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TAXATION, INEQUALITY AND THE ILLUSION OF THE SOCIAL CONTRACT IN BRAZIL¹

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1. Introduction

Brazil is one of the most unequal countries in the world, both before and after taxes and government transfers. At the same time, Brazil stands out as having the highest tax yield as percentage of the GDP among less developed countries. In fact, Brazil's tax burden now exceeds the Organization for Economic Co-operation and Development (OECD) average. This situation seems to contradict the predictions of two political economy theories of the relationship between taxation, economic inequality and income redistribution by the state.

The first theory predicts that, within a democratic context, high levels of income inequality should lead governments to carry out significant redistribution, usually financed by progressive taxation (Meltzer and Richard, 1981; Alesina and Rodrik, 1994). This theory is based on the median voter theorem, which states that under majority rule it is the median voter who is decisive, and thus political competition will result in the selection of policies that represent the median voter's demands. Accordingly, it is expected that in highly unequal societies, where the income of the median voter is well below average income, majority voting will result in considerable redistribution. The contrast between this prediction and many real world democratic outcomes, particularly in the case of Latin American countries, is known in the literature as *the redistribution puzzle*.

The second theory of taxation and democratic politics sees the government's ability to raise tax revenue as dependent on a social contract between the state and its citizens, and suggests a negative relationship between the level of taxation and social polarization. The argument is that tax compliance depends on the taxpayer's perception of the capacity of the state to promote political and social inclusion. This view is resumed in the analysis of von Haldenweng (2008) about the situation in most Latin America countries: "...where high income inequality prevents increasing tax revenues, which in turn prevents the state to act as a provider of equality of opportunities, and which in the long run keeps inequalities high."² In the case of Brazil, however, that combines high socioeconomic inequality and high tax revenue mobilization, this theory leaves us with a second puzzle, which could be named "the Brazilian tax collection puzzle".

In this paper, we propose that the *theory of fiscal illusion* can account for the double puzzle Brazil presents us. 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

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² See also Breceda, Rigolini and Saavedra (2008).

observed had voters correctly perceived the 'tax-price' of public outputs. Accordingly, our proposition is that, by heavily relying on the exploitation of fiscal illusions, the Brazilian state has been able to mobilize a huge amount of tax resources without the need of a broad social contract that could lead to more redistribution, effective public services, and growth-enhancing policies.

The paper is organized as follows. The next section provides evidence of the low redistributive performance of the Brazilian state. Section 3 outlines the central role taxation plays in the development of effective states. Section 4 summarizes the theory of fiscal illusion and provides evidence of illusion-creating mechanisms in Brazil. Finally, section 5 presents the final remarks.

2. Redistribution by the Brazilian State

There has been a sharp increase in public spending and in tax revenue in Brazil since the country's political re-democratization in 1985. Between 1985 and 2012 the tax burden increased from 24% to 36% of GDP (Afonso, Soares e Castro, 2013; Amaral, Olenike and Amaral, 2013). Inspired by the decrease in income inequality over the last decade, some analysts have interpreted the process of expansion of the Brazilian state as reflecting a redistributive social contract that would have emerged from the return to democracy. For example, Pessoa (2011) rationalize this interpretation using the median voter model, whereas Alston, Melo, Mueller and Pereira (2012) rely on a more complex model of social choice to base their view of a new social contract in Brazil.

In this section we provide evidence that the net effect of the government budget on inequality in Brazil can hardly be said to be an expression of an effective social contract for redistribution, not to mention of a preferential option for the poor, as some times it is claimed. Besides, we show that improvements in the redistributive impact of the tax and transfer system in the last decade have been marginal.

Empirical evidence is obtained by estimating the impact of the tax and cash transfer systems on the incomes of the Brazilian households. To do this, we used the tax-benefit microsimulation model for Brazil described in Immervoll, Levy, Nogueira, O'Donoghue and Siqueira (2006, 2009). The use of microsimulation techniques is necessary since the surveys available do not provide direct information on taxes paid by households and on some relevant transfers, or provide unsatisfactory information.³

In order to obtain the incidence of cash transfers and direct taxes, the microsimulation model uses the household survey *Pesquisa Nacional por Amostra de Domicílios* (PNAD). Since PNAD does not contain consumption data, the household budget survey *Pesquisa de Orçamentos Familiares* (POF) was used to estimate indirect taxes as a proportion of income by income group of the population, and these proportions were then applied to each individual in the corresponding income group in PNAD.⁴

³ For example, the total income tax reported by families in POF amounts to less than 60 percent of the personal income tax revenue effectively collected by the government. Besides, the data does not capture the effects of the deductions from taxable income permitted by the income tax legislation, as explained in Siqueira, Nogueira and Souza (2013).

⁴ Individuals in POF and PNAD were grouped in 20 percentiles of per capita monetary household income, and the estimation included all indirect taxes net of subsidies.

Siqueira, Nogueira and Souza (2013) provide a detailed description of the procedures used to calculate the incidence of direct and of indirect taxes, based on PNAD 2009 and on POF 2008-2009, respectively.⁵ Information on pension benefits – which account for 88.6% of all cash transfer simulated in this study for 2009 – is taken directly from PNAD. The other (non-pension) benefits are simulated.⁶ Essentially, the method consists in applying the rules of each transfer program to each individual and household in PNAD.

To assess the effectiveness of taxes and transfers in reducing inequality, we use a set of income concepts. The starting point is *private income*, which is the total income before the addition of transfers from the government and the deduction of taxes. Cash transfers are added to private income to obtain *gross income*. Personal income tax and employees' social security contributions are deducted from gross income to give *disposable income*. Indirect taxes are then deducted from disposable income to compute *final income*. Table 1 shows the distribution of income and the Gini coefficient of inequality for each of these income concepts.⁷

Table 1 - Distribution of income by quintiles⁸ and Gini coefficients

	Distribution by quintile (%)					Gini coefficient
	Bottom	2 nd	3 rd	4 th	Top	
Private income	3.1	7.2	11.3	19.2	59.2	0.601
Gross income	3.5	7.3	12.1	19.1	58.1	0.548
Disposable income	3.8	7.7	12.7	19.8	56.0	0.527
Final income	2.6	7.0	12.4	19.7	58.2	0.561

Source: Authors' calculations based on PNAD 2009 and POF 2008-2009.

The results clearly confirm the highly unequal distribution of income and the small equalizing effect of the tax-transfer system in Brazil. The income share of each quintile group suffers only minor changes across the income stages. Nevertheless, cash transfers reduce Brazil's Gini by 5.3 percentage points, and direct taxes lead to a further decrease in inequality of 2.1 percentage points.

However, the combined effect of cash transfers and direct taxes in Brazil is rather small when contrasted with that found in advanced countries. In the OECD countries, these instruments reduce the Gini index by 14.3 percentages points on average⁹, and in the

⁵ On the estimation of indirect taxes, see also Siqueira, Nogueira and Souza (2012). The direct taxes simulated are the personal income tax and the employees' social security contribution.

⁶ The benefits simulated for 2009 are: the wage family (*salário família*), the unemployment benefit, the wage bonus (*bônus salarial PIS/PASEP*), the family grant (*Bolsa Família*), and the old age benefit (*LOAS/idoso*). In 2003 the Bolsa Família was not yet implemented. In its place we simulated the school grant (*Bolsa Escola*) and the food grant (*Bolsa Alimentação*). In the case of the Bolsa Alimentação, as this program was very small, simulation of the benefit to all entitled families would greatly overstate its total value in comparison to administrative data. Instead, the benefit was simulated by randomly apportioning the total spending on the program in 2003, as officially reported, between a subset of all those families eligible to receiving the benefit.

⁷ For all distributions shown in Table 1, individuals are ranked by per capita *gross* household income. The calculation of the Gini index, however, involves ranking individuals according to the income indicated in the first column of the corresponding line of the table. Thus, only in the second line (gross income) the Gini corresponds to the distribution described.

⁸ Quintiles, or fifths, are created by ranking individuals by their per capita gross household income.

⁹ See OECD distribution tables at <http://stats.oecd.org/>.

seventeen European Union countries investigated by Paulus et al. (2009), the average decline in the Gini is 19.9 percentage points. Even the European countries with the lowest redistribution (Netherlands, Italy, and Portugal) still manage to lower inequality by about double the reduction in Brazil (see Paulus et al., 2009).¹⁰

Redistribution in Brazil becomes still more disappointing when indirect taxes are taken into account, with the Gini index increasing by 3.4 percentage points. Thus, as estimated here, the tax-transfer system taken as a whole reduced the Gini index by only 4.0 percentage points in 2009.¹¹

Even more worrying is the result that very often poor households are net contributors to the fiscal system (in monetary terms, that is, considering only cash transfers). This is clear from Table 2, which shows the average values of transfers received and of taxes paid by households in different income groups. As one can observe, even the poorest 20% of the population lives in households that, on average, pay more taxes than they receive in government transfers. The same is true for the second quintile group. Only the households in the third quintile, where there is a concentration of pensioners (usually receiving the basic pension benefit) are net beneficiaries.

These results are consistent with the findings of two recent studies. Silveira (2012), using POF 2008-2009, estimates that total cash transfers received by the poorest 10% of the population amounts to about 27% of their monetary income on average, and total taxes paid takes about 53% of their monetary income. By its turn, Higgins and Pereira (2013) make the following comment about their results: “Our analysis finds a troublesome result when taking into account post-fiscal income: there is a substantial deleterious effect of indirect taxes on poverty. In many cases, the benefits of transfer programs are offset by indirect taxes.”

¹⁰ Adopting an alternative approach, that includes (apart from transfers and direct taxes) public workers wage and pension differentials to private sector workers, Souza (2012) shows that the government in Brazil contributes to worsen income distribution.

¹¹ A qualification should be made here, however. As argued by Siqueira, Nogueira and Souza (2013), the regressivity of the indirect tax burden in Brazil is exaggerated when measured with respect to reported monetary incomes. The reason is that monetary incomes are severely underreported by households in the bottom of the income distribution, resulting in reported consumption being much higher than reported income. After adjusting incomes for underreporting, Siqueira, Nogueira and Souza (2013) conclude that indirect taxes essentially cancel out the progressive effect of direct taxes.

Table 2 - Average incomes, transfers and taxes by household (R\$/month)

	Quintile group					All households
	Bottom	2 nd	3 rd	4 th	Top	
Private Income	354	749	963	1.573	4.178	1,771
Cash transfers	152	203	345	410	1.017	473
Pensions	47	149	302	365	992	423
Others	105	54	42	45	25	50
Gross income	506	953	1.308	1.983	5.195	2,244
Direct taxes	7	30	48	104	625	196
Disposable income	499	922	1.260	1.878	4.570	2,048
Indirect taxes	192	236	275	370	695	381
Final income	306	686	984	1.509	3.875	1,667
Average n° of persons in the household	5.05	4.48	3.87	3.57	3.15	4.02

Source: Authors' calculations based on PNAD 2009 and POF 2008-2009.

Figure 1 compares the redistributive performance of Brazil with other countries. The vertical axis measures the reduction between the Gini coefficients of private income (income before any tax or government transfer) and disposable income (income after cash transfers and direct taxes), in percentage points, and the horizontal axis measures tax revenue as a percentage of GDP.

It is evident that the low fiscal redistribution in Brazil, in comparison with other countries, cannot be attributed to a lower tax burden. Note in particular that the United States, with a much lower tax burden than Brazil, obtain a larger reduction in the Gini of disposable income, whereas Uruguay, also with a much lower tax burden, has the same redistributive performance as Brazil. Furthermore, if the effect of indirect taxes was shown in Figure 1, Brazil would be still worse in the picture, since Brazil relies more heavily on this type of tax than the other countries in this figure.

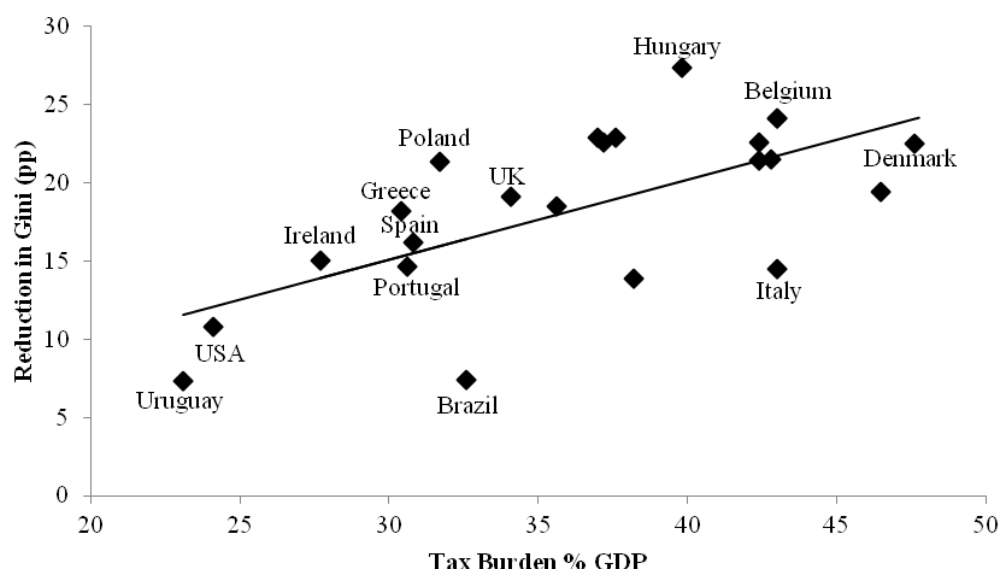


Figure 1 - Tax burden and reduction in the Gini index for selected countries – 2009

Source: Paulus et al. (2009), OECD, Bucheli, Lustig, Rossi and Amabile (2012), and authors' calculations for Brazil.

It should be remarked that, beyond cash transfers, taxation finances other social expenditures, like education and health, which may benefit the lower income groups disproportionately. However, it should also be said that the main channel through which investment in education and health affects inequality is by changing the distribution of human capital, which in turn changes the distribution of private (or market) income. Although inequality of market income in Brazil has been declining (as will be shown below), it is still extremely high, suggesting that social investment in human capital has not yet been sufficiently equalizing.

It is worth mentioning that investment in education in South Korea is known to play a major role in explaining the fact that the country has the lowest Gini of market income among all OECD countries, as pointed out by Luebker (2011). And despite the little effect of the tax and transfer system on the distribution of income, Korea's disposable income Gini (at 0.315) was virtually the same as the OECD average in the later 2000's.

As mentioned above, income inequality in Brazil declined over the last decade.¹² Figure 2 compares inequality in Brazil in 2003 and 2009 for each income concept defined in this paper. It shows that inequality after government transfers and taxes declined 4.4 percentage points between 2003 and 2009, as measured by the difference between the Ginis of final income. Of this, 3.4 percentage points are attributed to improvements in the distribution of private income (income before all taxes and transfers), and thus only about one fourth of the fall in inequality in this period resulted from changes in the tax-transfer system. In fact there was no significant change in the redistributive impact of the tax system, whereas the system of cash transfers became slightly more equalizing.

¹² According to Lustig, López-Calva and Ortiz-Juarez (2012), "Between 2000 and 2010, the Gini coefficient declined in 13 of 17 Latin American countries". In Brazil, inequality has been falling since 2001.

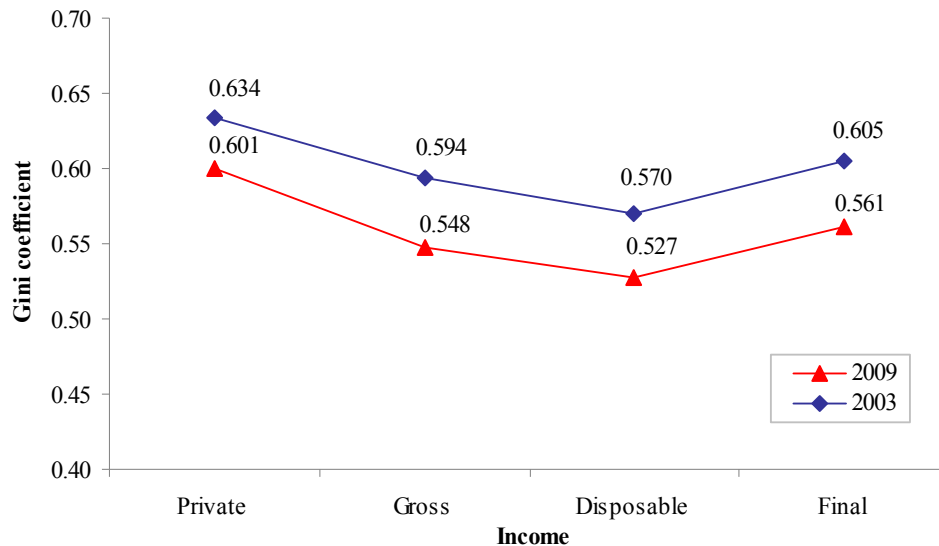


Figure 2 - Gini coefficient for different income concepts in 2003 and 2009 - Brazil

Finally, it is interesting to note that in 2011, 27 years after democratization and with a tax burden of 35.3% of GDP, Brazil managed to reduce the Gini of gross income (which includes government transfers) to 0.53, the same level of the Gini in 1960, when the tax burden was 17% of GDP.¹³

3. Taxation and the Effectiveness of the Social Contract

A fundamental characteristic of modern societies is the emergence of a political order that endows the state with legitimacy and regulate its interaction with the citizens. This political order is grounded on three basic institutions: the state itself, the rule of law, and accountability. Modern liberal democracies combine all these three institutions into a stable equilibrium (Fukuyama, 2011).

The set of rules and institutions that provides the basis for the establishment of a voluntary agreement between the people and the state is usually denominated the *social contract*. This agreement gives rise to the organized society, whose objective is the well-being and security of its members and the regulation of their relationships. To that extent, the social contract shapes the rights and duties that constrain the behavior of individuals, social groups and the state.

This consensual agreement depends fundamentally on the existence of social rules that regulate the collective interactions among the members of the society and are recognized as just and trustworthy. They legitimize the social order and are able to engender a cooperative behavior, even if self-interested, among the citizenry. Otherwise, the social contract would only give rise to an evasive and distrustful behavior in relation to the collective agreement, with the collective action becoming predatory and inefficient.

¹³ See Afonso, Soares and Castro (2013) and IPEAdata (www.ipeadata.gov.br).

Stable societies require that the social and political order, and all its conventions and legal rules, be seen as legitimate in order to command an institutional authority obeyed and respected by its members. And institutions are obeyed and respected for the reason that they bring about a social environment conducive to private and public benefits. Thus, stability of the social and political order rests on the legitimacy, confidence and durability associated with the social contract. This collective agreement is destroyed, or seriously weakened, when the trust deposited in it is broken and its legitimacy contested.

What then gives rise to and strengthens trust in the social contract and in its institutions? It seems reasonable to argue that each individual's expectation concerning the social contract depends on how its effects on individual and social well-being are perceived and assessed. Social interactions entail individuals' appraisal of what is being offered to them and what they hope to obtain. It is upon this expectation of mutually advantageous exchanges based on rules and conventions universally accepted and held that a sense of trust in institutions is developed. This requires the development of institutions acting on behalf of all citizens and aiming at promoting their objectives.¹⁴

In other words, the individuals carry out a cost-benefit analysis in order to identify the possible gains derived from social interaction and compliance with the social contract, assuming that other individuals will also behave accordingly. For this analysis to be correct, it is crucial to have access to an adequate informational base that unveils the true structure and consequences of the social contract. This transparency involves a clear depiction and universality of the social contract's rules. Clarity is fundamental for the individuals to have plain understanding of how the social game is to be played.

Among the institutions comprising the social contract, a central place is given to the tax system.¹⁵ Historically, the imposition of taxes mirrors the emergence and consolidation of the state. To finance its operations the state raises revenue from its citizens.

A recent literature focused on the role of taxation in state-building (for a summary see Moore, 2007)¹⁶ has emphasized that the way taxes are raised is crucial to the effectiveness of the state, as in Everest-Phillips (2011): "The political challenge for building an effective state is not only what and how much to tax, but how to tax, who pays, and why – that is, the balance between degrees of 'quasi-voluntary' compliance and coercion."

Specifically, it is argued that: "Governments that finance themselves by persuasion rather than coercion are likely to be more democratic and provide more services." (Everest-Phillips, 2011). The basic idea is that in this case a bargain between state and society develops that leads to the emergence of a *social fiscal contract*: the implicit agreement between the state and its citizens that taxes are paid in exchange for effective public services.

¹⁴ For a discussion of this question, see Sen (1999).

¹⁵ For instance, Schumpeter remarked that "The spirit of a people, its cultural level, its social structure, the deeds its policy may prepare, all this and more is written in its fiscal history, stripped of all phrases" (Schumpeter, 1918).

¹⁶ See also OCDE (2008), Everest-Phillips (2010), and Prichard (2010).

Thus, from this perspective, it is tempting to take the ability of a democratically elected government to mobilize large amounts of tax resources as an indication of its legitimacy and good governance. However, democracy by itself does not legitimate fiscal policy, as governments have the power to create *fiscal illusion*, and thus distort the democratic choices of voters-taxpayers. As claimed by Tanzi (2011): “Coercion need not necessarily be the main instrument for promoting the ruling class’s interest; often, and especially in a more democratic setting, fiscal illusion is.” In this case, large and inefficient states are compatible with democracy, as argued also by Eusepi (2006).

4. The Fiscal Illusion

This section presents the concept of fiscal illusion and provides some evidence of its creation or exploitation in Brazil.

4.1. The nature of fiscal illusion

The term “fiscal illusion” was first used by the Italian economist Amilcare Puviani, in 1903, in his book *Teoria della Illusione Finanziaria* (Puviani, 1903). According to Wagner (2001), Puviani sought to answer a simple question: How can a politician best use his powers of the purse to promote his political projects? In the 1960’s interest in this question was renewed with Buchanan (1960, 1967), who extended Puviani’s theory. There is now a vast literature around the notion of fiscal illusion.¹⁷

Broadly speaking, “Fiscal illusion occurs every time a taxpayer does not realize how much he pays to the state or how much he receives from the state” (Dell’Anno and Mourão, 2012). However, a definition that captures more accurately the nature of fiscal illusion is offered by Oates (1988, p. 65), who refers to it as “the notion that systematic misperception of key fiscal parameters may significantly distort fiscal choices by the electorate”. This definition embodies the basic hypothesis of the theory of fiscal illusion that governments are able to systematically produce a bias in the fiscal choices of the voter-taxpayer toward a specific direction.

The plausibility of this assumption is justified by the following argument. On the one hand, it is easy for the government to make it costly for the taxpayer the acquisition of full information about his contribution share to the financing of the state. On the other hand, the voter-taxpayer have little or no incentive to invest his time and money in acquiring the required information, since, being one among millions, his potential impact on public choice outcomes may be negligible. Thus, it may be fully rational to the individual taxpayer to remain misinformed and make his fiscal choices on the basis of his own subjective perceptions as influenced by the institutions of taxation (Buchanan and Wagner, 1977).

The theory of fiscal illusions covers both sides of the budget: It considers government strategies for revenue mobilization that induce the taxpayers to underestimate their full tax burden, as well as strategies that lead the citizens to overestimate the benefits of public spending programs. In both cases, governments deliberately create optimistic illusions among taxpayers-voters that make it easier to get political support for higher

¹⁷ For a recent and exhaustive survey of this literature, see Mourão (2007).

spending. Fiscal illusion can also facilitate bureaucratic spending and rent seeking activities, as observed by Eusepi (2006).

There are many ways in which governments can create illusions¹⁸, and new mechanisms appear when the old ones are negatively perceived by voters. The complexity of the legislation facilitates the promotion or exploitation of fiscal illusions.

Mourão and Cabral (2010, p. 235) claim that, at a critical point, fiscal illusion can become *fiscal delusion* and threaten social stability:¹⁹

“[O]ne of the most serious consequences of fiscal illusion is the abrupt change from a positive view of the State (in the perspective of taxpayers) toward a negative view of the same State. This leads to the degradation of their confidence in public agents and to their growing hostility to the same State.”

Tanzi (2011, p. 332) also alerts for this danger:

“[C]omplexity will make reality progressively different from the perception of it. It may be an extreme form of Puviani’s fiscal illusion, but it will be a fiscal illusion difficult to understand and monitor. [...] If not checked, it will increasingly lead to ‘state capture’ by those who have more resources, or to a popular backlash in the form of populism that will challenge the market economy.”

4.2. Fiscal illusion in Brazil

Any government may have interest in creating or take advantage of fiscal illusions. But one would expect that in a society characterized by high and pervasive inequalities, like Brazil, there are both more incentives and more opportunities for the exploitation of fiscal illusions. As mentioned before, fiscal illusion facilitates rent-seeking activities, and helps to accommodate the specific demands of groups with political voice. Lisboa and Latif (2013) provide evidence that historically rent-seeking activities characterize the interactions of the Brazilian society with government agencies.

Dell’Anno and Mourão (2012) carried out a comparative analysis based on the estimation of a fiscal illusion index for several countries and found that Latin American countries have higher fiscal illusion indexes, on average, than any other region of the world. Interestingly enough, among the 48 countries of their study, ranked in ascending order of fiscal illusion, Brazil occupies the 36th position.

Although fiscal illusions may arise from both sides of the fiscal equation, most of the literature has focused on sources of illusion on the revenue side. According to Tanzi (2011, p. 156-157), governments interested in creating fiscal illusion to increase revenue will often:²⁰

1. [R]ely on taxes that are included in the prices of the products [...]

¹⁸ We will list some common strategies in the next section.

¹⁹ Mourão (2010) remarks that this had already been claimed by Puviani (1903) and Fasiani (1941).

²⁰ Tanzi (2011) remarks that several of these strategies were already pointed out by Puviani (1903).

2. *[N]ot change the basic laws too often because taxpayers become particularly insensitive to taxes that have been levied for a long time [...] on the other hand, minor amendments aimed at benefiting particular groups of taxpayers will be frequent as they will often go unnoticed and unreported [...]*
3. *[T]ake advantages of shifts in public opinion that reduce the taxpayers' resistance to new or additional taxes [...]*
4. *[A]void relying on just one or two taxes [...]*
5. *[C]ollect the tax when and in the way least painful to the taxpayer (e.g. withholding at the source)[...]*
6. *[R]elying on borrowing rather than on higher permanent taxes [...]*
7. *[R]elying on deficit financing, financed not by borrowing from the public but from the expansion of the monetary base [...];*
8. *[I]ntroduce taxes, clearly intended to be permanent, as temporary [...]*
9. *[I]ntroduce new spending programs when the cost of these programs appears low (e.g., [...] social security programs that do not require payments for pensions until much later).*

Although there are several other ways in which governments can generate illusions through the institutions of payment (see, for example, the mechanisms discussed in Buchanan, 1967), we think the list above serves perfectly well as reference to start a discussion about fiscal illusion strategies in Brazil: We have seen all these films before!

Taxes on goods and services account for 49.2% of Brazil total tax burden²¹, and the personal income tax – the most visible among the direct taxes – contributes to only 7.4% of total tax revenue (SRF, 2012). The notion that taxpayers underestimate the tax burden from indirect taxes as compared to direct taxes is known in the literature as the “Mill hypothesis”. John Stuart Mill (1848, quoted in Fochmann et al., 2010) proposed that: “If all taxes were direct, taxation would be much more perceived than at present; and there would be a security which now there is not, for economy in the public expenditure.”

It is worth noting that the visibility of indirect taxation in Brazil is lower than in countries where it consists of a general, broad-based value added tax. In Brazil, the system embeds numerous taxes, including turnover taxes, several collection regimes (often for the same specific tax), and a myriad of rates and exemptions. In fact, the fiscal illusion literature predicts that the more complicated the revenue system, the more likely it is that the taxpayer will underestimate his share in the opportunity cost of public services. Buchanan (1967), for instance, claims that “[t]o the extent that the total tax load on an individual can be fragmented so that he confronts numerous small levies rather than a few significant ones, illusory effects may be created”.

In the case of Brazil, “illusory effects” may also arise from the fact that tax revenues are considerably augmented by the “cascade effects” resulting from the taxation of productive inputs. Siqueira, Nogueira and Souza (2012) estimate that about one third of all indirect taxes in Brazil falls on inputs, generating great discrepancies between the legal (statutory) tax rates and the effective tax rates faced by consumers.²²

²¹ This share will probably increase since, as from 2012, the employers' social security contribution on some specific sectors of production has been replaced by a (turnover) tax on the firm's gross receipts.

²² See also Siqueira, Nogueira, and Souza (2001).

For the last two decades, tax reform has been on the agenda for political debate in Brazil and many projects for substantial simplifications and improvements of the system have been discussed. However, no major reform in this direction has been carried out so far. On the other hand, according to Amaral et al. (2010), from 1988, when Brazil's new Constitution was promulgated, to 2010, there were 249,124 minor changes in the tax legislation, an average of 31 changes per day. They also estimate that in 2010 there were more than 18,000 tax norms in force in Brazil, taking into account all government levels. Thus, the complexity of the system has in fact been increasing.²³ Not surprisingly, Brazil ranked first in a sample of 183 countries in the number of hours a firm needs to comply with its tax obligations, which was estimated at 2,600 hours per year, according to PwC (2012).

One of the tax changes implemented under the new Constitution was the creation in 1996 of a contribution on bank transactions (Provisional Contribution on Financial Transactions, CPMF) to finance health spending. This contribution was supposed to be in force for two years. However, by threatening Congress and the citizenry with harmful consequences for the health service if the contribution was to be abolished, government was able to make it last for ten years. Thus, the case of CPMF, besides illustrating the strategy of introducing an intended permanent tax as temporary, also illustrates another source of fiscal illusion discussed in the literature, namely the “scare tactics”, which “[...] tend to make the alternatives to particular tax proposals appear worse than they are [...]” (Buchanan, 1967).

It is also worth mentioning the more recent reform of the COFINS (Contribution for the Financing of Social Security). In this case, the government managed to take advantage of the widespread criticism of the cumulative incidence COFINS to pass a (partial) reform of this contribution that resulted in a considerable increase of the tax burden, without effectively reducing the “cascading” effects.

For many years, borrowing and currency creation also provided major sources of public revenues in Brazil. As observed by Giambiagi and Além (2011), until stabilization in the 1990s, it was often said that the large public debts and high inflation rates in Brazil reflected the inconsistency between the demands of the different sectors of society for public expenditures and the unwillingness of this same society to be taxed. Indeed, Buchanan and Wagner (1977) considered inflationary finance worse than ordinary taxation in terms of illusion-creating effects: “Individual citizens are likely to be less informed about the probable costs of an ‘inflation tax’ than they are about even the most indirect and complex explicit levy.”

These are only some examples of illusion-creating mechanisms in Brazil.²⁴ The information about fiscal illusion has yet to be systematized and mapped. A historical perspective is also fundamental to a better understanding of the sources and consequences of fiscal illusion.²⁵

²³ As *The Economist* (2005) put it: “[T]he more complicate a country’s tax system becomes, the easier it is for governments to make it more complicate still, in an accelerating process of proliferating insanity”.

²⁴ Lisboa and Latif (2013) discuss other mechanisms that have been used to finance public spending in Brazil which also lack transparency, like extrabudgetary accounts.

²⁵ As argued by von Stein (1885): “The history of taxation forms an essential part of the history of the conflict between the idea of the State and social rights and interests. In its turn, each form of tax has its

5. Final Comments

In the light of both theories of taxation mentioned in the introduction of this paper, namely, the median voter model and the social contract approach, a high tax burden would predict progressive taxation and/or effective redistribution towards the more needed in the society. The latter theory would also predict effective public services and growth enhancing policies. In these theories, democracy provides the feedback mechanisms necessary to ensure that government actions will effectively represent citizens-voters preferences.

Contrary to these predictions, for almost three decades, Brazil has been in an equilibrium that combines: democratic elections, high inequality, high and increasing taxation, low redistribution, ineffective public services, and low investment. This paper proposes that the theory of fiscal illusion plays a key role in explaining Brazil equilibrium. By heavily relying in fiscal illusion strategies, the Brazilian state has managed to bypass the need of a broad bargain with society in raising its high level of tax revenue.

Brazil's experience may be seen as evidence that fiscal illusion has the power to distort choices in the political market and make dysfunctional the social contract. Thus, by weakening the connection taxation establishes between the state and its citizens, fiscal illusion is a source of distrust between them.²⁶ Furthermore, Brazil's experience indicates that, to the extent that social inequalities tend to favor the exploitation of fiscal illusion by governments, the relationship between inequality and state redistribution cannot be predicted without an understanding of the way inequality influences state financing²⁷: the institutions of taxation matters!

own, highly instructive history. The system of taxation which we now possess can therefore perhaps best be explained in terms of the main outlines of its own history".

²⁶ Disconnection and distrust between citizens and government were indeed expressed in many ways in the recent wave of social unrest in Brazil.

²⁷ For a discussion about how inequality in Latin America countries influenced the evolution of the region's tax systems, see Sokoloff and Zolt (2007).

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