# TAXATION, INEQUALITY AND THE ILLUSION OF THE SOCIAL CONTRACT IN BRAZIL

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Brazil is one of the most unequal countries in the world, both before and after taxes and government transfers. At the same time, the Brazilian state stands out as one with the highest tax yield as percentage of the GDP among less developed countries. In fact, Brazil's tax burden stands at levels very similar to the average tax burden of the Organization for Economic Co-operation and Development (OECD). This situation seems to contradict two important theories of the political economy of taxation. The first theory, deriving from median-voter models, predicts that within a democratic context high levels of income polarization should lead governments to carry out significant redistribution, usually by taxing the rich to benefit the poor. The second theory, sees taxation as embodying a social contract between the society and the state – which "carries a promise of political and social inclusion"[1]– and suggests a negative relationship between polarization and taxation, due to low tax morale.

In this paper, we suggest that the theory of fiscal illusion[2] can account for this double puzzle. This theory predicts that the lack of transparency in state financing – such as complex and indirect tax structures – creates a fiscal illusion that will systematically produce higher levels of public spending than those that would be observed had voters correctly perceived the 'tax-price' of public outputs. Accordingly, we argue that the use of fiscal illusion strategies has been central to the size of public spending and revenue mobilization in Brazil, and that this reflects the weakness of the underlying social contract. After an introductory section, the paper is organized as follows.

In section 2, we first observe that there seems to be an acceptance of the median voter result for Brazil on the basis that it is consistent with the remarkable increase in the tax collection since the country's political redemocratization in the 1980's and the reduction in income inequality in the last decade. We then argue that this view is not supported by a detailed analysis of the redistributive impact of the Brazilian fiscal policy. Using the PNAD 2009 and POF 2008/2009 household surveys, and a tax-benefit microssimulation model, we estimate the redistributive impact of the Brazilian tax and transfer system (as a whole and by type of tax and transfer) and compare it with other countries' data. The results show that direct taxes and cash transfers reduced Brazil's Gini coefficient of income inequality by just 7 percentage points in 2009 (when the tax burden was 32.6% of GDP), whereas the corresponding reductions, for example, in the United Kingdom (with tax burden of 34.2% of GDP), the United States (with tax burden of 24.2% of GDP) and Uruguay (with tax burden of 22.5% of GDP) were 18, 15, and 7 percentage points, respectively.[3] We also show that when the impact of indirect taxes and subsidies

[1] C. von Haldenweng, "Taxation, social cohesion and fiscal descentralization in Latin America", German Development Institute, Discussion Paper 1/2008, Bonn, 2008.
[2] J. M. Buchanan, *Public Finance in Democratic Process: Fiscal Institutions and Individual Choice*, Chapel Hill, University of North Carolina Press, 1967.
[3] See E. Goñi, J. H. López, L. Servén, "Fiscal redistribution and income inequality in Latin America", Policy Research Working Paper WPS4487, The World Bank Development Research Group, Macroeconomics and Growth Team, 2008; Congressional Budget Office, "The distribution of household income and federal taxes, 2008 and 2009", 2012, supplemental data, available at

is taken into account, even the poorest 20% of the Brazilian households become, on average, net contributors to the fiscal system (in monetary terms). It is thus that while the increase in tax yields in the last decades has indeed been dramatic – from 23% of GDP in 1988 to 35% of GDP in 2011 –, the decrease in income inequality in the same period was less impressive. For instance, the Gini of gross income (which includes government transfers) declined from 0.62 to 0.53, the same level of the Gini of gross income observed in 1960, when the state's tax take was 17 per cent do GDP. We also make some comments on the access to and quality of public services such as health, education and basic sanitation.

In section 3, we briefly review some political philosophy approaches that see the establishment of a social contract between the citizens and the state as the basis of the emergence of modern states. We then focus our discussion on the recent literature that stresses the relationship between taxation and governance. According to this literature, the social (fiscal) contract is the implicit acceptance between the state and its citizens that taxes are paid in exchange for government provision of effective services, the rule of law and accountability. Thus, it sees a country's tax system as the core manifestation of the social contract, and the willingness to pay taxes as an indicator of the legitimacy of the state. We emphasize that predictions about the relationship between inequality and redistribution, as well as between inequality and growth, depend crucially on a country's (formal and informal) tax institutions.

In section 4, we suggest that the high levels of government spending and tax revenue in Brazil is not an expression of a broad (implicit) bargain between government and its citizens but rather reflect the fact that political competition has led politicians to accommodate spending pushed by competing and fragmented interest groups. We then argue that the promotion and exploitation of fiscal illusion have been central to this process, given the historic low 'tax morale' observed in the country. Although the theory of fiscal illusion covers both sides of the budget – taking into account the government's strategies to disguise the full cost of public programs as well as to exaggerate their benefits –, our focus is on revenue mobilization strategies. We note that inflation tax and debt finance had important illusionary effects in the past, but that nowadays "invisible" taxation has been the main source of illusion. The section then discusses at some length the Brazilian tax system, highlighting its extreme complexity and heavy reliance on indirect taxes.

In the fifth and last section, we make final comments and point to some policy implications. In particular, we stress that inequality itself has shaped the Brazilian tax system, and in such a way that it has prevented the emergence of an effective social contract. In this context, the most promising tax reforms should primarily aim at promoting transparency, accountability and trust between the tax authorities and the taxpayers. By its turn, public spending should target the deep roots of inequality, by promoting, for instance, equal access to high quality basic education.

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http://www.cbo.gov/sites/default/files/cbofiles/attachments/43373-Supplemental_Tables_Final.xls, and M. Bucheli et al, "Social spending, taxes and income redistribution in Uruguay", Tulane Economics Working Paper Series, Working Paper 1217, Tulane University, Tulane, 2012.