OECD ECONOMICS

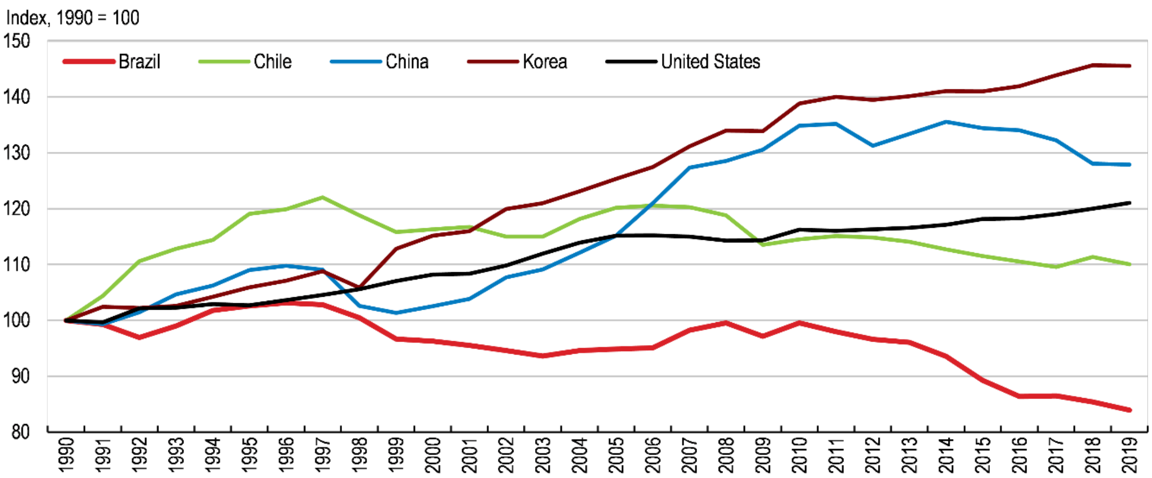
Policy Brief

Redesigning Brazil's consumption taxes to strengthen growth and equity

Brazil is currently discussing a major tax reform. This Policy Brief provides background and a preliminary high-level assessment of the current tax system, the reform and its potential implications for growth and productivity, analysed in the context of work undertaken on the OECD Economic Survey of Brazil.

Implementing structural reforms is key to boost productivity growth in Brazil. In the past decades, Brazil's growth in GDP per capita has been mostly explained by rising labour force participation and educational attainment while productivity growth has fallen (Figure 1). However, with rapid population ageing and limited fiscal space for public investment, total factor productivity growth will need to become the principal source of long-run growth in the coming years. Barriers to entry, exit and the growth of performing firms can partly explain the weak productivity performance of the Brazilian economy. In particular, a complex system of indirect taxes adds to the costs of doing business, distorts production chains, obstructs inter-state trade and hampers competition (OECD, 2020[1]).

Figure 1. Total factor productivity growth in Brazil lags behind other economies



Source: Penn World Table; and OECD calculations.

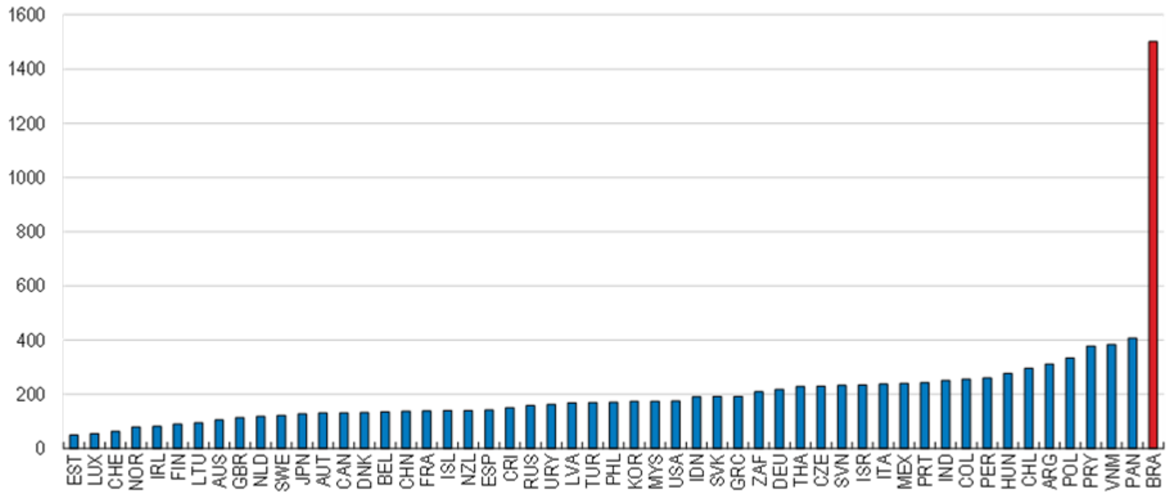
Brazil's current tax system is complex and hampers economic efficiency

Brazil's tax system is extremely complex and induces several distortions in the economy. First, tax compliance costs are among the highest in the world, which is a result of the fragmented rules across different subnational jurisdictions (Figure 2). From an efficiency perspective, costly compliance activities can be seen as a waste of economic resources, as they increase the implicit tax burden of individuals and businesses without increasing the revenues of the government

(Eichfelder and Vaillancourt, 2014[2]). Second, the incentives created by the current tax system distort economic decision-making and the optimal allocation of resources. Finally, complex rules can provide tax planning opportunities for well-informed taxpayers, thus contributing to the persistence of income inequalities.

Figure 2. Tax compliance costs are extremely high

Hours required to prepare taxes, 2018



Source: World Bank.

There is ample scope to simplify consumption taxes in Brazil

The current system of consumption taxes is characterised by overlapping taxes levied at different levels of government. Currently, there are five main different taxes on the consumption of goods and services, applying to sometimes overlapping bases and at different levels of government: three federal taxes (PIS, Cofins and IPI), one state tax (ICMS) and one municipal tax (ISS). None of these taxes has a broad base: the IPI only applies to industrial goods; the ICMS applies to the sale of merchandise and to transport and communication services provided across municipalities and states; the ISS applies to most services. It is often difficult to determine where the scope of the ISS ends and where the incidence of the ICMS starts. Determining which goods and services fall into the category of industrial goods for the IPI is also a frequent source of litigation.

Tax credit rules are complex, increasing costs related to tax controversy and litigation. The PIS, Cofins, and the ICMS are - in principle - designed to be mostly non-cumulative. However, businesses' right to claim tax credits for these taxes paid on intermediate inputs are often restricted and subject to complex definitions and procedures, which gives rise to excessive delays, controversy and litigation. Obtaining tax credits for interstate transactions is even more cumbersome.

The ICMS is not fully uniform across the states, hampering interstate trade. Each state applies its own ICMS tax rates, exemptions and tax benefits, which introduces compliance costs for companies wishing to sell goods and services nationwide are required. The lack of harmonisation across states creates additional complexity. For foreign companies wishing to enter the Brazilian market, this represents a significant barrier. Adding to the issue, for interstate transactions, the system applies a mixture between origin and destination principles, leading often to double taxation and curbing incentives to trade goods and services across states.

Consumption taxes are not uniform across sectors, resulting in the misallocation of resources. The ISS, which applies to most service activities, has a lower tax rate than the other taxes. As a consequence, firms have low incentives to hire services from external firms in other sectors of activity that do not fall into the ISS list, even if these firms are more productive. Imported services and financial transactions are subject to yet other levies, called respectively CIDE and IOF, which precludes Brazilian firms from the competitive advantage of imported tradeable services.

Reforming the consumption tax system would bring significant benefits

The government has made reforming the taxation of consumption of goods and services one of its key priorities. Several proposals have been put forward to reform the consumption tax system. The Senate and the Chamber of Deputies have both made comprehensive proposals to consolidate the different consumption taxes into a unified value-added tax. These proposals have been combined into a single draft Constitutional Amendment Bill, endorsed by the government. The draft law was approved by the Chamber of Deputies in July 2023 and is currently under consideration at the Federal Senate (Box 1).

Box 1. The current reform proposal approved by the Chamber of Deputies

The Chamber of Deputies approved a tax reform (Constitutional Amendment Bill 45/2019) on 7 July 2023, which is now under consideration at the Federal Senate. The aim of this reform is to replace the existing consumption tax system (including IPI, PIS, Cofins - Federal, ICMS - State, and ISS - Municipal) with a dual value-added tax made up of the Contribution on Goods and Services (Contribuição sobre Bens e Serviços or CBS), managed by the Federal government, and the Tax on Goods and Services (Imposto sobre Bens e Serviços or IBS), managed by states and municipalities. Two distinct features of the reform proposal are that it is not meant to increase the overall tax burden, nor is it meant to alter the distribution of revenues across levels of government.

The main elements of the draft bill are:

- The CBS and IBS would have the same basis nationwide and both components will be collected together.
- The Federal government would set the rate for the CBS component, while states and municipalities will set the rate for the IBS component.
- A Federative Council would be created to represent and coordinate states and municipalities, to collect the IBS component, manage the tax, offset credits, distribute resources across subnational entities, and to issue sub-legal norms of national repercussion.
- The unified tax would be destination-based instead of origin-based.
- The new system will help reducing special regimes and harmonising the rules across products, services, sectors, and regions.
- All rules would be harmonised, including the taxable event, calculation basis, hypotheses of non-taxation, taxable persons, immunities, specific, differentiated or favoured regimes, non-cumulative rules, etc.
- Three regimes of rates would be created:
    - The standard rate.
    - A reduced rate equivalent to 40% of the standard rate for education and health services; medical and accessibility devices for people with disabilities; medicines and basic menstrual health care products; public passenger transportation services; agricultural inputs and in natura agricultural products; food and personal hygiene products; national artistic, cultural, journalistic and audio-visual productions and sports activities; goods and services linked to national sovereignty, cybersecurity and information security; and urban rehabilitation activities in historic areas and critical urban recovery and conversion areas.
    - A zero rate for goods in the National Basic Food Basket, to be further specified.
- The draft bill also foresees the possibility for a targeted tax refund mechanism for lower-income taxpayers, to reduce the regressivity of the VAT, sometimes referred to as "cashback".
- Different funds will be created to support the transition toward the new system, including through temporary compensation mechanisms.

Source: Independent Fiscal Institution (2023), "Fiscal Follow-Up Report N° 79", August 2023, https://www2.senado.leg.br/bdsf/bitstream/handle/id/641018/RAF79_AGO2023_eng.pdf

If approved in its current form, the draft reform would bring Brazil closer to OECD best practices and reduce distortions. The draft law is based on a coherent set of rules harmonised across states, a broad base, with a harmonised system for crediting the value-added tax paid on inputs, and zero rating for exports. The proposal unifies three federal taxes (PIS, COFINS, IPI), as well as one state and one municipal tax (ICMS and ISS, respectively), into separate value added taxes (VATs) administered by the federal and the subnational governments. These two VATs would have a common tax base, but the states could apply different rates, while collecting taxes at the destination of goods and services. The draft law stipulates a specific timeline for the transition to the new system, beginning in 2026 and ending in 2033 for taxpayers. Questions that are currently still open for debate include the extent of exemptions and different rates across goods and services.

The tax reform affects the distribution of revenues between the federal and subnational governments. Some states and municipalities will experience revenue losses with a full application of the destination principle. To address these concerns, the draft law guarantees a transition period of 50 years, during which the current distribution across states would be preserved initially, and progressively changed to the destination principle. This would ensure that states have time to adapt. India faced similar challenges for the VAT reform implemented between 2003 and 2017. The reform also introduces a fund to compensate states, to be financed by the Federal government.

The reform would reduce tax distortions and could bring about substantial improvements in productivity and economic growth. The benefits of a well-designed destination-based VAT include its neutrality for production and sourcing decisions. It would also align the tax burden across goods and services, with the current lighter taxation of services being likely to have regressive distribution effects.

Current discussions should avoid wide-ranging exemptions and special rates, which would undermine the expected gains from the reform. While many OECD countries apply exemptions or reduced rates for some goods and services, empirical evidence suggests that exemptions and reduced VAT rates are not the most effective way of achieving those policy objectives (OECD, 2020[3]). Other measures, such as providing targeted support through the income tax and/or the social transfer and benefit system, tend to be more effective in addressing equity concerns and to pursue policy objectives other than raising tax revenues (Thomas, 2020[4]).

Targeting measures to reduce the burden of consumption taxes for low-income households may be a better way forward than reduced rates for all. New digital payment and identification systems are being explored to include a targeted social benefit dimension in the reform. For instance, ways could be explored to reduce the burden of VAT for purchases of essential goods by low-income households and the beneficiaries of social transfers through targeted transfers ("cashbacks") using a combination of existing identification instruments such as the national registry of low-income households (CadÚnico), and Brazil's digital payment system PIX.

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