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Inequality, Ability to Pay and the Theories of Equal and Proportional Sacrifices

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Inequality, Ability to Pay and The Theories of Equal and Proportional Sacrifices

Abstract: Brazil has one of the worst distributions of income in the world. The wealth of the richest 1% of the population is equal to that of the poorest 50%. Brazil has a greater concentration of wealth than ninety-five percent of the countries on which data is available. In the legal field, tax justice is based on the constitutional principle of the "ability to pay", according to which taxes should be paid based on the economic capacity of the taxpayer. This principle first appeared in the Brazilian legal order in the 1946 Constitution, was excluded from the texts of 1967/69, and reappeared in § 1 of article 145 of the 1988 Constitution.

The aim of this paper is to examine two possible grounds for the ability to pay principle (equal sacrifices and proportional sacrifices) to show how, in Brazil, the interpretations that seek to assign a positive content to the principle are limited to the horizons of a particular form of State associated with the theory of equal sacrifice. This theory for its turn is consistent with a theory of justice, under which no expense or charge levied by the government can alter the distribution of welfare produced by the market. As the application of the ability to pay principle is done within the limits of that horizon, as a consequence, this principle does not play an important role in the issue of reduction of inequality in Brazil.

Keywords: ability to pay – tax justice - equal sacrifices – proportional sacrifices — inequality – distribution of income - theory of justice – Brazilian Federal Supreme Court

I. Introduction

Brazil is a country marked by social inequality. Although it has decreased recently, income inequality in Brazil remains one of the largest in the world. In the book edited by Ricardo Paes de Barros, Miguel Foguel and Gabriel Ulyssea on the recent reduction in income inequality, are presented data showing how bad is the current situation: "the income earned by the richest 1% of the population is equal to income earned by the poorest 50%" what makes that "95% of the countries for which data is available, present lower concentrations than Brazil". [1] [2]

[1] R. Barros, R. e M. Carvalho, Nota Técnica, In*: Desigualdade de Renda no Brasil: Uma análise da queda recente vol. 1*, (ed. by R. Barros; M. Foguel; G. Ulyssea), 2006, 22.

[2] In the book mentioned, it is shown that there is a long tradition of research on inequality in Brazil dating back to the 1970s. They write: "Shortly after the publication of data from Census 1970, two studies showed the large increase in inequality of income distribution in Brazil between 1960 and 1970: A. Fishlow, 'Brazilian size distribution of income'. In: *American Economic Review***,** v. 62, n. 2, 1972 e R. HOFFMANN; J.C. DUARTE, 'A distribuição da renda no Brasil', In: *Revista de Administração de Empresas***,** v. 12, n. 2, p.46-66, 1972".

While research on economic inequality date from some time, the discussion about how to face it, in terms of tax policies, is not an issue in Brazil. Tax Justice is not a recurring theme in the research taking place in the country. Very little has been written about it and this has never been a topic in the public sphere debates. In this sphere, when the tax system is discussed, it is usually discussed in terms of its efficiency. The proposal to impose a tax on the financial transactions, for example, has this sense. This is also, in general, the goal of the various tax reform proposals under discussion in Congress.

Recently, this situation has changed a bit. In the first presidential campaign, President Lula has touched the issue of tax justice, when he said that the personal income tax, in Brazil, should be more progressive, so that the rich would pay more tax than they currently do. A Study of the IPEA[3], from 2008, pointed in the same direction: from a comparison with other countries, the study has shown that, in Brazil, the income tax is less progressive than in the majority of these countries. In Lula's government it was enacted a norm [4] that established two new rates for the personal income tax, making it a little more progressive.

In the law field, the issue of tax justice is almost immediately linked to the constitutional principle of the ability to pay. This principle entered the Brazilian legal order with the Constitution of 1946, was excluded from the texts of 1967/69 and was once again included in the Constitution of 1988. The first paragraph of article 145 of this Constitution states: "Always when possible, taxes will have a personal character and will be graduated according to the economic capacity of the taxpayer (...)".[5] Both with respect to law making and to its application, discussions on tax justice depart from that concept.

Under the Legislative, this has occurred, for example, both when the Lula administration increased the number of income tax rates, such as when the government Erundina [6] sent to the parliament the proposal to increase taxation on property, in order to make public transport free. Measures were justified by saying that the framework should be changed for taxation to be in accordance with the ability to pay. Moreover, one of the strongest arguments against the introduction of a single tax on financial transactions - proposal that is in the Brazilian

[3] The acronym IPEA means: Institute of Applied Economic Research. It is the main institution for research in this area in Brazil.

[4] It was a *Medida Provisória.* It is a norm that is enacted by the executive power, but has to be approved by parliament.

[5] Victor Uckmar shows a series of recent constitutions that predict that taxes should be paid based on "the economic possibilities" of taxpayers: Argentina (1946, art. 28), Bolivia (1967, art. 8 d), Bulgaria (1947, art. 94), Ecuador (1966/67, art. 94), Greece (1951, art. Art. 3); Mexico (1917, art. 31), Switzerland (1981, art. 41), Chile (1925, art. 10), Jordan (1952, art. 111), Italy (1947, art. 53), Syria (1950, art . 25), Spain (1977, art. 31.1), Venezuela (1947, art. 282). Cf. V. Uckmar, *Princípios comuns de direito constitucional tributário,* 2ª edição, 1999.

[6] She was the major of the city of São Paulo between 1989 – 1992.

Parliament - is that financial transaction are not a basis that reports adequately the different manifestations of the ability to pay.

Also in the Judiciary discussion about justice in taxation is made based on the concept of the ability to pay. Some jurists think that the practical application of this principle would result in greater tax justice.

The aim of this paper is to analyze the interpretation that the legal literature and the Brazilian Federal Supreme Court gave to the constitutional principle of the ability to pay. But this analysis will be quite specific: its purpose is to put in evidence two possible grounds for the principle (equal sacrifices and proportional sacrifices) and the social models or views that correspond to each of them. This will be done in order to show how, in Brazil, the interpretations that seek to assign a positive content to it are limited to the horizons of a particular form of State associated with the theory of equal sacrifice.

The paper is divided in seven sections including this introduction. The second section presents the interpretations of the principle in the legal literature, the third section examines how it was interpreted by the Brazilian Federal Supreme Court, the fourth discusses two possible grounds for the principle, the fifth explores the consequences of these different grounds, the sixth section presents some final considerations.

II. The interpretations of the ability to pay principle in the legal literature

After the publication of the 1946 Constitution, the ability to pay principle was the object of discussion and divergence amongst jurists, principally in relation to its application. [7] In the first edition of his book, *Teoria Geral do Direito Tributário*, Becker shows how two currents were in opposition in this point. [8]

Even if some would defend that the ability to pay principle should produce effects immediately, the position that it should be considered as a rule that merely states policies[9] prevailed. This rule would serve, according to Sousa, to guide the lawmakers "in the choice of facts, acts or transactions that should be subject to taxation, and in the grading of this measure". [10] Over the years, this initial interpretation began to change and the other, according to which the rule would take effect immediately, became the majority.

Historically, the interpretation of the effects to be produced by the principle has gone through two distinct phases. This was true also in Italy, whose literature greatly influenced the

[7] In Brazil, it is used a concept of "technical efficaciousness". I am not sure which term should be used in English

[8] Alfredo Augusto Becker. *Teoria Geral do Direito Tributário*, 1963, 441.

[9] A kind of norm that states a program.

[10] Rubens Gomes de Sousa, *Compêndio de Legislação Tributária*, 1975, 95.

Brazilian tax law. According to a first interpretation, a precise content was assigned to the principle: *economic force*. Only where economic force could be found could there be as well ability to pay and, consequently taxation. One of the practical consequences of this was the recognition of some situations, such as the zone of *vital minimum* which could not be taxed because the people in this zone do not have ability to pay.

Later, it was interpreted that the ability to pay principle would be virtually linked to other constitutional norms as the one which consecrates the duty of solidarity. In this sense, it would have a fundamental role in the protection of the interest of the state: having in view, the ideal of solidarity, the aspect to be singled out in the principle turns to be that no one should shirk to contribute to public expenses in conformance with his ability to pay.

In this way, two distinct interests are protected by the ability to pay principle: in the first place, the interest of the taxpayer, in the sense that no one should be taxed beyond his ability to pay. Besides that, the interest of the state, for all manifestations of ability to pay cannot escape taxation. [11]

III. The Brazilian Federal Supreme Court

These two interests also appear in the interpretation that the Brazilian Federal Supreme Court, the highest body of the Brazilian Judiciary, gave to the norm. In a research conducted on the web site of the Federal Supreme Court, [12] it was verified that from the promulgation of the 1988 Constitution, in October 2008, until November 2008, the ability to pay principle was applied 70 times at the decisions. After being excluded the judgments in which the use of the principle was merely apparent, they were divided according to the interests that were being protected - State or taxpayer.

In a few decisions, some dissenting opinions applied the ability to pay principle to protect the interest of the taxpayer. Examples of these are the following: in one of them, it was argued that financial transactions could not be chosen as the base for the CPMF [13] for not expressing any manifestation of ability to pay. In another case, according to other dissenting opinion, the introduction of a tax regime called in Brazil *substituição tributária* - in which the tax of the entire production chain is paid at the beginning - would result in the violation of the ability to pay principle.

[11] This theme was developed in: L.C. Pessôa, Interesse fiscal, interesse do contribuinte e o princípio da capacidade contributiva, In: *Direito Tributário Atual*, nº 18 (2004), 123-136.
[12] The results of the research were presented at the *Law and Society Annual Meeting*, in Denver (CO) in may 2009 and were published later in *Revista Direito GV*, 5 (2009), 95-106.
[13] A Brazilian tax on financial transactions.

In several cases, however, the ability to pay principle was applied to protect the interest of the state. Examples of applications of the principle to protect the interest of the State are the following: in the terms of article 145, first paragraph of the Constitution of 1988, literally, the ability to pay principle applies in only one of the five types of tribute that being, the taxes [impostos, in Brazil]: "Always when possible, the *taxes* (...)" (art. 145, § 1º). But there are several decisions of the Federal Supreme Court which sought to apply the ability to pay principle to another type of tribute: fees [taxas, in Brazil]. Even the fact that the constitution literally determines that the principle is only applicable to taxes [impostos], the federal Supreme Court understood that nothing impedes that it should be applied to fees [taxas] as well.

There are also several court cases in which the ability to pay principle was applied in a similar way. They are cases in which a differential treatment was given to some situations that presented themselves as distinct. The taxpayer always rebelled against the distinction, arguing principally violation of the principle of equality. The ability to pay principle was used in all judgments, so as to ensure differential treatment to different situations. An example is the following. It was argued that Article 9 of law 9.317/96, by impeding the corporations that provide services to opt for a special tax regime for small business called *simples*, would be establishing unequal treatment for taxpayers and then violating the principle of equality. The Supreme Court decided that there is no violation of the principle of equality if the law, for non-tax reasons, gives unequal treatment to micro and small businesses that have different ability to pay. Therefore, the principle of ability to pay was being used to protect the interest of the state and justify differential treatment.

The analysis of the decisions led to a principal conclusion: in Brazil, the ability to pay principle was utilized by the Justices of the Federal Supreme Court, in some few dissenting opinions, to protect the interests of the taxpayer and several times to protect the interests of the state. Be it to assure differentiated taxes in some situations, as in the case of companies who opted for the special tax regime, be it to guarantee that fees, [taxas, in Brazil] can be collected at differentiated rates, be it, in general, to assure taxation in situations in which the manifestation of the ability to pay exists, the ability to pay principle was always used in a way that in situations in which the ability is revealed the tax should be collected.

This analysis could make people believe in the thesis that the application of the ability to pay principle would signify greater distributive justice. After all, if it is the State's interest, not the taxpayer, which predominates widely in the interpretation of the Court, wouldn't this lead to more distributive justice? However, a careful reading of the situations in which the

principle was used does not indicate that its application has resulted in large gains in terms of distributive justice. Even if it was to defend the interest of the state, the principle has been used only in a few specific situations of the business life and fundamentally to ensure differentiated treatment to companies of different sizes. But could it be different? To answer this question, this paper is intended to go back to its foundations and present tow possible senses for the ability to pay principle.

IV. Equal and proportional sacrifices

For what reason should taxation be a function of the ability to pay of each one? Historically, not always the principle of ability to pay was dominant. At least one criteria ran with it throughout history: the benefit principle. According to the latter, there would be justice in taxation if the amount to be paid in terms of tax correspond to the benefit of each one for the existence of the state. But why the principle of the ability to pay would be better than the benefit principle in terms of justice? What are the fundamentals of the ability to pay principle that mark its superiority?

The principle of ability to pay seems to be founded on a simple idea: those who have more money, have more capacity to contribute. Murphy and Nagel show, however, that this apparent simplicity hides major theoretical difficulties, since one can say that the rich have more ability to pay the poor in at least two different senses. [14] In this regard, they write:

> "First we might think that people with more money can afford to give away more in the sense that additional money is worth less to them in real terms, so they can pay more money than a poorer person – sometimes much more – with no greater loss in welfare. Alternatively, we might think that people with more money can afford to give away more because even if they sustain a larger real sacrifice they will be *left* with more: they will still have, in some sense, enough – and will still be better off than those who started out with less". [15]

These two senses in which one can say that people have different ability to pay will give rise to two theories that try to substantiate the principle differently. On the one hand, according to the theory of equal sacrifices, the principle of the ability to pay determines that the richer

[14] According to Murphy and Nagel, there is also a third interpretation of the of ability to pay principle presented by them, according to which the ability to pay would be related not to the person's current wealth, but to its potential wealth, to the decisions that could have been taken by the person and to the income that the person could have obtained by virtue of those decisions. This interpretation leads to the theory of taxation according to endowment: people should pay based not on the income that they actually hold, but "according to their endowment, which is defined as their ability to earn income and accumulate wealth". (L. Murphy, T. Nagel, *The Myth of Ownership,* 20) "The origin of the endowment principle lies", according to Murphy and Nagel, "in the earliest versions of the ability to pay approach". (op. cit., 21) The professor of the New York University School of Law, David Bradford, recently died, is one of its most eminent defenders.

[15] L. Murphy, L.; T. Nagel, *The Myth of Ownership*, 2002 p. 24.

contribute more than the poorer ones, because the amount of taxes to be collected should be different in nominal terms, so that the sacrifice is equal in real terms.

This theory assumes, therefore, that the marginal value of money is decreasing. This means that the money that one person has more than the other does not have its nominal and real value raised the same way. While the nominal value increases to a certain extent, the real value of money increases less than that. In other words, under this theory, the rich should pay more than the poor ones, because with this payment they will not suffer a greater loss in their welfare, because to them, money does not have the real value it has for the poorest.

On the other hand, according to the theory of proportional sacrifices, both "A" and "B" must collect taxes in a different amount, because, it will rest much more money for those that have more, even if they make a real greater sacrifice. The consequence is that, besides having enough, they will continue to be richer than those with less and it is this difference that justifies, for this theory, that they should contribute with more.

The difference between the theories of equal and proportional sacrifices were presented at a given level of abstraction. It is important now to point out this difference more concretely discussing, from the standpoint of the state organization, the consequences of the application of both theories.

V. The differences between the theories

According to the so-called liberal paradigm, the state should be minimal. It should perform minimal functions, such as ensuring the existence of the police and the judiciary to resolve any conflicts. All that it could not do is to intervene in relations between the parties, which should be absolutely free to interact in the market.

As Habermas points out, on the basis of these ideas there is a very particular conception of justice: as the law ensures formal equality to the actors who interact in the market, it is enough to define the individual spheres of freedom of each one, i.e. ensure that the state does not intervene in private spheres, for the relations between them to shape and develop in a fair manner.

Thus, justice in the relations between citizens is assured, according to the liberal paradigm, by the minimal state intervention in these relations. Whitin the grounds of taxation, the theory of equal sacrifice conceives the state just like that. According to Murphy and Nagel, the idea of equal sacrifices "does make sense if embedded in a wider theory of justice

that rejects all government expenditure or taxation to alter the distribution of welfare produced by the market". [16]

For the state not to intervene in the relations between the parties, the tax system could not play any role that would undermine the free market interaction. The more neutral it is, the better it would perform its function of not intervening in the decisions of economic agents. It is precisely not to intervene in the pre-tax relationships that exist between economic agents, that the state should require from each of them, in terms of tax, the same sacrifice. Murphy and Nagel accordingly conclude:

> "Such a libertarian theory of justice, typically based on either some notion of desert for the rewards of one's labor, or of strict moral entitlement to pretax market outcomes, limits the role of the state to the protection of those entitlements and other rights, along, perhaps, with the provision of some uncontroversial public goods. If (and only if) that is the theory of distributive justice we accept, the principle of equal sacrifice does make sense". [17]

Therefore, the theory of equal sacrifices makes sense within a particular theory of the state, according to which its role is limited to ensure certain private rights and provide some public uncontroversial goods.

However, the ability to pay principle can be also founded on the idea of proportional sacrifices. This theory for its turn is compatible with the claim that the state perform broader functions to correct the inequality of income distribution. Require, for example, from the richer, to pay more taxes than the poorer not only to correct market failures, but to correct the inequity of the current state of affairs is also to impose that both contribute according to their ability to pay. But in this case, not ability to pay as equal sacrifices, but as proportional sacrifices.

VI. Final Considerations

At the beginning of the work were presented data on the inequality in income distribution in Brazil and it was seen that, in the law field, the discussion about tax justice departs from the concept ability to pay that reentered in Brazilian legal system with the Constitution 1988.

It was presented the interpretation originally given to this constitutional disposition. From the works of Rubens Gomes de Sousa, it was seen that this principle would be interpreted as a merely programmatic norm. Over the years, the legal literature both in Italy and Brazil, as the Brazilian Federal Supreme Court gave the ability to pay principle an effective role in protecting both the interest of the taxpayer and the state.

[16] L. Murphy; T. Nagel, *The Myth of Ownership*, 2002, 26.
[17] L. Murphy, T. Nagel, *The Myth of Ownership*, 2002, 26.

It was seen then that the idea that everyone pays taxes according to their ability to pay is compatible with two different grounds: equal and proportional sacrifices. Thus, the same principle may give rise to different interpretations as distinct social models or visions are at its foundation.

According to the theory of equal sacrifices, the richer should pay more taxes than the poorer so that the ultimate sacrifice is the same. According to the theory of proportional sacrifices, the richer should pay more because even if they pay, they will still be better off than the poorer and this form of taxation reduces the injustice of the current situation of inequality.

Internationally, the theory of equal sacrifices has always prevailed as the foundation for the principle. Writing about vertical equity that is a term that, in the economic literature, corresponds to the principle, Musgrave wrote: "vertical equity, since Stuart Mill, has been viewed in terms of an equal-sacrifice prescription. Taxpayers are said to be treated equally if their tax payments involve an equal sacrifice or lost of welfare". [18]

In Brazil, the ability to pay principle is always invoked when the issue is the reduction of inequality and the role the tax system can play in this regard. Within the judiciary, the principle appeared in 70 decisions of the Supreme Court.

The analysis of these decisions showed that, even though the principle was almost always applied in the defense of the interest of the state, it has been used only in a few specific situations of the business life and to ensure, fundamentally differentiated treatment to companies of different sizes.

From a normative point of view, the issue in those decisions is the possibility to provide more favorable conditions to a particular group of companies. Large and small companies should pay taxes differently, since they have different ability to pay, in order for the sacrifices to be the same. This use of the principle, therefore, is compatible with the Liberal State in which the idea of taxation based on the theory of equal sacrifice is grounded.

In these decisions, in was never called into question the so-called pre-tax distribution established by the market: the application of the principle not even remotely threatened to problematize it.

[18] Richard Musgrave; Peggy Musgrave, *Public Finance in Theory and Practise*, 1989, 228.

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