OBSERVATÓRIO DAS DESIGUALDADES

INEQUALITY, TAXATION AND PUBLIC EXPENSES

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Inequality, *Taxation and Public* Expenses

There are several ways in which the State can intervene in the distribution of resources in society: providing public goods and services, regulating the labor market, creating affirmative actions, criminalizing or not certain behaviors. The result of each one of them may imply the maintenance, increase or decrease of social inequalities, as we have already shown in other editions of this bulletin. The fact is that, throughout its operations, the State withdraws resources from a certain portion of the population and distributes them in different ways: personnel expenses, interest payments, investments in infrastructure, social expenditures. Deciding where public resources come from and where they go is, in itself, a way of combating inequality or, on the contrary, reproducing it.

This is precisely what we are going to address in this issue of the bulletin of the Observatory of Inequalities1: the close relationship between Brazilian fiscal policy – the way in which the State collects and spends its resources – and our profound social inequality. For this, we will deal with two central questions. The first one is: where do they come from – and, above all, from whom do public resources come? To this end, we will focus on our tax system, the main form of State revenue. Secondly, we will analyze: where – and to whom do these resources go? In this case, we will focus on social spending, responsible for the expenditure of a considerable part of the Brazilian GDP. Finally, we will see the result of these two mechanisms in Brazilian social inequality and how Brazil has been trying to balance these two sides of the fiscal balance.

Good reading and good discussion!

1 Partnership between João Pinheiro Foundation (FJP) and the Regional Council of Economics of Minas Gerais (Corecon-MG), the Observatory of Inequalities is an extension project of the FJP's Public Administration course. The opinions expressed in this bulletin do not necessarily represent the position of the institutions.

THE IMPORTANT COMBINATION BETWEEN TAXATION AND PUBLIC EXPENDITURE

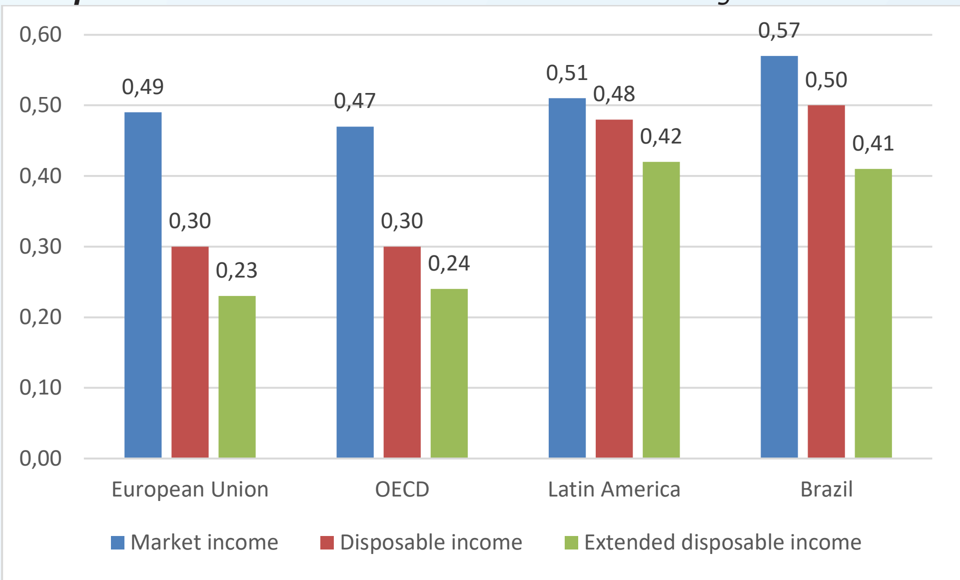
Before we move on to the specific analysis of the Brazilian tax system and social expenditures, let's show our starting point: choices regarding fiscal policy vary among countries and are a relevant factor in differentiating income inequality in each one.

Graph 1 proves this issue by comparing the impact of fiscal policies on income inequality, as measured by the Gini Index, in European Union (EU), OECD and Latin American (LA) countries, in which we highlight the specific situation of the Brazil. Thus, it is possible to visualize three stages of income inequality: (i) the distribution of market income, exclusively generated by the productive system; (ii) after deducting the payment of direct taxes and incorporating income transfers, which results in disposable income in kind; (iii) after the incorporation of free public health and education services, equivalent to an indirect income transfer, as families stop spending on these services, resulting in the so-called extended disposable income.

In this context, Graph 1 allows us to infer four conclusions:

i) the highest inequality index refers to the income earned in the dynamics of the marketplace.

Graph 1: *Gini Index for different income levels and regions – 2011*



Source: *Own elaboration, based on Cepal data (2015).*

Here, it is important to draw attention to the fact that this type of inequality for LA, the OECD and the EU has a very similar magnitude, while Brazil has a higher level[2];

ii) after discounting the taxation directly paid by families and the sum of transfers (disposable income) and the inclusion of free public health and education services (extended disposable income), inequalities are reduced in all scenarios, showing the importance of role of the State;

iii) the extent to which income inequality is reduced as a result of the fiscal instruments used by the government is very different between the groups presented. While EU and OECD countries strongly reduce inequality through direct taxes and income transfers, in LA the drop is much less significant.

iv) in all groups and also in Brazil, the provision of basic social services (such as health and education) is an important instrument not only for guaranteeing social rights, quality of life and opportunities, but also a redistributive instrument to reduce material inequality.

We will detail the Brazilian scenario a little more in order to understand how each of the components of fiscal policy influences the increase or decrease in income inequality in the country, starting with taxation.

TAXATION AND INCOME DISTRIBUTION

The tax organization of a country has an important impact on its income distribution, as it defines where a considerable part of the money that will be spent by the State will come from. In this context, each citizen will be influenced differently by taxation, depending on state choices in two basic aspects: which economic facts will be taxed (possession or transfer of goods, income, salary, profits received or consumption) and what will be the size of that taxation, represented by the rate, that is, the percentage with which a tax will be levied on the value of the taxed economic fact.

The tax structure of a country may be progressive or regressive, depending on

[2] *To learn more about inequalities in the market, of Brazilian work, access bulletin no. 3, available at: http://observatoriodesigualdades.fjp.mg. gov.br/wp-content/uploads/2019/05/OD3.pdf.*

the impact that taxes have on the population's income. While progressive systems generate a redistributive effect on the income structure, by making the wealthiest pay proportionately more than the poorest, regressive systems make the population's income more concentrated after tax collections have been made, thus penalizing those with less income.

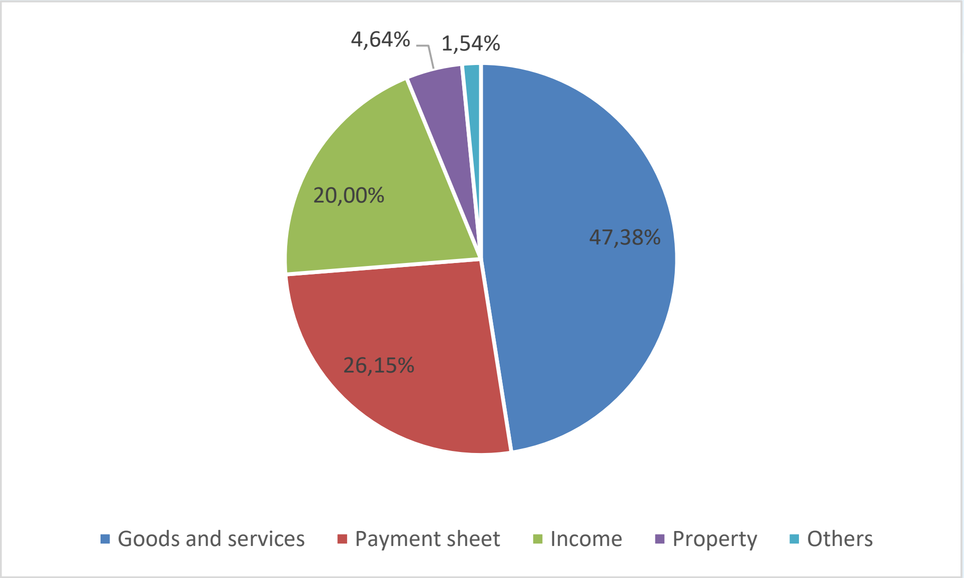
An important factor for determining the progressivity or regressivity of a tax system, although not the only one, is the composition of its tax burden, if it is more backed by notably more progressive direct taxes or in notably more regressive indirect taxes. Before moving on to the reasons that explain the progressive or regressive nature of each tax, let's understand what direct and indirect taxes are.

Direct taxes are those that fall, directly and definitively, on the taxpayer, who will bear that load without the possibility of transferring it to third parties such as income and property taxes.

In indirect taxes, on the other hand, there is a differentiation between the rightful taxpayer on whom the tax is legally levied and the de facto taxpayer, who is the one who will pay the tax. In the latter type, represented mainly by taxes on the production and consumption of goods and services, the rate is normally the same for all individuals, with no differentiation according to contributory capacity, unlike what usually occurs in direct taxes.

In this context, the regressive nature of indirect taxes is based on the fact that the wealthiest save much more than the poorest, who are forced to spend all or almost all of their income on subsistence and maintenance; that is, in consumption. Thus, as consumption taxation does not affect the portion of income that is saved, nor on patrimony and property, people with less purchasing power, when consuming goods and services, pay a greater proportion of their income in the form of taxes.

Graph 2: Composition of tax collection - Brazil, 2017.



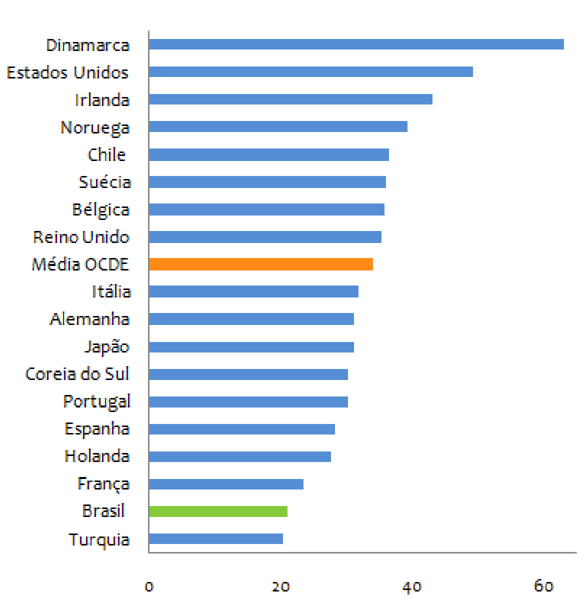
Source: *Own elaboration based on data from the Federal Revenue Service, 2018.*

In turn, the personal income tax (IRPF), which is the most relevant among the direct taxes, is, in any country, a highly redistributive tax, since it has explicitly progressive rates according to each person's ability to pay, and directly taxes what is so unequally distributed in capitalist economies: income (CASTRO et al, 2010).

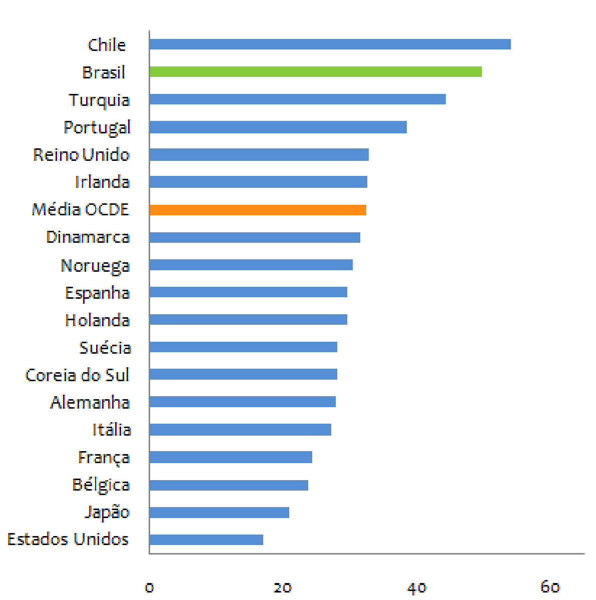
At this point, it is not difficult to imagine that the Brazilian tax burden is more concentrated in indirect taxes. This is what Graph 2 shows, according to which the taxation of goods and services in the country corresponded to 47.38% of the total collection in the year 2017.

If we compare this composition with the collection of other countries, we will see that, in Brazil, direct taxation is poorly explored and indirect taxation is very high. This is what Graphs 3 and 4 show, which refer, respectively, to the percentage of direct and indirect taxation in the tax composition of OECD countries and Brazil in 2015. While Graph 3 shows that only one of the selected countries taxes income and property less than Brazil (Turkey, with 25.2%), Graph 4 illustrates the opposite situation: only one country taxes consumption more than Brazil (Chile, with 54.1%).

Graph 3: *Share of taxation on income and wealth – Brazil and OECD, 2015*



Graph 4: *Consumption tax share – Brazil and OECD, 2015*

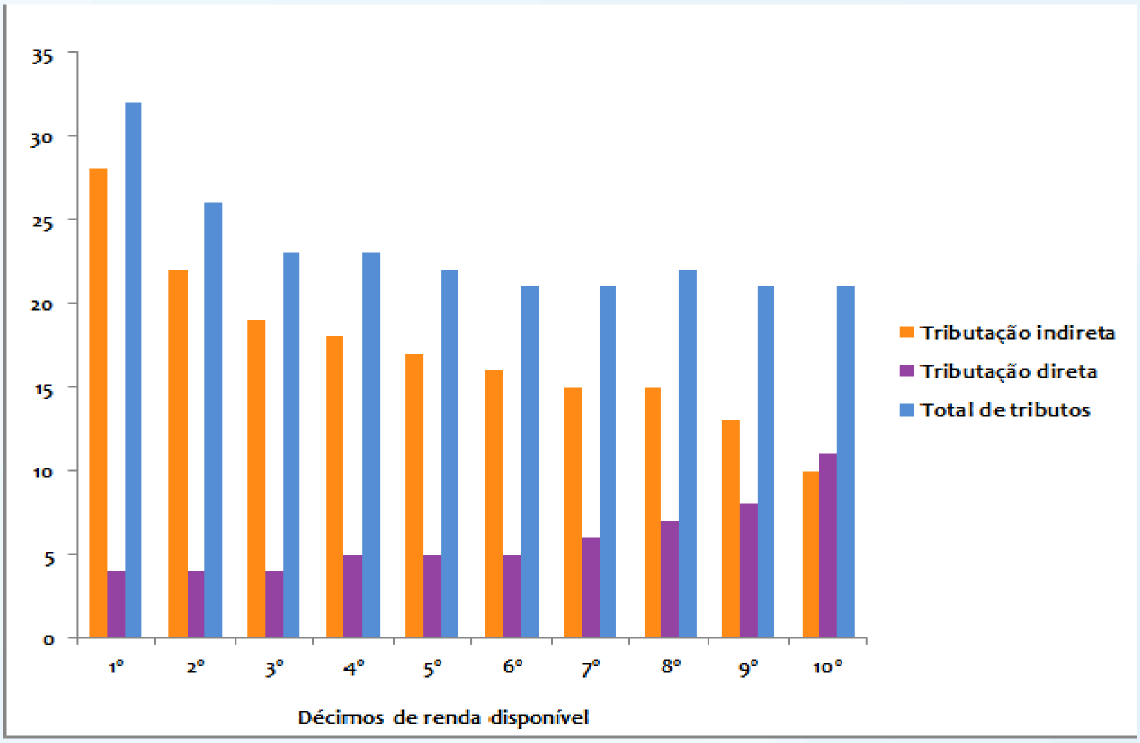


Source: *Own elaboration based on OECD data: Revenue Statistics Comparative Tables.*

It is interesting to note the high share of direct taxes in developed countries such as Denmark (67.2%), the United States (59.4%) and Ireland (49.4%).

The consequence of this tax composition is the regressivity of our system, in which the population of the lowest income strata is burdened more significantly, which can be seen in Graph 5, formulated by IPEA (2011) based on data from the 2008/2009 Family Budget Survey (POF). The graph shows that, while the poorest 10% in Brazil allocate 32% of their disposable income to pay taxes, for the wealthiest 10% the weight of taxes is reduced to 21%.

Graph 5: *Participation of direct and indirect taxes in monetary income – Brazil (2008-2009)*



Source: *Ipea, Sindifisco, Dieese, 2011, based on data from the POF 2008/2009.*

On the other hand, it is also possible to see that the income paid in the form of direct taxes is progressive, but it is not capable of annulling the regressiveness of indirect taxes. Thus, in the total sum, taxation is still regressive and deepens income inequality.

As if this tax regressiveness was not enough, Brazil also has high tax evasion. According to a study carried out by CEBES (2018), accumulated tax evasion is estimated at R$500 billion, and there is an estimate of R$1.7 trillion in Brazilian accounts in tax havens. Finally, revenue waivers continue at very high levels, reaching an estimated amount of R$377.8 billion in 2016, while investment expenses fell by 57%, from R$87.2 billion in 2012 , to R$ 37.3 billion, in 2016. But the reduction in expenses is also a subject for another section of this bulletin.

The impact of direct taxes

Direct taxes are levied on income and property and, as already mentioned, promote more tax justice, although still shy within the Brazilian tax composition. Let us now analyze the characteristics and impacts of these taxes on Brazilian income inequality.

Property taxes

As shown in Graph 2, property taxes are little explored in Brazil, corresponding to only 4.64% of the Brazilian tax burden. Currently, the most important property taxes are the Urban Property and Territorial Property Tax (IPTU) and the Motor Vehicle Property Tax (IPVA).

In addition to the low share of the tax

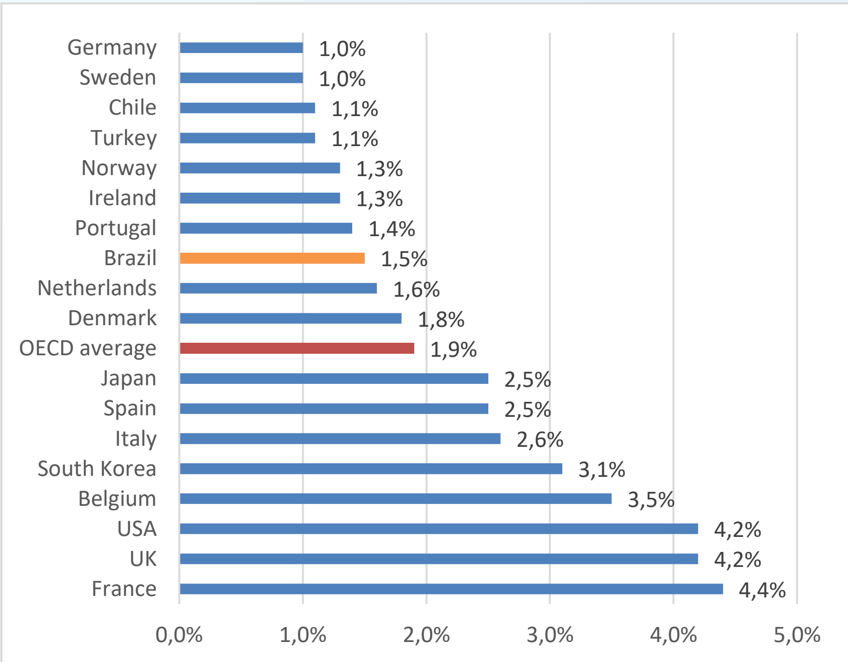
burden, Silveira and Passos (2018) list other limitations to the progressive potential of property taxes: the rates are low and not very progressive, and the IPTU is a source of revenue whose competence is local, where the tax administration capacity is more fragile. Furthermore, Brazil exempts large fortunes from taxation[3] (in OECD countries, taxation is between 2% and 5%).

[3] *A complementary law, although provided for in the 1988 Constitution, has not yet regulated the Great Wealth Tax (IGF).*

Finally, private planes, speedboats and helicopters are incomprehensibly exempt from IPVA.

Graph 6 compares, among some countries, property taxation (in relation to GDP) in the year 2017. It can be seen that property taxes in OECD countries correspond to approximately 1.9% of GDP, while in the Brazil, this figure is 1.5%. If, on the one hand, this number is close to the average for these countries,

***Graph 6:** Share of wealth taxes in GDP - Brazil and OECD, 2017*



***Source:** Own elaboration based on OECD data.*

on the other hand, there is a caveat presented by Silveira and Passos (2018): only Brazil computes the IPVA in this calculation, if it did not do so, the share of property taxes would be only 0.8% of GDP, taking the country to the last position among those analyzed.

Income taxes

Income taxes are levied on both the individual and the legal entity. By income, according to classical economists, we can understand the remuneration of equity (profits and interest), labor (wages) and land (rents and leases.

An important debate in Brazil, as pointed out by Queiroz and Silva et al (2015), concerns taxation on equity income: whether this will be supported only by legal entities, only by partners, or by both. Brazil adopts the model that taxes companies exclusively, exempting the income earned by shareholders. According to Caroll and Prante, cited by Queiroz and Silva et al. (2015), only in Brazil, Estonia and Slovakia does equity income taxation occur exclusively within the scope of legal entities. But what is the implication of adopting this model on Brazilian income inequality?

The fact is that this model is regressive, since very high amounts are incorporated into individuals' incomes, without being taxed. As an example, according to the Federal Revenue (2019), in 2017, R$ 280 billion were earned by shareholders in Brazil. In OECD countries, this value could be taxed at up to 40% (the minimum found among countries is 20%, which, in a very preliminary estimate, would mean more than 50 billion additional revenue). This factor directly influences the progressive potential of the IRPF, which we will discuss next.

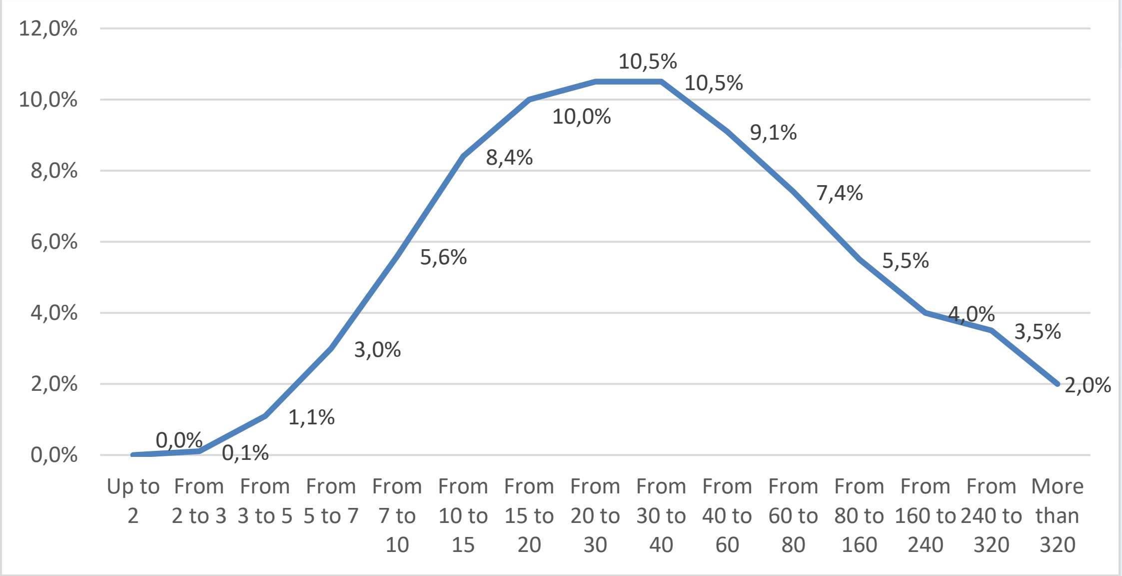
Personal income tax

As profits and dividends earned by shareholders of companies are exempt, the income on which the IRPF is levied is mainly that from work. Its distributive character is the result of its progressive rates, distributed according to the monthly income received by each individual, and its exemption range (up to R$1,903.98 per month in 2018).

Despite the IRPF being the most progressive tax in Brazil, some reasons limit the scope of its full distributive potential. The first refers to its relatively small participation in the Brazilian tax composition, as seen in Graph 2, especially when compared to other countries (Graph 3). The second relates to the IRPF exemption on equity gains (profits and dividends), as explained above. Still in relation to equity gains, it is important to point out that, in addition to interest and dividends, financial investments in the banking market also have differentiated taxation, not following the progressive rates of income tax.

The third reason concerns the IRPF deductions referring to some expenses, such as health and education, and the number of legal dependents. In 2017 alone, deductions and discounts totaled R$ 387.55 billion (data from the Federal Revenue), constituting a waiver of public resources for the market to the detriment of increased collection. The limitation to the progressive potential of the IRPF generated by the deductions lies in the

Graph 7: *Average effective rate by monthly minimum wage range – 2017*



Source: *Own elaboration based on data from the Federal Revenue, 2019.*

fact that the wealthiest strata of the population are the ones that spend the most of this nature, being, therefore, the most benefited. These deductions reduce (in relation to the total income obtained) the amount on which the IRPF will be levied, constituting a means for the taxpayers to "take a large part of their income from the realm of the taxable to the non-taxable" (Soares et al, 2010)).

The limitations to the progressive nature of the IRPF are evident in Graph 7, which shows the effective tax rate for each income range, calculated from the comparison between the actual total contribution of individuals to the tax and the total income (including those exempt) received by them in period[4]. It is possible to see that the higher the income range, the greater the share of exempt income, which makes the top of the pyramid pay a lower effective rate. Thus, the highest effective rate in Brazil is 10.5% and is levied on individuals with total incomes between 30 and 40 times the minimum wage. From that point on, the effective rate decreases, until it reaches 2%, when it is applied to the wealthiest individuals – with a total monthly income above 320 minimum wages.

The fourth reason is related to the number of income ranges on which the tax is levied. In Brazil, there are only four taxable bands, which limits the State's ability to collect proportionately more from those who earn more. Let's see: in 2018, the income range that defines the rate starts at an amount above R$4,664.68, so that the maximum amount of 27.5% is levied on the income of a citizen who earns R$5,000.00 a month and another that earns R$30,000.00.

[4]*We can understand the concept of effective tax rate in the following example: for an annual gain of R$52 thousand and a rate of 27.5%, the tax payable would be R$14,300. With the possibility of deducting R$ 8,687.45 (allowed deduction for those who fall into the last tax range), the tax drops to R$ 5,612.55, that is, 10.79% of taxable income.*

In addition, the maximum rate in Brazil is quite low compared to other countries, such as the Netherlands and Belgium, whose taxation of the last income range reaches around 50%. Finally, the degree of tax evasion and avoidance[5] in the IRPF is high. According to a study by Soares et al. (2010), based on data from the 2003 POF, more than a third of the total amount that should be paid to the tax authorities in the form of IRPF is elided or evaded. The study also concludes that evasion and elision are increasing with the level of income, reducing the degree of progressivity in the effective rates of this tax.

INEQUALITY, TAXATION AND PUBLIC EXPENDITURE

Now let's analyze one of the most important ways of distributing public resources: social spending. In this context, we can already say that, if the Brazilian tax system exerts a significant weight on the poor and intermediate income groups, which is mainly due to indirect taxes, social spending acts in the opposite way, with an important distributive impact.

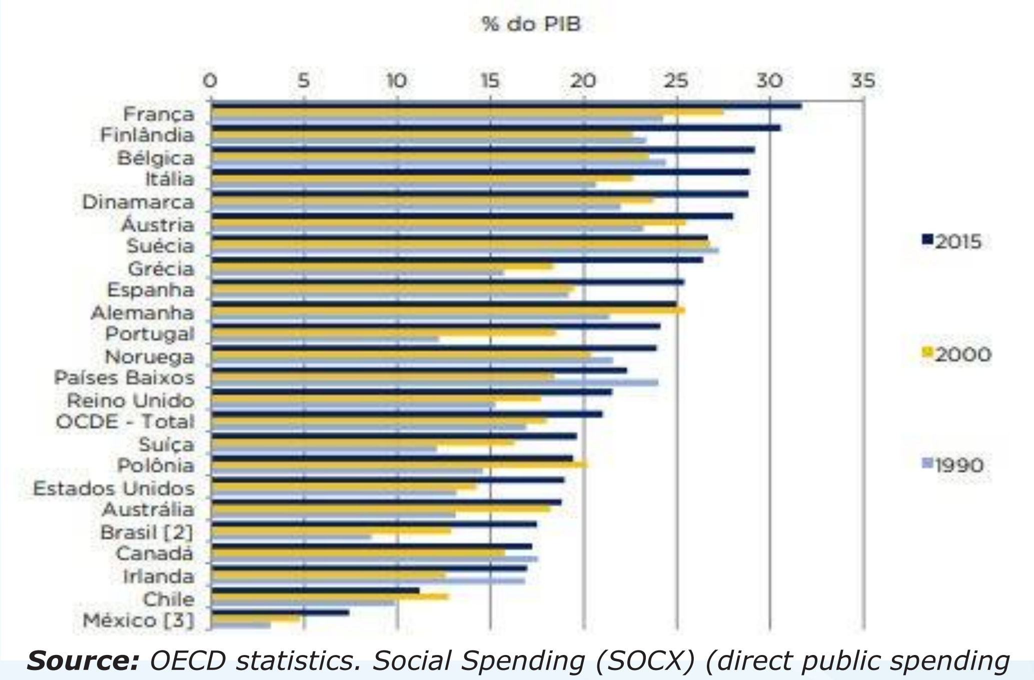
Social policies in the Federal Constitution of 1988

The Federal Constitution of 1988 constitutes the main institutional framework that established a broad set of social policies in Brazil, increasing both access to these policies and the types of existing benefits. In order to ensure stable sources of funds for these policies, notably for Social Security (health, social security and assistance), the constitutional text linked, in the chapter

[5]*Tax avoidance is an accounting practice that makes it possible to adapt a company to the most advantageous tax payment format, without committing any illegality.*

of the Social Order, its funding for the collection of specific taxes – the social contributions. To this measure were added other constraints foreseen in the traditional budget tax, in the case of education financing. The linkages of revenue to the financing of policies that benefit the least favored strata

Graph 8: *Direct public social expenditure, as a % of GDP. OECD Selected countries (1990, 2000, 2015).*



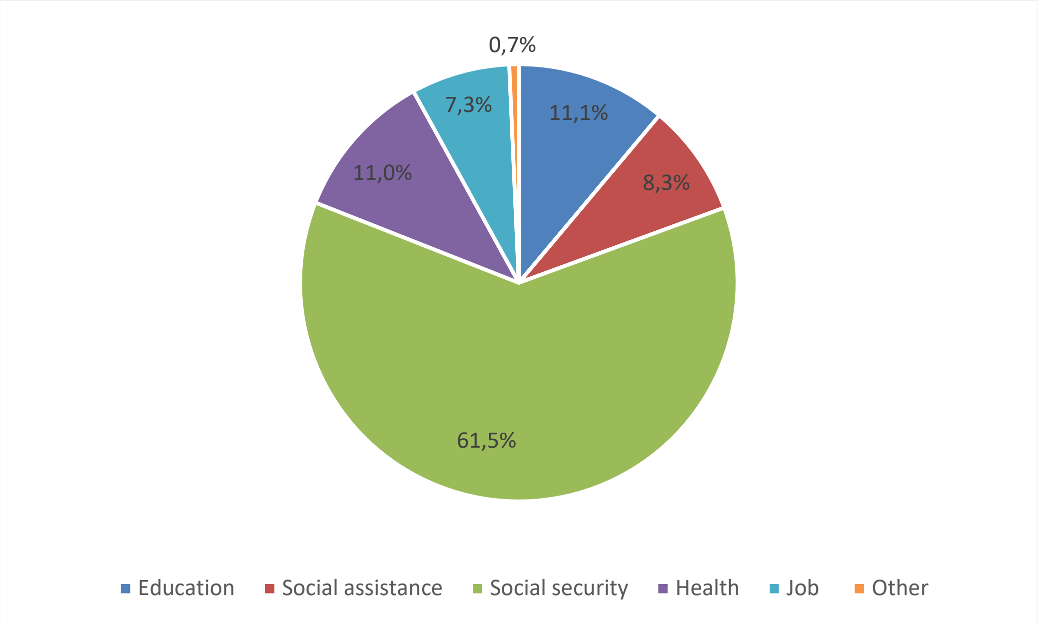
Source: *OECD statistics. Social Spending (SOCX) (direct public spending only); Social Investment Database (ECLAC); Central Government Social Spending (2002-2015) (National Treasury Department/Siafi/Disor). Prepared by Anfip and Dieese, 2017, taken from FAGNANI et al (2018).*

of society represent a guarantee that State resources will not be fully, or at least in large part, appropriated by the ruling classes, which have control over the budget (OLIVEIRA, 2018).

In this context, considering that the linkages narrow the margin of resources to be negotiated and decided between the Executive and the Legislative, it did not take long for them to begin to suffer attacks (OLIVEIRA, 2018), such as, for example, the dissemination of the idea that the social spending in Brazil is very high. However, the international comparison reveals that the country's social spending is comparatively low in relation to OECD countries, as can be seen in Graph 8. Furthermore, it is possible to see that like Brazil, all the analyzed countries increased their social spending in the period between 1990 and 2015.

As for the results achieved with social spending, in addition to those that are difficult to measure – which are perhaps the most important, such as the degree of citizenship and the standard of well-being they provide – social spending guarantees a double benefit: it promotes growth with a better distribution of income and skills (IPEA, 2011). The relationship between social spending and economic growth is explained by Esther Dweck and Pedro Rossi (2018): most social spending benefits the poorest and the middle class, generating an acceleration of the income circuit, as this portion of the population has a greater

Graph 9: *Union social expenditure, 2016 (in R$ million and % of the total)*



Source: *Independent Tax Institution (2017).*

propensity to consume, as their income barely covers their basic subsistence needs. The increase in demand generates an increase in the volume of sales, which can increase the scale of domestic companies and increase productivity. In addition, improving people's quality of life implies greater productivity in the system: they are workers with better health, more education, more leisure, more culture and who take less time to get to and from work with higher quality transport services.

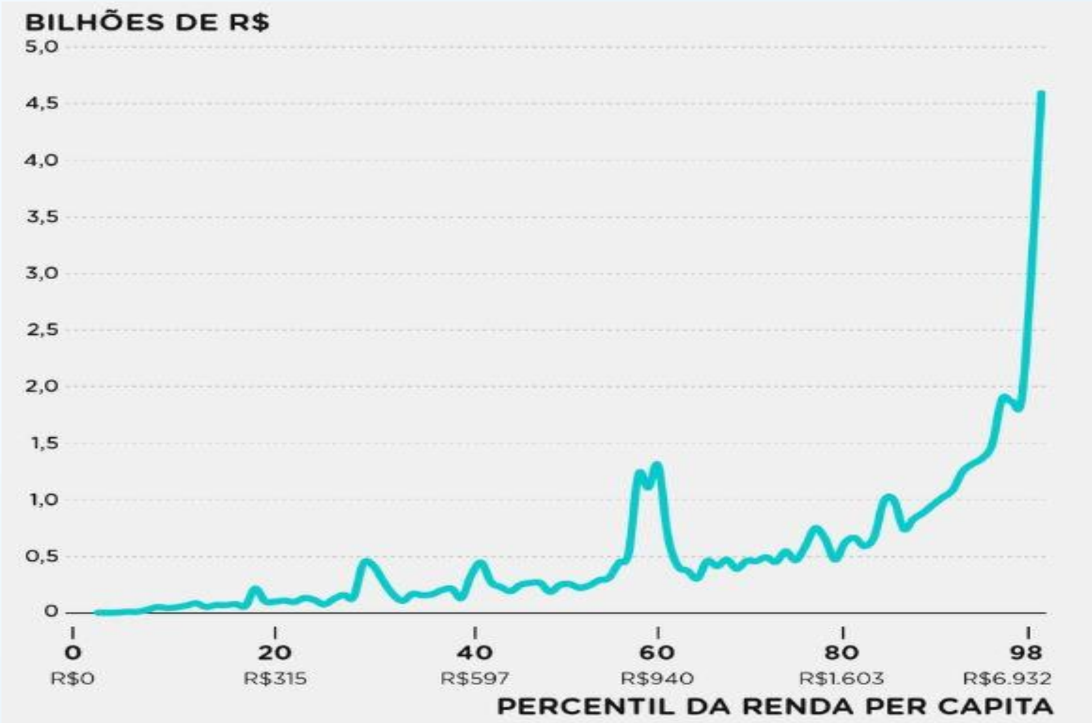
Although the discussion about the impact of social spending on economic growth is of undeniable importance, we will limit it here to our theme, related to its direct impact on social inequalities in Brazil. Therefore, we will analyze the effect of social spending on social security, education and public health and social assistance, since, in addition to being target of the largest applications of resources (Graph 9), are identified as those with the greatest distributive impact (IPEA, 2011).

Spending on social security and income inequality

Brazil has two main social security systems: the general social security regime (RGPS), which covers workers in the private sector, and the social security regimes (RPPS), which serve public servants, including military personnel and magistrates. With the 2003 social security reform, the general rule of the RPPS started to limit the value of the pensions of the federal public service new entrants to the social security cap of the general system, currently set at R$ 5,839. Civil servants who entered the public service before 2003 continue to have the right to a full retirement, which has a strong impact on social security spending, which, as can be seen in Graph 9, constitutes the country's main social expenditure[6]. RPPS represent the most concentrated of the pension, especially due to the group of civil servants whose pensions and pensions exceed the cap.

[6]Currently, the proposal for a pension reform is being processed in the National Congress, which intends to change the rules of the RGPS, from which most of the economy would start, and of the regimes specific to federal public servants.

Graph 10: *Total pension income by percentile of total per capita income*



Source: *Prepared by ROSSI et al (2019), based on 2017 PNADC data.*

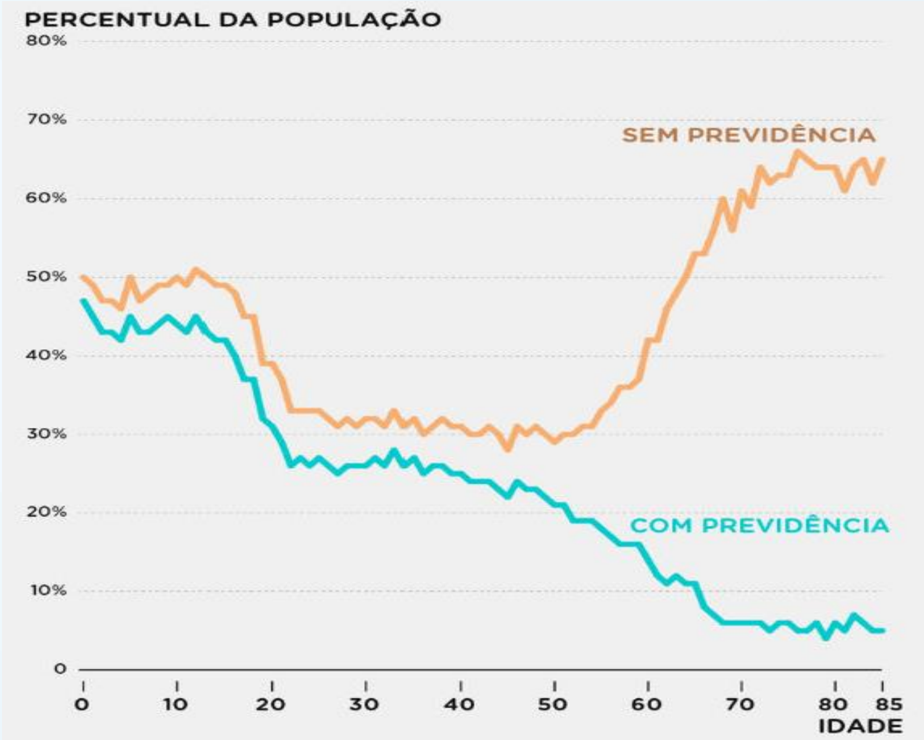
The study by Marcelo Medeiros and Pedro Souza (2013) points out that the concentration coefficient in this extract is 0.824, a value 47% higher than income inequality in Brazil, which is already very high. According to the authors, there is no other source of income that contributes so proportionately to inequality.

In Graph 10, based on data from the 2017 Annual PNADC, it is possible to visualize this scenario: around 15% of social security transfers go to the wealthiest 2% of the population (monthly per capita income above R$6,931.00), with 9% for the wealthiest 1% of the population (per capita income above R$9,526). Obviously this income does not derive from the RGPS, whose cap is R$5,839.00, but from the Own Regimes, from civil servants of the Civil Executive, Judiciary, Legislative and military (ROSSI et al, 2019), since all civil servants who entered the State before 2003 maintained their right to full retirement.

In turn, retirements and pensions for workers in the private sector generate progressive effects on income distribution. This is due to a combination of three factors: first, rural pensions provide income for families that would be very poor if they could not count on these resources; second, the social security floor, equivalent to a minimum wage, benefits more than 60% of the members[7] and guarantees reasonable transfers for those who were unable to make high contributions during their working lives; third, the legal cap of the RGPS prevents benefits from reaching very high values(MEDEIROS and SOUZA, 2013).

[7]*Data from Instituto Mercado Popular, referring to 2017.*

Graph 11: *Proportion of people below the poverty line (R$ 406) by age*



Source: *Prepared by ROSSI et al (2019), based on 2017 PNADC data.*

Thus, the first and second factors are closely linked to the contribution of social security to combating poverty in Brazil, especially among the elderly, as we can see in Graph 11. Thus, in the artificial hypothesis of eliminating incomes of social security, poverty would exceed 60% among the older population (ROSSI et al, 2019).

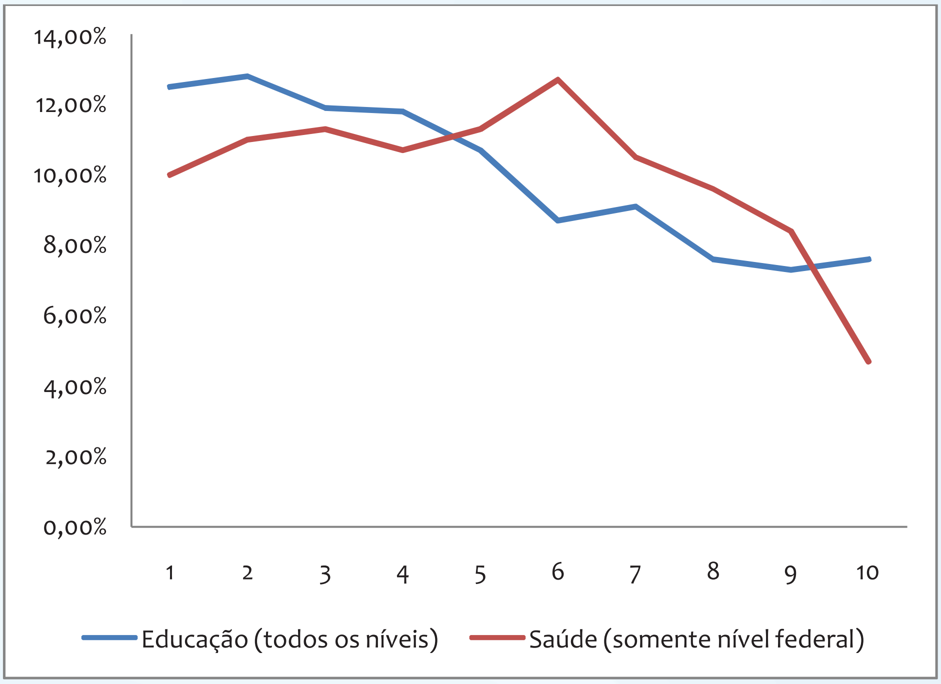
It is evident that the debate around the social security issue in Brazil is complex and exceeds the limits of this bulletin. However, with regard to the issue of income inequality in Brazil, what we can say is that, on the one hand, the importance of the RGPS is undeniable for a large mass of Brazilians who depend exclusively on its benefits for subsistence, thus constituting the progressive character of the system. That is, in aggregate form, the RGPS contributes to reducing income inequality.

On the other hand, there is a regressive character found in the Own Regimes, mainly due to the pensions granted to certain categories of civil servants in Brazil, especially those who receive amounts well above the General Regime cap.

Health and education expenditures and income distribution

In relation to public spending on health and education, both have an important impact on improving indicators of social inequality in Brazil. This can be seen in Graph 12, based on a study carried out by Silveira et al (2011), which shows the progressive distribution of these expenses. In fact, the graph shows that, in general, the lower the income of a segment, the greater the proportion of public spending on health and

Graph 12: *Distribution of public spending on health and education, by income tenths (2008)*



Source: *Own elaboration, based on the study by Silveira et al (2011).*

education intended for it. According to the authors, increases of 1% of GDP in spending on health and education contribute, respectively, to a reduction of 1.5% and 1.1% in the country's Gini index.

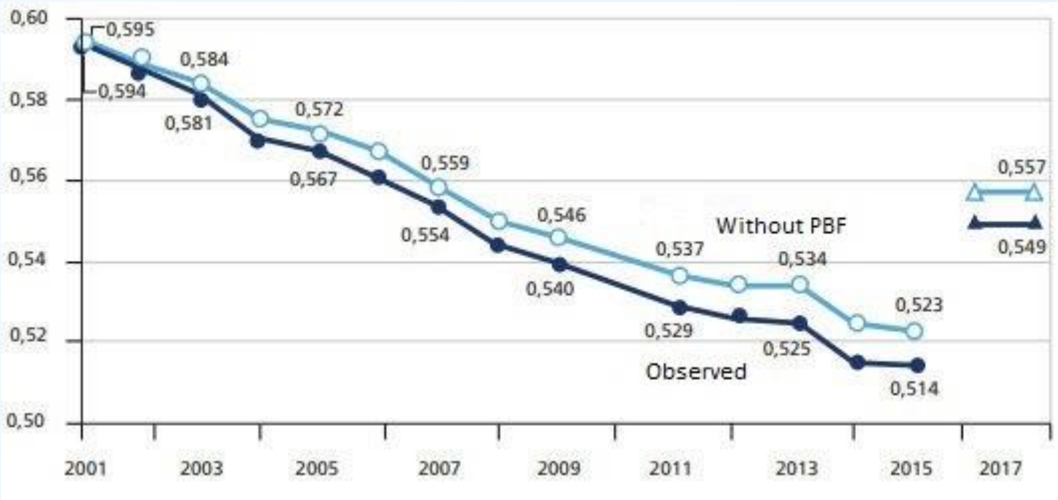
In the case of education, it is important to analyze not only the direct destination of public spending, but also the impacts of schooling on income in the labor market. Much of the wage inequality that exists in society is a reflection of educational disparities. As already discussed in Bulletin n. 2 of this Observatory, Brazil is one of the countries with the highest reward for years of study, that is, our labor market has very high salary differences between people with different levels of education. As schooling is one of the main determinants of workers' earnings, public policies that contribute to reducing educational disparities are essential to also reduce economic inequality.

Spending on social assistance and income inequality

Social Assistance, made up of the Unified Social Assistance System (SUAS), the Continuous Cash Benefit (BPC) and the Bolsa Família Program (PBF) – programs primarily focused against poverty – is highly progressive. According to IPEA (2010), transfers related to the BPC and PBF are clearly the ones that most contribute to the reduction of income inequality in Brazil: a 1% increase in GDP in spending on these benefits generates a decrease of 2.33% and 2.15% in the Gini Index, respectively.

The BPC is intended for elderly people aged 65 or over who have not had access to retirement and people with disabilities in extreme poverty, and constitutes a non-contributory benefit in the amount of one minimum wage. In this context, the BPC, together with the RGPS and the Rural Welfare, contributed to ensuring that poverty and indigence among the elderly population became an almost residual phenomenon in Brazil. In 2014, only 0.78% of seniors aged 65 and over lived with a per capita family income of up to one quarter minimum wage, and 8.7% lived with a per capita income of up to half a minimum wage. On average, income from the BPC represents 79% of the budget of these families, and, in 47% of cases, it is the only income of the family (IPEA, 2018).

Graph 13: *Gini coefficients with and without PBF transfers (2001-2017)*



Source: *PNADs (2001-2015) and Continuous PNADs (2016-2017). Prepared by, 2019.*

In turn, the PBF, created in 2003, is the main income transfer program of the federal government and is aimed at families in poverty or extreme poverty. The PBF is by far the best-targeted monetary benefit in Brazil, and its coverage has increased considerably since 2004, reaching around 60% of the poorest fifth of the population as of 2012 (IPEA, 2019). Graph 13 shows the estimated Gini coefficients for per capita household income with and without the PBF. It is noted that the PBF contributed a lot to the fall in inequality in the country, and this contribution increased along with the expansion of the program's coverage.

Therefore, expenditures on direct income transfer programs to the population in poverty and extreme poverty are presented as the most effective instrument for combating income concentration.

Although the other social expenditures – such as health, education and social security – are also progressive, they are distributed among all strata of the population, while assistance benefits have a specific focus on the poorest strata, being fundamental to the promotion of a more equitable society. However, it is important to emphasize that this comparison between the different types of social spending is focused only on the impact on inequality, and that investments in health, education and social security have other objectives and contribute in other ways to the well being of society.

THE RESULT OF THE BRAZILIAN TAX POLICY

The result of the Brazilian fiscal policy can be seen in Graph 14, based on data from the 2008/09 POF, which assesses inequality in Brazil according to five stages of income.

Graph 14: *Stages of fiscal policy and Gini reduction - Brazil, 2009*

Source: *Source: Prepared by Brasil Debate and Friedrich Ebert Foundation (2018), based on calculations by Silveira and Passos (2017).*

In the first stage, only the income from the market is considered. Next, government monetary benefits (such as retirement, pensions, allowances, scholarships, unemployment insurance and others) are added. The second stage is called "initial monetary income". In the third stage, direct taxes are deducted, and disposable income is obtained. Then, indirect taxes are subtracted for the fourth stage and, finally, in the fifth stage, the value of public expenditures on health and education is added.

Therefore, in view of the data and arguments presented in this bulletin and as shown in Graph 14, which shows the distributive impact of taxation and social spending, we have two conclusions: in general, the Brazilian tax system does not contribute to reducing inequality, since all the distribution gain from relatively modest direct collection (3rd stage), is eroded by indirect collection (4th stage).

On the other hand, public expenditures, represented in the 2nd and 5th stages, especially in health and education, RGPS pensions and income transfers, play a relevant role in reducing social inequality.

In light of these findings, let us now see how Brazil has been trying to balance the two sides of its fiscal balance in a context of serious economic crisis.

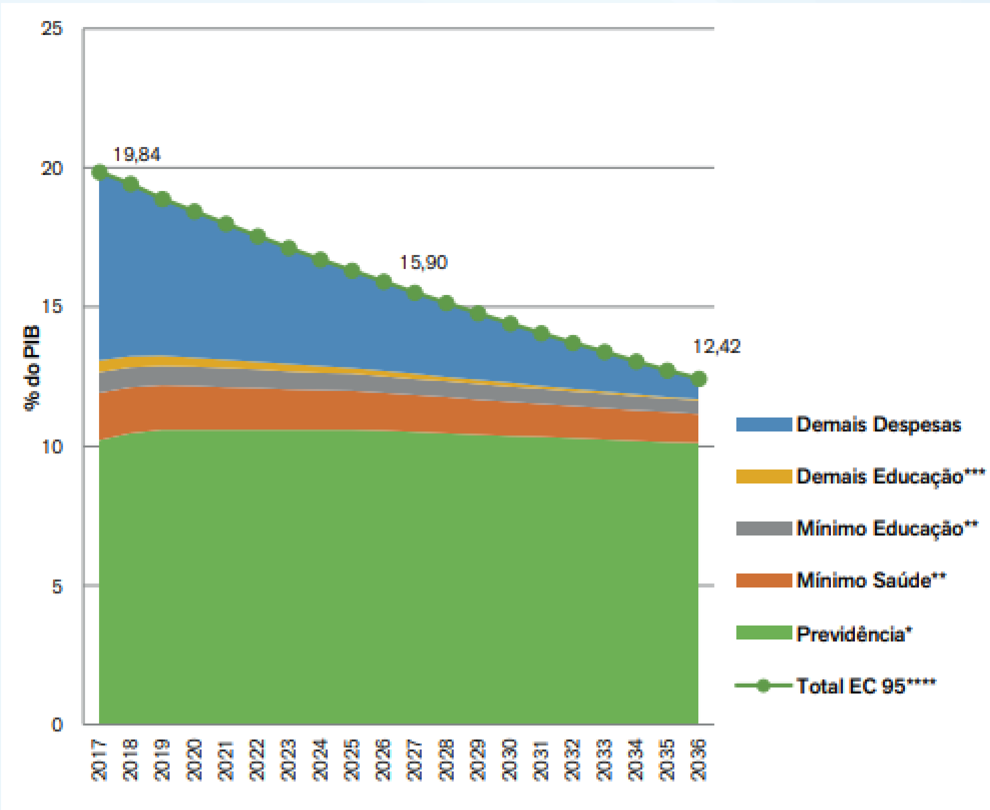
THE CONSTITUTIONAL AMENDMENT 95/16

Constitutional Amendment 95, approved in December 2016, established a cap for the Federal Government's primary expenses – those related to works, investments, maintenance of programs and policies -, defined by the amount executed in 2017, and adjusted each year by the accumulated inflation in the previous year. The spending restraint is valid for 20 years, and can be reviewed after 10 years.

Contrary to what was advocated at the time of its approval, the CA 95 does not actually freeze spending, on the contrary, it imposes a declining cap in relation to GDP and, even more serious, in terms of what is currently spent per citizen. This is because, even if real GDP and tax revenues grow during this period, there will be no real growth in total Federal Government spending. Over the next 20 years, if we consider an average GDP growth rate of 2.5% per year, the federal government's primary spending will have to increase from 20% of GDP in 2017 to 16% in 2026 and, with no change, it would reach 12% of GDP in 2036. Furthermore, spending will not keep up with population growth, which will occur until 2047, according to the latest IBGE projections. Therefore, spending will fall in relation to GDP and population size, making improvements in public services unfeasible and reducing the redistributive impact of fiscal policy (BRASIL DEBATE AND FRIEDRICH EBERT FOUNDATION, 2018).

In addition to the impact generated in the size of spending, CA 95/16 also influences the way they are distributed among the various areas. This is because the budget will be increasingly committed to mandatory government spending – such as the constitutional minimum allocated to health and education and those related to social security – leaving fewer resources for non-mandatory policies, such as social assistance, public safety, investments in infrastructure, culture, and sports. This is the so-called "flattening effect", which can be seen in Graph 15, which simulates the

Graph 15: *Simulation of the Federal Government's primary expenditures with CA 95 - 2017-2036 (in % of GDP)*



Note: *The simulation used a growth rate of 1.7% for 2018 and 2.15% for the other years. For pension expenditures, it was assumed that a reform will keep the RGPS at the same percentage of GDP from 2020.*
Source: *National Treasure. Prepared by Brasil Debate and Friedrich Ebert Foundation, 2018.*

federal government's primary expenses until 2036. For this forecast, it is noted that the category "Other Expenditures" is the one that will suffer most cuts with the implementation of the public spending cap.

Still, the CA 95/16 unlinked spending on health and education of federal government revenues – education received, before the CA 95/16, at least 18% of federal tax revenue and health 13.7%. Now, the floor of investment based on the previous year, plus inflation adjustment, also applies to these areas, which can generate lower percentages than those previously stipulated in case of GDP growth.

CONCLUSION

In this edition of the bulletin of the Inequalities Observatory, we show how tax policy directly influences social inequality in Brazil. On the one hand, we have a regressive tax system that is more heavily taxed by the poor, due to its composition, which is mostly made up of indirect taxes. Still, the distributive potential of direct taxes in Brazil is poorly explored, given their low participation in the tax composition, the low progressivity of tax rates, exemptions that favor the wealthiest social strata, and tax evasion and avoidance. On the other hand, social expenditures in transfers, health, education, besides the RGPS, are progressive, since they are mostly destined to the poorest social strata, contributing to the reduction of social inequalities.

Given this scenario, a tax reform that seeks to balance the public accounts in Brazil together with a fairer income distribution should be focused on the most regressive side of our fiscal policy. However, the current proposals for reform of the Brazilian tax system have not focused on the need to reverse the regressive logic of taxation, being focused mainly on simplification and unification of taxes. It is important that there are changes aimed at better income redistribution in Brazil, which involves reducing the share of indirect taxes in the tax composition, increasing the progressiveness of the rates of direct taxes, higher taxation of equity gains and taxation of large fortunes.

However, as we showed in the case of PEC 95/16, the current attempts at fiscal adjustment are aimed at containing public spending, precisely the most progressive side of fiscal policy, which will certainly affect proportionally more the poorest and most vulnerable segments of the population. Thus, it is necessary to consider that, in an unjust and unequal country such as Brazil, fiscal choices are not neutral – they produce winners and losers. Along with economic stability, balance, and efficiency, fiscal policy cannot renounce the search for what only public intervention can provide and what the Brazilian State continues to owe its citizens: social justice.

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