THE SHOUP REPORT ON THE TAX SYSTEM OF BRAZIL, 1964

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I. Introduction

This is a retrospective look, not at a report of a "tax mission," as for Japan, Liberia, and Venezuela, but at a one-man brief survey of the tax system of Brazil, in 1964. The following extracts from the foreword to the published report, by Luiz Simoes Lopes, President of both the Vargas Foundation and the Reform Commission of the Ministry of Finance, give some of the background of this project:[1]

"The Tax System of Brazil, now presented to the public in the form of a book, is another contribution of the Reform Commission of the Ministry of Finance to the Brazilian literature on the modern aspects of taxation.

"....It contains a study conducted by Professor Carl Shoup...for the benefit of the Commission.

"...At the invitation of the Getulio Vargas Foundation and under the auspices of USAID, he came to Brazil in August 1964 in the ...capacity of tax expert.

"...the Reform Commission...held two round tables....The first round table dealt with the Brazilian tax system as a whole, its origin, its evolution and its present structure. The second dealt with the income tax....several experts on tax policy and tax administration attended these round tables [names follow]....

"Even though it was prepared in a very short time (Professor Shoup had only four weeks to examine the basic legislation, interview authorities and experts in the Finance Ministry and write the text) the present report presents a fairly comprehensive picture of the shortcomings, inconsistencies and anachronisms of the Brazilian tax system. It points out as well, under the form of specific recommendations, the institutional measures that Professor Shoup prescribes to remedy the problems. As he himself confesses, some of his recommendations are in conflict with certain constitutional provisions, being consequently infeasible unless the Brazilian Constitution is amended." (XIII-XIV).

Insofar as the study was successful, much of the credit must go to my assistant on research and staff arrangements, Arthur S. Xavier Ferreira, and the members of my secretarial staff, seven in all.

The Report was published, in Portuguese and in English editions, in 1965

[1]. In the present paper, numerals in parenthesis refer to page numbers of the Shoup Report. Numerals in parenthesis with "PW" refer to the Price Waterhouse Information Guide of 1986 on Brazil.

(see References), by the Vargas Foundation and the Reform Commission of the Ministry of Finance. The English edition was of 85 + XVI pages.

Perhaps the main occasion for the study of the Brazilian tax system was a supposition (which I conjecture but cannot document) that at last there would be a period of economic and financial stability in Brazil that would allow rational tax reform. The grounds for this belief, insofar as it existed, were perhaps based on the military insurrection in April, 1964, that ousted President Goulart, who has succeeded, as vice-president, an elected president (Quadros, 1960) who had resigned within seven months of taking office. The military and conservatives had forced constitutional changes that created a parliamentary form of government and weakened the president's powers, after Goulart took office, but full powers were restored to him by a plebiscite in 1963. Goulart's insistence on further radical constitutional changes was apparently one factor that promoted the military takeover. Meanwhile, a high rate of inflation (rise in prices) had been a characteristic of much of the two decades preceding, stimulated in part by President Kubitschev's massive spending on the creation of the new capital, Brazilia (1955-1960). (See <u>Columbia Encyclopedia</u>, "Brazil").

There was no immediate fiscal crisis that required heavy new tax measures to raise large sums of revenue; estimated tax revenue for the Federal Government in 1965, at Cr $3.2 billion, compared with estimated expenditures of Cr $3.8 billion (10-11). Inflation had subsided (but not disappeared). No quantitative goals were set for the tax reform study. The aim seemed to be, rather, a qualitative appraisal of the tax structure, to identify "shortcomings, inconsistencies, and anachronisms." Furthermore, technical problems of tax administration were not to be covered.

One thread did run through this report that was not found, except occasionally, in the reports on Japan, Liberia and Venezuela: how to make the tax system able to live with continuing inflation without becoming obviously unfair and hindering efficient allocation of economic resources.

Against this background, it is perhaps understandable why this report, far more so than those on the other three countries, contained little more than "soft" recommendations: of frequent occurence are the terms "might", "sooner or later", "ideally", "seems to be", and the like. But softness does not imply vaugeness; the recommendations were specific enough so that one can check on whether subsequent changes in the tax system accorded with them.

One more reason for having an outsider appraise the Brazilian tax system in 1964 may be found in the fact that a draft of a new income tax law had just been presented by Dr. Jose Luiz Bulhoes Pedreira of the Vargas

Foundation to the study committee on tax reform, at the committee's request. "This draft...is designed to replace in its entirety the present series of laws, amendments to laws, and amendments to amendments, which in the view of some Brazilian tax lawyers is no longer possible to work with adequately. The Project, besides being a complete recodification, introduces several new conceptual and administrative ideas of importance, which will be noted in the appropriate sections below (28)." On balance, the Report favored repeal of the old income tax law and introduction of a new code based on the Bulhoes Pedreira draft.

II. Composition of the Report

The Report was divided into four sections: a Background and Summary (18 pp.), Part I, The Income Tax (36 pp.), Part II, The Federal Government's Consumption Taxes, Stamp Taxes, and Taxes on Motor Fuels, etc., (7 pp.), and Part III, The National (i.e., Overall) Tax System of Brazil (6 pp.). Three pages were taken up by Appendix Notes. There was no list of references.

The relative amount of space devoted to the income tax did not reflect its proportionate share in total revenue. It was accounting for only about 28 percent of Federal tax revenue, against 50 percent from the consumption taxes (ex the gasoline tax) (9). Partly the space - and effort - allocation reflected my own greater familiarity with the income tax, but chiefly the fact that there are so many structural decisions to be made in building an income tax, and they are often problems that are exacerbated by inflation.

The Background and Summary Section concluded by extracting from Parts I, II and III the recommendations made in the Report, and grouping them in a two-way classification. The first classification, reflecting a time dimension, divided the recommendations into three groups: Those that could be enacted within the coming few months, those that had to await amendments to the Constitution, and those that could be introduced only gradually over a period of years as tax administration improved (16). The second classification divided each of these three first classifications into two sub-groups: those measures that were designed primarily to check inflation, and those designed for other purposes. It happened, perhaps not unexpectedly, that all the primarily anti-inflation measures fell in the time group 1, measures that could be enacted during the remaining months of 1964.

The Report did not cover Brazil's social security system, including a 3 percent tax on payrolls introduced in July, 1964. It did include the compulsory loans (see below). The revenue gained by the Government from differential exchange rates was also not included (contrast the report on Venezuela's tax system).

A considerable part of the Report was devoted to tax-structure and tax policy problems caused by inflation. The identifying of the recommendations made primarily to check inflation has just been noted. The personal exemption under the income tax had been fixed, since 1961, not in cruzeiros, but in units of the "fiscal minimum wage", and this was noted and appraised (28-30). Six pages were devoted to inflation and the taxation of business income (52-58), with a discussion of the conflict between equity and the financial needs of business firms, and a conclusion that "the economic consequences probably have to be given some priority," (54) thus permitting an income tax system that would avoid taxing paper gains, but would not allow deduction of real losses (e.g., depreciation in real value of debt holdings). As to intergovernmental fiscal relations, "the theory of public finance contains no formulae for a stable system of federal-state-local fiscal relations in a world of unstable prices" (79).

III. Recommendations

A summary of the Report's recommendations and suggestions is reproduced below from pp. 17-24. They called for repeal of four important levies: excess profits tax, compulsory loans, schedular income taxes, and the legal-entity tax on sole proprietorships and partnerships. The revenue loss would be recouped by raising rates of the basic income tax.

The only new tax suggested was a value-added tax for the states, to replace the cascade turnover tax they were collecting.

Certain changes in state and local taxing powers were suggested, along with introduction of a formulae type of grants-in-aid, to replace the sharing of income and consumption taxes.

A number of changes in the income tax base, exemptions, and rate scale were suggested.

The excess profits tax had become, under the rise in nominal profits due to inflation, largely a tax on ordinary profits, until assets were allowed to be written up in 1964, and, with inflation continuing, further write-ups would be needed. In any case, the definition of "excess" was deemed so difficult that "The administrative effort that would be needed to develop a true excess profits tax could better be devoted to improving the regular corporation income tax" (59).

The compulsory loan was condemned as carrying a hidden tax element, even when indexed to the price level (as it had not been, until shortly before 1964), this tax element to be measured, conceptually, as the amount the taxpayer would be willing to pay outright in tax to be free of the loan requirement. (This hidden tax was almost surely regressive with income.)

The schedular rates called for segregating the individual's income into eight categories, with six different rates, including a zero rate. The chief distinction desired could be better obtained by an earned income credit, and much administrative effort would be released to more important tasks if the schedule system was repealed (31).

The value-added tax, for the states, was recommended with some diffidence, but at least as being better than the cascade tax:

"If the states are to retain the sales tax, consideration could be given to transforming the turnover, cascade-type taxes into the value-added type employed by the federal consumption taxes, or possibly into a single-stage tax. The single-stage tax, however, might favor the producing states over the consuming states. But so too would a value-added tax, unless it could be extended to the retail level, which seems impracticable, at present, administratively. A higher tax rate would be required but if evasion were reduced it might not need to be much higher." (79) The federal value-added tax should in any case give credit for tax paid on purchase of machinery and other items not tax-creditable under current law (21, 65).

For the reasons underlying the other changes recommended, the reader is referred to the Report itself, to avoid unduly lengthening the present paper, especially as most of the changes have rather self-evident justifications.

The "Summary" from the Background and Summary section of the Report follows:

SUMMARY OF RECOMMENDATIONS AND SUGGESTIONS

	Measures designed primarily	
	To check inflation	**For other purposes**
Group 1	**Income Tax:**	
Those that can be enacted during the remainder of 1964.	(1) Lower the basic (single-person) exemption to Cr$ .. 756,000, starting with 1965 incomes, adjust withholding scale accordingly (Part I-A). (2) Raise the 3%, 5% and 8% bracket rates to 10%, starting with 1965 income (Part I-D). (3) Put the progressive-rate scale for 1965 incomes into terms of cruzeiros at the same scale as for 1964 incomes (Part I-D). (4) Replace the compulsory indexed loan of 15% to 25% by a supplementary tax designed to yield about half the revenue of the loan, and expressed as a percentage of the entire regular tax due (not of that part paid directly) and with bracket rates (not effective rates) (Part I-E). (5) Extend to the full year 1965, at the monthly rates for	(a) Increase allowance for each dependent from 3/8 of the basic exemption to 1/2 that exemption, starting with 1965 incomes (Part I-B). (b) Do not extend the 1963-1964 compulsory indexed loan (Part I-F). (c) Repeal deduction of preceding year's income tax for computation of current year's taxable income of corporations (Part I-I). (d) Allow revaluation of inventories to 1964 price levels free of tax, but retain traditional valuation method from this level. (e) Replace excess profits tax by equivalent revenue increase in regular corporation tax (Part I-N). (f) Put corporate income tax on a current-payment (pay-as-you-go) basis, over a three-year period (Part I-N).

the last half of 1964, with the withholding provisions of the July 16, 1964 law, Art. 12 (Part I-F).
(6) Replace compulsory loan of corporations by an increase in corporation income tax of somewhat smaller amount (Part I-I).
(7) Raise the regular rate on corporations, for 1965 incomes only, by say, 5 percentage points (Part I-I).
(8) Do not allow skipping a year in transition of corporations to pay-as-you-go basis (see Background - F). (Part I-N).

Consumption Taxes

(9) Increase tax rates on cigarettes, and distilled spirits, effective as soon as possible (Part II-A).
(10) Extend the rate increases of the Law of August 28, 1964, indefinitely (Part II-A).

(11) If rate of inflation has not greatly decreased by November, 1964, increase rates of consumption tax by average of 100 percent, as temporary measure for 1965.

Stamp Taxes
(no recommendations)

Taxes on Motor Fuels, etc.
(no recommendations)

State and Municipal Taxes
(no recommendations)

Measures designed primarily for purposes other than checking inflation

Group 2

Those that cannot readily be enacted until 1965 or later, often because amendment of the Constitution is required.

(a) Repeal present income tax code and substitute code based on draft code of July 30, 1964 (Dr. Bulhoes Pedreira) after discussion and amendment. Some details follow:
(b) Repeal the normal (schedular taxes) and increase progressive-rate scale to recoup revenue loss (Part I-C).
(c) Call in all bearer shares and replace them with nominative shares forbid issuance of bearer shares henceforth (Part I-F, Part I-L).
(d) Adopt modified split for family income (Part I-G).
(e) Repeal legal-entity tax as to sole proprietorships and partnerships (Part I-J).
(f) Do not require or permit revaluation of fixed assets after 1965 (Part I-K).
(g) Include capital gains and losses from shares, real estate, and other assets in individual income; adopt an averaging device; and possibly allow a slight reduction of tax (gains) and tax relief (losses) (Part I-L).

Consumption Taxes

(h) Give credit for tax paid on purchase of machinery and other items not now creditable (Part II-A).
(i) Extend the consumption tax to certain services, after amending the Constitution (Part II-A).

Stamp Taxes
(no recommendations)

Taxes on Motor Fuels, etc.
(j) Increase rates if more revenues is needed for highway expenditures.

State and Municipal Taxes
(k) Transfer export-tax power from states to federal government (Part III-A).
(l) Transfer rural-land-tax power from municipalities to federal or state governments (Part III-A)
(m) Transfer death-duties power from states to Federal Government (Part III-A).
(n) Allow state governments to impose certain overlapping consumption taxes (Part III-A).
(o) Introduce formulae type grants-in-aid: repeal present sharing of income and consumption taxes and the 30 percent rule for state sharing with municipalities (Part III-A).
(p) Reduce tax on transfer of real estate to almost 1 percent: (Part II-B, Part III-B).

General

(q) Repeal constitutional provision requiring tax rates of one year to be voted in the preceding year (Background, E).

Group 3

Those that cannot be made fully effective until administration is greatly improved depreciation though partial

Income Tax

(a) Refine withholding on wages and salaries, using either USA or UK methods, or a compromise (Part (I-F).
(b) Give prompt refund on overpaid tax (Part I-F, Part I-N).
(c) Define rules on depreciation (Part I-K).

effectiveness may in some cases be achieved in 1964 or 1965.	(d) Amplify regulations on capital gains and losses (Part I-L). (e) Improve assessment of agricultural incomes (Part I-O).
	Consumption Taxes (no recommendations)
	Stamp Taxes (no recommendations)
	Taxes on Motor Fuels, etc. (no recommendations)
	State and Municipal Taxes (f) Replace state turnover (cascade) sales taxes with single-stage or value added taxes (Part III-B). (g) Reform assessment of municipal real-estate tax (Part III-B).

IV. Twenty-Two Years Later

There was no follow-up visit to Brazil, as occurred in Japan and Venezuela (one year later) or Liberia (five years later). Nor have I kept in touch with my colleagues in Brazil in subsequent years to the degree I have done in the cases of Japan and Venezuela. Accordingly, the task of ascertaining the extent to which the Report's recommendations were adopted, or followed, purposely or coincidentally, year by year since 1964 poses a substantial research problem, one beyond the resources available for this part of the tax missions study.

What can be done is to look at the Brazilian tax system as it exists today and note the changes from the 1964 system that coincide with the changes recommended in the Report, and the corresponding lack of change. This is done in the present section, with the aid of the Price Waterhouse booklet on Brazil in its Information Guide series, containing material assembled at May 31, 1986, including 47 pages devoted to taxation, and material supplied on request by the International Bureau of Fiscal Documentation.

No claim of cause-and-effect linkages is made here. Possibly, all of the "agreeing" changes have been coincidental; almost surely, some of them have been. Lack of an agreeing change, on the other hand, does always imply a rejection of that part of the Report (even not reading the Report is a form of rejection).

The recommendations for repeal of certain taxes and for introduction of a value-added tax at the state level have all taken effect, except that the legal-entities tax still applies to partnerships. Partners are also taxed separately, as before, when profits are distributed to them, or they may elect to have their share of the profits taxed at the source at 25 percent (PW-102). There is no excess profits tax, no compulsory loan.[1] An individual's gross income is distributed among six schedules, but only to classify for related deductions, not for differential tax rates (PW, 98). The states' turnover tax has been transformed into a value-added tax (PW, 109).

No new taxes other than the one recommended in the Report are in force today, and all of the 1964 taxes not recommended for repeal are still in force.

Passing now to structural changes in particular taxes, we find that the three chief recommendations for the corporate income tax have been adopted. The statutory rate of the legal entity (corporation, chiefly) tax has been raised from the 28 percent of 1964 to 35 percent, but there

[1]. But see p. 13 below.

has been added another 10 percent applicable to large-income corporations (those that must file semi-annually), which was not recommended. This additional 10 percent may have been adopted as a sort of substitute for the old excess profits tax, though this remark is conjecture on my part.[1] The deduction of corporation income tax paid this year on last year's income, in computing this year's taxable income, has evidently been repealed. (For these two items, see PW, 82, 83). A pay-as-you-go regime has been adopted for the corporate income tax, on a modest scale: large-profit corporations must file semi-annually, instead of annually, and must pay the tax on the half-year's income within three months (PW, 104, and Tax News Service ("TNS"), Jan. 31, 1986, p. 8).

In contrast, the chief recommendations with respect to the individual income tax have not been adopted, with a minor exception: the initial bracket rates of 3, 5, 8 and 10 percent have been consolidated, not into a 10 percent rate, but into two rates: 5 and 10 percent (PW, 116). The rate schedule continues upward with 5 percent intervals. The allowance for dependents has been made smaller, not larger, relative to the primary allowance, than it was in 1964 (PW, 116, 119). Bearer shares are still allowed (PW, 32).

Capital gains and losses are still not taken into account in computing an individual's taxable income when they are from shares in "quoted companies" ("public corporations"), or, if the asset has been held five years or more, from other shares (PW, 99). Withholding of income tax from individuals' incomes has apparently not been refined as suggested (3(a) in summary table).

Structural recommendations under "consumption taxes" in the summary table are only two (Group 2, items (h) and (i)). Neither of them has been adopted. The federal value-added, or "excise" tax gives credit for tax paid on raw materials and component parts (PW, 110), but apparently not on machinery and plant, etc. As to services, a tax reform that was said to be "under way" in 1985 (TNS, July 31, 1985, p. 101) included "extension of VAT to services: services, currently subject to the municpal tax on services (ISS) at rates between 2% and 5%, will be subject to VAT (ICM) [the state tax] at the rates applicable to the suppliers of goods", but PW, 109, describes that tax as still applying only to "physical movement of merchandise."

As to stamp taxes and "taxes on motor fuels, etc.", no structural recommendations were made by the Report.

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[1]. This conjecture is based partly on the fact that this addition to the regular corporation income tax is termed, inexactly, a "permanent excess profits tax" (TNS, Jan. 31, 1986, p. 8).

The record on the tax measures listed under "State and Municipal Taxes" in the summary table is mixed. The tax on transfer of real estate has been reduced from its highest rate of 12 percent (80), not to about 1 percent (22), but at least to 2 percent, and, for transfers at death or by gift, to 4 percent (PW, 112). (This tax is now a state tax; in 1964 it was reserved to municipalities.) The power to tax rural land has evidently not been transferred from the municipalities to the states or the federal government (22; PW, 112). As to death duties proper, "There are no wealth, gift or inheritance taxes" in Brazil (PW, 101). The Report remarked that "The state tax on transfers at death will be kept at low levels because of interstate competition for wealthy decedents as long as it remains reserved to the states" (76). Did competition in fact reduce the rates to zero? Transfer of real estate, at least, is taxed.

Although the compulsory loans based on income have evidently been abolished, the use of a sales figure, rather than net income, as the basis for such a loan is now in effect. A Decree-Law of July 23, 1986 imposes a compulsory loan on sellers of alcohol and gasoline for motor vehicles and sellers of private passenger cars. The loan is repayable, together with capitalized interest, in three years, and amounts to 28 percent of the receipts from the sale of alcohol and gasoline and 30 percent, 20 percent, or 10 percent of receipts from sales of cars that are, respectively, not older than 1, 2, or 4 years (TN, Aug. 31, 1986, p. 114). This experiment should be watched with interest; so far as I know, this is the first time in any country that a compulsory loan has been based on a gross receipts figure.

V. Hindsight

Had the forthcoming periods of renewed severe inflation in Brazil been foreseen, perhaps most of the Report would have been devoted to methods of maintaining real revenue from a tax system in such periods without gross inequities. The ensuing inflations might not then have been as severe. This was not the task set for the Report, however. Today (mid-1987) that problem could scarcely fail to dominate a similar study. Inflation at an annualized rate of more than 400 percent in early 1986 was followed by the "Cruzado Plan" (the cruzado was the name given to the new currency) involving wage and price freezes, but not fiscal measures needed to make such freezes last, and currently inflation is again about 400 percent annually (Cohen).

Another direction the Report might have taken would have been to set forth in more detail the problems and possiblities of new forms of tax that were suggested in the Report. A special case is the value-added tax suggested for the states. To have made such a contribution, the Report would have had to depend largely on introspection and speculation, since no country, in 1964, imposed a value-added tax that extended throught the retail stage. Indeed, when the Brazilian states, three years later, introduced such a VAT, they were the first (Shoup, September, 1986, pp. 2-3). For a VAT restricted to stages prior to retail, experience could in 1964 be drawn from only one country, France aside from Brazil itself (Federal tax).

A more drastic judgement would be that no project at all should have been undertake with so restricted resources and time period. But this seems unduly conservative a view, considering the several recommandations that were in fact adopted (or at least duplicated).

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