced into an institutional environment inherited from the socialist past. China's 30 years of growth at an average rate of 9% a year suggest that the country's gradualist strategy — under the state's iron fist — was the right choice.

Clearly, simply transplanting institutions does not necessarily improve social conditions. Easterly (2008) observes that institutions are not built from the top down; rather, they are the outcome of the social norms, traditions, and values of a society, as well as a country's degree of

development.[7] Dixit (2009) argues that to bring about changes, the first step must be to understand the reasons for the existence of the institution one wishes to change; only then can the ramifications of projected changes be calculated.[8]

Incremental institutional changes — In the debate on the tax burden and income redistribution in Brazil, it is fundamental to adopt the institutional approach that takes into account all the peculiarities of the country. Our redistributionist state has many distortions, but those distortions did not come from nowhere. The institutional fabric stems from a historical process where uncountable interests, ideas, programs, and negotiations intertwine to shape outcomes for any country. What results from this process may not be the ideal solution and, as in Brazil, may even have some apparent absurdities (such as the pension case). But it is always associated with the way society works and with compromises between social actors, in subtle forms that are not always visible to "scientists" who have ready and definite solutions.

Thus, rather than considering a top-down reform of the Brazilian state, or reversing its expansion following the increase in the tax burden, a wiser alternative would be to seek incremental changes. The new steps should build upon what already exists, seeking to disseminate the gains obtained by the different sectors, or build on developments that point toward the natural next stage of our institutional evolution. Here, there are three possible small steps to improve the Brazilian tax system.

The first step would be to eliminate or at least significantly reduce the lack of transparency associated with the taxes Brazilians effectively pay. It is important to make clearer the contributions each individual makes to financing different state programs. One possible measure would be to show on sales receipts the amount of taxes effectively paid by the consumer — something that is an established practice in many countries. So a typical Brazilian would know exactly how much tax he pays every time he makes a purchase or eats at a restaurant. The important point here is that, in a simple and transparent way, Brazilians become aware of the taxes they pay and take a democratic stand on the issue when electing their representatives. In fact, for the Brazilian democracy model that kind of transparency is indispensable.

The next stage of our institutional evolution should be carried out through incremental changes.

The second step would be to address the current redistribution system. As far as transfers are concerned, one of the most significant institutional developments of the past few years has been to reach the

poorer sectors of society in a focused and large scale way. The Bolsa Família (Household Grant) program reaches about 12 million families at a relatively low cost of about 0.4% of GDP.

It is true that some of the programs introduced before Bolsa Família and still active today had the specific objective of reaching poorer Brazilians. An example is the pension program for rural workers. At the time, the conviction (later proven in practice) was that by addressing the needs of the elders in the rural population, it would be possible to transfer income indirectly to poor youth. The pension paid to seniors in rural areas became the main source of income for households in many of the country's pockets of poverty.

It would be important to create instruments to eliminate the lack of transparency associated with the various taxes effectively paid by the population.

Notwithstanding the importance of the rural pension, it is clear that the redistributive element of the Bolsa Família is immensely superior because it considers the poor in a context other than old age. The program transfers money directly to poor mothers whose children attend school. That seems to be a better solution than having those mothers depend on the good will of the family's pensioner — assuming that the household has an elderly pensioner. Would it not therefore be the right moment to revisit the programs that are focused on the less favored sector of the population but that do not adopt the Bolsa Família's data base to target better benefits to the poor? Obviously, the rural pension should be preserved, but there are more effective ways to support younger members of poor households. The institutional development, in this case, would be the realization that it no longer makes sense for the state to approve new social programs whose beneficiaries are not in the Bolsa Família data base, which reaches the poorer sectors of the Brazilian society.

A third step is to introduce incremental changes in the civil service pay policy. The federal civil service wage bill has risen from 3.1% of GDP in 1995 to 5% in 2008.[9] Alone, these figures are not very significant, but they should be examined in terms of the quantity and quality of services provided. Although higher-income classes consider that health and education in Brazil, for example, are of very low quality, those services are better assessed by the poor and the lower middle class, who are the consumers of these services. This does not mean that we should celebrate the results in health and education; rather, it suggests that the issue of assessing public services in relation to the increase in spending is more complex than that it would have seemed at first glance.

Today, there is no transparency about how the civil service wage structure has evolved. As Douglass North has pointed out, a good institution is not one conceived according to a perfect model, but rather

one that manages to address the needs of a particular society; in his words, "The major role of institutions in a society is to reduce uncertainty by establishing a stable (but not necessarily efficient) structure for human interaction."[10] One positive way to introduce transparency and predictability into the civil service pay policy that would have immediate gains would be to align it with policies adopted in the private sector. This would help to reduce uncertainty on all sides: the citizen-taxpayer would be reassured, seeing more clearly the policy that orients increases in public sector wages; the change should also be welcomed by civil servants, who no longer would have to depend for fair pay on the good will of whatever administration is elected.

The improvements suggested here are not revolutionary. They are not even what one could call a "management shock." They simply seek to add new bricks to the existing institutional architecture. Their purpose is to introduce greater transparency and rationality into the Brazilian public sector.

[1] Bénabou, R. (2005), "Inequality, Technology and the Social Contract," in *Handbook of Economic Growth*, edited by Philippe Aghion and Steven N. Durlauf (North-Holland), vol. 1B, pp. 1595-1638.

[2] Bartels, L. (2002), "Economic Inequality and Political Representation," Princeton University photocopy.

[3] World Bank (2006), *World Development Indicators 2006*. CD-ROM. Washington, DC.

[4] IBRE's Letter, *Conjuntura Econômica*, April 2008.

[5] Zockun, M.H., H. Zylberstajn, S. Silber, J. Rizzieri, A. Portela, E. Pellin, and L.E. Afonso (2005), "Simplificando o Brasil: Propostas de Reforma da Relação Econômica do Governo com o Setor Privado," Textos para Discussão FIPE Nº 03, Fundação Instituto de Pesquisas Econômicas.

[6] Djankov, S., C. McLiesh, and R. Ramalho (2006), "Regulation and Growth," *Economics Letters*, vol. 92, pp. 395-401; and Rodrik, D.N (2008), "Second-Best Institutions," *American Economic Review: Papers & Proceedings*, vol. 98, pp. 100-104.

[7] Easterly, W. (2008), "Institutions: Top Down or Bottom Up?" *American Economic Review: Papers & Proceedings*, vol. 98, pp. 95-99.

[8] Dixit, A. (2009), "Governance Institutions and Economic Activity," *American Economic Review*, vol. 99, pp. 5-24.

[9] State and municipality civil service wage bills have not been taken into account in the figures provided.

[10] North, D. (1990), *Institutions, Institutional Change, and Economic Performance*. Cambridge: Cambridge University Press, p. 6.