

# Cut, grow, and collect taxes

In addition to reducing spending, balancing public accounts depends on how much tax is collected once growth resumes.

## Solange Monteiro

BRAZIL'S SEVERE FISCAL CRISIS has directed the spotlight onto the urgent measures being proposed to contain public spending, especially the debate on Social Security reform and the proposal for a ceiling on current spending. These measures also depend, to a considerable degree, on how tax revenues will perform. Federal tax revenue will depend on its sensitivity to the ups and downs of economic activity—how tax revenues change relative to GDP growth.

IBRE researcher Livio Ribeiro has estimated that the elasticity of federal revenues to GDP is close to 1—federal government revenues move approximately in the same proportion as GDP. Another study, published by the Institute of Applied Economics (IPEA), agreed. “We also concluded that neither net debt nor inflation is a statistically significant driver of tax revenue,” adds Mário Jorge Mendonça, co-author with Luis Alberto Medrano.

The conclusions of the two studies may be the same, but they differ on the premises from which they reached it. While the IPEA model indicated that this level of elasticity has been almost constant since the 2000s, Ribeiro identified a structural break between 2008 and 2011 that significantly reduced the sensitivity of tax revenue to GDP growth. He found that before 2008 tax rate



increases and improvements in tax collection storage technology had raised the elasticity of revenue to GDP to 1.59. Because the ratio was lower after 2008, the current resumption of economic activity should be accompanied by less revenue growth than in previous economic recoveries. This makes the recovery of a fiscal surplus “even more challenging,” he says.

### **Burden of formal employment**

But analyzing changes in aggregate tax revenues does not identify the losses and gains related to different taxes that lead to the estimated elasticity. Seeking to filter these effects, Luka Machado Barbosa, an economist at Itaú-Unibanco, conducted a study using a methodology that divides federal revenues into five groups, based on household consumption, wages, corporate profits, GDP, and other nontax revenues such as royalties and dividends that are not as closely related to economic activity. Barbosa wanted to identify what kept the tax revenue-to-GDP ratio constant between 2005 and 2014 despite more tax exemptions and elimination of the financial transactions tax (CPMF).

Barbosa found that wages and consumption contributed significantly to total tax revenue in 2005–14. According to his estimates, growth of wages above productivity accounted for 43% of the growth in federal tax revenue. “During this period,” he says, “wages of workers with a formal contract increased on average 8% a year above inflation.” Household consumption (controlling for indirect taxes) accounted for 30% of the growth in federal revenue.

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Barbosa believes resumption of growth will not provide the same favorable conditions for growth in wages and household consumption that helped to sustain federal revenue growth in the past. He estimates that between 2016 and 2020 net revenue will fall annually by 0.3 percentage point of GDP, from 17.6% of GDP to 16%. He also notes that his calculations were made in 2015 on the assumptions that the unemployment rate would be 7.9%, the employed population would grow at the same rate as the working-age population, annual real GDP growth would be 2%, the average wage would fall annually by 1.5%, and annual retail sales, tracking the formal payroll, would be down about 0.7 %.

Although long term the economy’s recovery may bring better numbers than Barbosa expects, and thus more tax revenue, the short-term outlook is less favorable for household consumption and employment. With retail trade closely related to household consumption, IBRE estimates a drop of 6.4% for the former in 2016 and 3% for the latter through 2017.

As for formal employment, IBRE estimates a net loss of 1.12 million jobs. For the first half of 2016, job losses reached 623,000 against 485,000 in



## **Resumption of growth will not provide the same favorable conditions for the growth in wages and household consumption that helped to sustain federal revenue growth in the past.**

the same period of 2015. IBRE's unemployment forecasts are for 11.6% in 2016 and 12.5% in 2017. "The labor market has inertia to fall and to rise, and we are still in the process [of recovering]," says IBRE researcher Fernando de Holanda Barbosa Filho. In terms of income, he says, last year the impact of unemployment was partially mitigated by the migration of contractual workers to self-employed, which does not generate as much tax revenue as contract work. However, while in 2015 the number of those self-employed increased by 1.14 million people, this year through June it has grown by just 20,000. "This suggests that during 2017 we will have fewer people employed, less tax collections, and a reduction in payroll," he says.

The good news, Barbosa Filho says, is that the adjustment of wages to productivity should be positive for the resumption of formalization in the labor market because all elements that promote formalization, such as higher education and electronic tax invoices, are still operating and will have more effect as the economy recovers. However, he does not expect informality to drop as much as in the last ten years, or have the same impact on tax collections.

Itaú-Unibanco's Barbosa adds that an export-led economic recovery will not promote federal revenues as much as domestic demand-driven growth, which is as yet still subdued. "This underscores the need for fiscal adjustment based on spending cuts," he says. If public spending cuts do not materialize, increasing the tax burden is still an alternative to curb the ballooning fiscal deficit. One way to do that is to continue eliminating tax exemptions, says Braulio Borges, IBRE associate researcher. Borges says that in addition to the elimination of tax breaks in the industrial product tax (IPI) already in effect, the government could also eliminate the payroll tax relief. "There was a partial exemption at the end of 2015, which represented a renunciation of R\$24 billion. But we're still talking about R\$15 billion a year that can be reversed," he says. Another possibility, says Borges, is increasing exceptional revenues, as occurred in 1998-2000. Such revenues could come from privatization and debt securitization.

IPEA's Mendonça reiterates the need to cut spending and emphasizes that heightening the tax burden would be the worst option. "What we see in Brazil is that, once taxation is raised, it does not return to its initial level; even if it is temporary, the heavier tax burden becomes permanent," he says. He adds that a higher tax burden has a negative effect on economic growth, and calls for measures to promote growth and increase revenue, such as privatization of state-owned enterprises and measures to make the labor market more flexible. ▾