Financing social protection through financial transaction taxes

International Labour Office

Brazil

Brazil offers an excellent example of how financial transactions taxes (FTTs) can be used to generate revenues for public provisioning of social services while concurrently mitigate financial instability arising from short-term capital flows.

A financial transaction tax is a small tax levied on various types of financial instruments, such as shares, bonds, foreign currency transactions, derivatives and bank debits and credits. The FTTs are implemented in at least 40 developed and developing countries. Ten European Union countries are expected to adopt FTTs in January 2017. The existing rates vary from a maximum of 2 per cent to as low as 0.00001 per cent.

FTTs have a dual goal of raising revenues while discouraging the type of short-term financial speculation that has little social value and poses high risks to the economy. One estimate shows that FTTs can generate US$2.9 to $14.5 billion in all developing countries combined depending on their design (coverage or base and rate) and the size of their financial sectors.

FTTs are easy to administer by existing authorities with no new institutions required. It also can be highly progressive as it allows resources to be channelled directly from the formal economy to those who need social protection.

National social protection floors (SPFs) guarantee access to essential health care and basic income security for children, persons of working age and older persons.

185 countries have adopted the Social Protection Floors Recommendation, 2012 (No. 202), an approach to achieve universal social protection.

This note presents a successful country experience of expanding social protection.

Main lessons learned

- FTTs in Brazil contributed to the collection of nearly $20 billion in additional government revenues per year.
- The Government earmarked income generated through FTTs directly to funding for social protection programmes (health care (42 per cent), social insurance (21 per cent), Bolsa Família cash transfers (21 per cent) and other social services (16 per cent)).
- FTTs assisted Brazil in consolidating the health system. The largest proportion of FTT revenue is earmarked for health care.
- The FTTs helped Brazil to expand its social protection services and contributed to the reduction in inequality. The Gini coefficient fell by 5.2 points and the percentage of households living below the poverty line halved between the early 1990s and 2008.
- FTTs serve a dual purpose both to encourage certain types of market behaviour (such as longer term investments) and as a revenue raising mechanism.
- Contrary to what is often communicated, there is no evidence of adverse impacts of FTTs on the financial markets.

1. FTTs in Brazil

Brazil first introduced a bank debit tax in 1993, but it was short-lived. The longest lasting bank debit tax – Contribuicao Provisoria sobre Movimentacao ou Transmissao de Valores e de Creditos e Direitos de Natureza Financiera (CPMF) – was put in place in 1997 at an initial rate of 0.20 per cent. The rate increased gradually starting in 1999 (0.22 per cent) to 0.38 per cent in 2002. Revenues raised from the CPMF were originally earmarked to finance health-care programmes (0.2 per cent), to combat poverty (0.1 per cent) and for social assistance (0.08 per cent). The CPMF collected nearly $20 billion per year.

The CPMF was discontinued by the Senate in 2008 after the Supreme Court ruled that earmarking revenue from such taxes was unconstitutional. The CPMF was replaced by a higher tax rate for financial firms (Social Contribution on New Corporate Profits) of 15 per cent, but the tax was repealed in 2013.

According to an International Monetary Fund (IMF) report, the CPMF raised about three times the amount raised by the corporate income tax (CIT) on financial companies. As can be seen from table 1, the bank debit tax, or CPMF, was a significant source of tax revenue accounting for 7.4 per cent of total taxes collected in 2001.

Table 1: Gross revenues from bank debit tax

		Gross revenue	
Year	Tax rate	% of GDP	% of tax revenue
1994	0.25	1.06	3.6
1997	0.20	0.80	2.8
1998	0.20	0.90	3.0
1999	0.22	0.83	2.9
2000	0.34	1.33	4.8
2001	0.36	1.45	7.4
2002	0.38	NA	6.1
2003	0.38	1.48	NA

The financial operations tax (IOF), a second component of FTTs introduced in 1999, subjected capital inflows for portfolio investments and investments in local assets to a 2 per cent tax to be paid at the point of the settlement date in Brazilian reals. That is, the tax is paid when foreign currency is converted into Brazilian reals.

According to the Government, the IOF tax is designed to offset the impact of short-term capital inflows on the Brazilian real. Thus, the rate was raised subsequently to slow the appreciation of the Brazilian currency and to prevent speculation in the Brazilian stock and capital markets when the United States pursued expansionary monetary policy in response to the 2008-09 global financial crisis.

The Government increased the IOF rate to 0.38 per cent in 2008 on several financial transactions involving foreign exchange, loans and insurance. Since 2009, the IOF has been levied at the rate of 5.38 per cent on foreign loans, where the average payment term of the loan is lower than 90 days. For loans with an average payment term higher than 90 days, the IOF rate is now 0.38 per cent. Increases in the IOF rate compensated for the loss of tax revenue caused by the abolition of the CPMF in 2008.

In June 2015, Brazil slashed the IOF from 6 per cent to zero to prevent sharp depreciation of the Brazilian real against the US dollar with the normalization of the market and the upward adjustment of the US interest rate. However, this adjustment will have a significant impact on government tax revenues, especially when the economy slows down.

Therefore, in December 2015, Brazil’s Congress approved the 2016 Budget which calls for the creation of a tax over financial transactions (CPMF tax). According to the Finance Minister of Brazil, Joaquim Levy, if the CPMF was not approved, certain important programmes, such as unemployment benefits and workers’ protection, would be at risk.

2. FTTs and social protection

As the CPMF was designed mainly to finance social protection expenditures, the mechanism was classified as a "social contribution". During the period in which the CPMF was in place, 42 per cent of the revenue collected was used for the public unified health system, 21 per cent for social insurance, 21 per cent for Bolsa Família (conditional cash transfers) and 16 per cent for other social purposes. By 2007, total revenue from the CPMF amounted to 1.4 per cent of GDP, enough to cover the total cost of Bolsa Família and other non-contributory social protection programmes.

This represents how other developing countries can raise their own revenues to help finance public services. The Gini coefficient fell by 5.2 points and the percentage of households living below the poverty line halved between the early 1990s and 2008 when notable legislative and programmatic changes were made in the economic and social policy sphere, including increasing the minimum wage and public expenditures on health, education and social services.

3. Assessment

One estimate shows that Brazil could potentially raise $227 million per year from FTTs. Brazil also successfully earmarked revenues for use by local governments to fund health programmes. CPMF revenues rose from approximately 0.8 per cent to 1.3 per cent of GDP in 1997-99 and 2000, respectively. In terms of total tax revenues, the CPMF increased from 2.8 per cent in 1997 to 7.4 per cent in 2001 (table 1). Thus, there seems to be very little leakage or avoidance. From the experiences of other countries, it seems that Brazil's success is likely due to three factors. First, the latest CPMF rate was not excessively high. Second, the Brazilian banking system is relatively sophisticated and widely used for payments. Third, the CPMF was levied on bank debits only, rather than on both debits and credits. This highlights how the implementation details affect success and the importance of setting appropriate rates.

There is no evidence of adverse impacts of the CPMF on the financial market. However, there is consistent evidence that the CPMF altered financial and investment behaviour, especially in the wake of its introduction at the end of January 1997. Between January and February 1997, demand deposits increased by almost 40 per cent as the introduction of the CPMF reduced the opportunity cost of holding funds in non-interest-bearing demand deposits.

Evidence on incidence is mixed. The bank debit tax was progressive in that it affected those with bank accounts, which is a minority in the wealthiest group of the population. One study found that the incidence of the tax was approximately proportional over the entire income distribution, making the tax neither progressive nor regressive. Another study, using household consumption data and the incidence of the FTT through the price system, found that it fell proportionately more on lower income families.

4. Conclusion

Brazil is an important example of an FTT regime in a developing country with a relatively large financial sector. Between 2000 and 2005, the CPMF accounted for more than 8 per cent of total expenditures on social protection, which shows just how important it was in financing social protection. In particular, revenue raised through CPMF assisted Brazil to consolidate the health system as the largest proportion of FTT revenues was earmarked for health-care programmes. During the early 2000s, Brazil collected about 37 per cent of GDP in taxes and spent 8.4 per cent of that on health. Thus, government expenditures on health care represented 3.4 per cent of GDP.

FTTs serve a dual purpose both to encourage certain types of market behaviour (such as longer term investments) and to raise revenue. However, Brazil's on and off episodes with FTTs display the resistance that such taxes can face from vested interests, especially in the powerful financial sector.

There are some concerns that FTTs may harm the poor, especially those dependent on remittance income from abroad. A group of international finance experts hold the view that it is highly unlikely that the cost of a small tax of say 0.005 per cent on such transactions, which would amount to a tax of just 5 cents on a $1,000 transfer, would be passed on to the retail customer. Furthermore, the poor are highly unlikely to be engaging in the high-speed speculative trading activities that are the target of these taxes. Moreover, remittances can be exempt from FFTs if required.

FTTs are becoming easier to administer as technological advancements facilitate this type of tax collection. A number of developing countries have already implemented some form of tax on financial transactions and the IMF believes that such taxes can generate substantial revenues.

Taxing financial transactions is one of the many alternatives that countries have to expand fiscal space for social protection. Governments normally use a mix of taxes and social security contributions to fund social protection, with other options (Ortiz et al, 2015).

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