TAX JUSTICE FOCUS

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RESPONDING TO CRISIS

The role of tax policy

The financial crisis threatens the fiscal balances of most countries in the Latin American region, but a vicious circle of economic and political barriers stand in the way of needed tax reforms. However, a number of factors, not least the crisis itself, but also international pressure, the threat of social disruption and an ideological shift, might create an opportunity to strengthen tax systems and make them less regressive.

The financial crisis has had a significant impact in Latin America and the Caribbean, moving through all the channels that connect Latin America with the rest of the world: trade, capital flows, remittances and foreign direct investment. The region's economies have simultaneously suffered declining exports, severe limitations on access to capital markets, lower remittances and less foreign direct investment.

These factors affect public finances and limit governments' abilities to respond. Tax revenues have fallen a long way, owing to the economic slowdown and lower commodity prices – and fiscal stimulus packages will erode their fiscal balances further. And, in tandem with shrinking fiscal balances, external financing has slowed significantly. The worsening fiscal situation, and the possibility of solvency problems, are closely linked to the pre-crisis fiscal position – and outcomes will be depend partly on how long the crisis lasts.

The crisis and its impacts vary from country to country, so designing any package of measures should reflect the specifics of each country, taking account of their economic and social structures, as well as institutional factors. No single model fits all. If there is one generally applicable point, it is that the stimulus packages should be consistent with basic premises: that they be temporary and sustainable, and accompanied by institutional strengthening. Measures should be able to create an immediate "shock" impact rather than an impact that is diluted over time, and they should include a time limit. This is especially important for investment-demand-stimulus policies with no end date, which leave economic actors free to determine when to use the benefit.

Measures should not compromise fiscal solvency in the medium and long term, for obvious reasons. This means making short- and medium-term decisions that are consistent, although often these two types of measures are not considered in tandem. The measures should also be susceptible to rapid reversal once the crisis clearly changes course.

In the context of the international crisis, tax measures will be shaped by powerful economic, political, social and institutional forces which tend to emerge powerfully in times of crisis. These will play a major role in these countries' abilities to emerge from crises, strongly affecting economic stability, political legitimacy and levels of social welfare.

Most political economy studies on taxation in Latin America agree that there is a vicious circle, which largely explains why reforms are so difficult to implement. The main elements of the vicious circle are:

(i) A socioeconomic structure marked by high inequality, capital concentration and informality;

(ii) Political institutions that are delegitimised and heavily influenced by power groups;

(iii) A fiscal system marked by insufficient funds, regressiveness (that is, the poor pay a higher share) and limited capacity for reform.

Latin American countries' socioeconomic structures typically involve a heavy dependence on primary sectors (like oil or minerals), large informal economies, very high concentration of capital, high income inequality and low per capita income. These harm institutions, including in the area of taxation.

In the area of tax, there are major limitations: very small potential income tax bases, a dependence on non-tax revenues, weak capacity in tax administrations, low level of tax awareness and morality, high levels of tax evasion, and incentives for corruption and rent seeking.

Political institutions are, among other things, highly susceptible to influence. They may even be run by lobbies, producing policies that benefit a small group, generally an elite, while blocking reforms.

As a result, the region's governmental institutions and policies are severely delegitimised and weakened. Delegitimisation and institutional weakness directly affect tax policy. According to data from the Latinobarometer, 79 percent of Latin Americans are not confident that tax monies will be well spent, and 50 percent believe that the State is capable of solving few or no problems. These perceptions and beliefs create systematic resistance to tax collection and to actions designed to change collection procedures.

The factors affecting tax reform cited so far create very limited room for possible change in tax policy and are directly associated with two of the most notable tax problems in Latin America: insufficient revenue and regressiveness of the tax regime. These two factors, which are difficult to change, mean that tax policy not only does not reverse socioeconomic inequalities and combat poverty, but in many cases increases them.

These factors will to a great extent determine the ability of each country to respond to the conflicts that arise in the present crisis — a situation that calls for pro-active policies.

One of the lessons for the region, emerging from the analysis of previous crisis, is the importance of countering the volatility of fiscal revenues and addressing the effect this has on public spending. To accomplish this, it is essential that the solvency of public accounts be based on revenue sources that are less vulnerable to business cycle. The sustainability of public finances over time is a necessary condition in creating the fiscal context in which countercyclical fiscal policy can be successful.

So the conditions created by the crisis not only require reforms, but may also help make them possible. Commentators have noted that during crises it becomes possible to overcome coalitions of political opposition and administrative inertia that ordinarily block important reforms. One example is the economic emergency laws passed in Argentina in 2002, when it became possible to approve tax measures that had been rejected by the legislature only a few years earlier.

Another factor facilitating reforms is international pressure. This pressure may appear as a result of economic policy conditionalities, or from external trends. In the area of tax there is ample room for an "imitate your neighbour" effect, which explains why the region's tax systems have been strongly influenced by trends elsewhere, with implementation of the VAT being one of the most important and widespread examples.

Threats, both internal and external, generate *windows of opportunity* for tax reform. Many historians hold that these threats —in the form of wars or invasions— were determining factors in the creation of the Western nation states, opening the way for citizens to be less resistant to increased taxes. These days, threats might include action by domestic social movements, fiscal crises or global economic conditions.

Finally, we must not ignore ideological changes, and what many see as a paradigm shift in the structure of the economy, the role of the State, and the State's relation to society. This shift involves a major change in countries' fiscal policies, moving toward higher levels of spending, and hence more tax revenues. The current situation may aid many of the region's countries in reaching greater consensus for measures that reduce the system's regressiveness and increase the tax burden, thus strengthening the State's ability to act, particularly with regard to combating poverty and reducing economic inequality.

This article is based on a document prepared by Juan Pablo Jiménez, Economic Affairs Officer of the Economic Development Division of ECLAC (the Economic Commission for Latin America and the Caribbean) and Juan Carlos Gómez Sabaini, consultant to ECLAC. The original document was presented at a fiscal forum in Montevideo, Uruguay in May 2009.

editorial

Matti Kohonen

FROM BELÉM TO PITTSBURGH

For the Tax Justice Network, 2009 really got under way in Latin America. More precisely, it got going on the tranquil yet festive island of Mosqueiros near the city of Belém, in Pará, Brazil. There we held our bi-annual council meeting on 29 January, where chair Bruno Gurtner presented an ambitious vision for TJN: to become a significant global policy network in the coming two-year term.

At the World Social Forum, 28 January–1 February, we and our partners organised three sessions on the financial crisis and made the following declaration: to **Put Finance in its place**. We also forged new alliances and started the work of establishing the TJN Latin American secretariat, led by **Federico Arenoso**, who analyses the development of our network on page 16 of this edition.

We also started building a Brazilian network at a seminar organised in collaboration with the Brazilian Institute for Tax Law (IBDT) in São Paulo on the February 2. Tax avoidance, competition and compliance costs were the key issues identified as facing a federal country with a three-tier tax system, and which, as **Luis Flávio Neto** argues on page 9, has resulted in fierce domestic tax competition, known popularly as the 'Guerra Fiscal'; or Tax War.

Guatemala and Nicaragua are also caught in a cycle of tax competition where, as **Maynor Cabrera** argues on page 11, tax incentives and 'special jurisdiction manufacturing zones' should be added to the State's 'Tax Expenditure' calculations to reflect their true costs. A recent **IMF paper** supports this argument by demonstrating that Foreign Direct Investment flows don't appear in fact to follow tax breaks at all. Instead, they result partly from tax bargaining by powerful lobbyists, and poor policy advice from International Financial Institutions.

Resisting these lobbyists requires better representation, while drawing up new policies requires research and informed policy debate forums. **Maaike Kokke** on page 18 points to ways to advance in both areas, in her article on the 'Towards Tax Justice' programme led by **SOMO** in the Netherlands, with funding from the European Union.

Across Latin America the tax landscape is dramatically different from country to country, and thus so are the responses to the global financial and economic crisis. In an article on page 1, **Juan Pablo Jiménez** and **Juan Carlos Gómez Sabaini**, summarising a paper they presented at the EU-Latin American and Caribbean conference in Montevideo (19-20 May), consider that fiscal volatility and historical legacies are the key constraints. The conference called for strengthening tax systems across the continent, as **Birger Nerre** concludes in his report on page 17.

Latin American states also suffer from weak controls against capital flight. As **Jorge Gaggero** demonstrates (page 5), accumulated capital flight in Argentina has markedly and consistently followed rising levels of external debt. This suggests a strong argument favouring further capital controls, and the removal of poorly designed policies which facilitate destructive capital flight.

On the subject of capital controls, Brazil offers an interesting insight. There, the National Registry of Legal Entities (CNPJ) and the Board of Control of Financial Activities (COAF) require the registration of all board members and administrators of companies operating in Brazil. The catch? Foreign companies are exempted from the first, and not pursued by the second, so nothing is achieved. It is time for President Lula da Silva to change these rules, and to support country-by-country reporting standards. This could be achieved by a simple change in national disclosure laws. Foreign investors are allowed to operate in a sphere of secrecy, while nationally based companies have more stringent requirements.

Guest editor Matti Kohonen being interviewed in Saint Helier, Jersey during the tax justice event immediately preceding the April G20 Summit in London

Indeed, knowing where a company is based is a prerequisite for any information exchange

Bruno Gurtner chairing the Tax Justice Council Meeting in Belem, Brazil, January 2009

to be meaningful. This is why TJN supports country-by-country reporting as a major reform of international tax and accounting standards. As **Richard Murphy** points out on page 15 in updating us on the 'Where on Earth?' project, even discovering where multinational corporations base their subsidiary operations is a painstaking task: discovering what they are *doing* with those subsidiary operations is near impossible given the secrecy world in which they operate. Country-by-country reporting would help us find out what global corporations are doing, where they are doing it, and to whom they owe money.

Although the political battles on secrecy jurisdictions have a very, very long way to go, TJN considers that the intellectual arguments on secrecy are essentially won. The *Financial Times* recently opined, however, that there is an outstanding argument to address: "The very real fear of kidnapping in places such as Latin America is one of the few good reasons that might justify allowing the rich to hide their wealth." On Page 7, **Nick Shaxson** demolishes the *FT*'s superficial argument. There is no intellectual justification *whatsoever* for offshore secrecy. We challenge our readers to prove us wrong.

"True democracy means rules that apply in Delaware and Cayman, London and Panama – rules which are as fair to the middle-income countries of Latin America, as they are to the wealthy nations of Europe, or to the poorest states of Africa."

As we gear-up for the Pittsburgh G20 meeting from September 24–25, we need to make the voice of Latin American and other developing nations heard. After all, this forum has effectively replaced the United Nations as the key global economic policy arena. Democracy – the Tax Justice Network believes – is not just about a few sherpas playing hockey on financial regulation, tackling the BRICs and bribing the referees at the IMF. True democracy means rules that apply in Delaware and Cayman, London and Panama – rules which are as fair to the middle-income countries of Latin America, as they are to the wealthy nations of Europe, or the poorest states of Africa.

Before and after the Pittsburgh G20 we must concentrate our efforts on bringing together popular representatives – as well as tax collectors and legal experts – to voice concerns on the failing regimes of capital flight controls, tax information exchange, and corporate accountability. The Tax Justice Network will therefore be writing an open letter to the G20 leaders calling for reform, sending a clear message to the world's leaders that the time for international change has come. Given the prominence of tax justice at the London G20 meeting, we can have every expectation that our message can and will be taken seriously.

Matti Kohonen, Tax Justice Network – International Secretariat

WEAK CONTROLS CAN'T STOP CAPITAL FLIGHT IN ARGENTINA

feature

Jorge Gaggero

Argentina built up a large stock of external debt from 1976 to 2001. The vicious cycle which produced this situation consisted of tax evasion and avoidance; associated corruption; increased capital flight; mounting debt – and the persistent fiscal irresponsibility of a succession of governments.

These problems weakened the economy and led to persistent stagnation rooted in ill-chosen macroeconomic policies implemented for most of the period. These policies have, in general, aimed to limit the State's freedom and ability to exercise its powers.

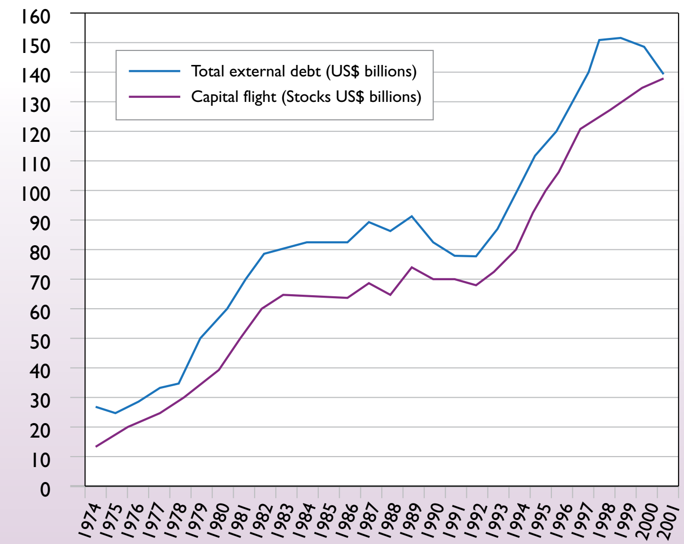
The close relationship between long-term capital flight, on the one hand, and foreign debt, on the other, illustrate this perverted process (see Figure 1).

In 1974 Argentina's external debt was twice the stock of accumulated capital flight. The Falklands War and the Latin American debt crisis in 1982 saw a significant increase in the relative weight of capital flight, which had grown to exceed 75 per cent of the value of the debt. By the time the first period of Argentine hyperinflation struck in 1989, the debt had climbed to US$ 65 billion – mainly due to the accumulation of interest on the principal during the military dictatorship of 1976–83. By then capital flight had already reached around US$ 53 billion, about 90% of the value of the debt stock. The relative value of capital flight as a share of the debt stock was aggravated severely by hyperinflation.

By the end of 2001, when Argentina's convertibility regime collapsed, the corresponding amounts were US$ 140 and US$ 138 billion. That is, foreign debt had doubled from the level it occupied at the initial adoption of the freely convertible regime, and the stock of capital flight was 2.6 times higher than in 1989. During 2001, when the Argentine economy faced its most severe crisis for a century, the stock of capital flight abroad was equivalent to the accumulated foreign debt.

During this same period (1976–2001) a sustained process of 'legislative erosion' affected income taxes. The main causes were: high inflation, macroeconomic volatility and deliberate policies to weaken the tax system.

Figure 1. External debt vs. Capital flight



Note: All values are in 2001 prices; for capital flight the residual model is followed.
Source: Gaggero, J. Casparrino, C. and Libman E. (2007)

Inheritance taxes and capital gains taxes on physical persons were eliminated in 1976 and 1990 respectively. Taxes on the earnings of highest-income groups were cut to a minimum, although nominal corporate taxes remained high. In 1942, income taxes had contributed 4.2 points of GDP in revenues, but during the period 1975–90 this fell to just 1 percent of GDP. The level of income taxes recovered to mid-twentieth century levels by the mid-1990s.

Levels of tax evasion were also very high during the period of dictatorship. A vicious cycle was created, as high levels of evasion led to rising nominal tax rates to compensate for

"During the dictatorship a vicious cycle was created, as high levels of evasion led to rising nominal tax rates to compensate, with the cumulative result being de-legitimisation of the entire tax system."

state revenue shortfalls. This put increasing pressure on small companies and low-earning individuals, with the cumulative result being a widely perceived de-legitimisation of the entire tax system. For these reasons, the concept of 'taxpayer citizenship' has been historically and culturally weak in Argentina.

In the early 1990s the tax system went through a period of attempted reform, but there were no real changes in the increasingly regressive nature of Argentina's tax regime whereby the tax burden was increasingly shifted to lower earners and small businesses, unable to evade or avoid tax in the manner of their wealthier counterparts. In particular, the Argentine authorities opted to take 'global earned income'* as the basis of the tax regime. These reforms, however, were implemented without corresponding reforms in tax administration, or adequate measures to increase and enable the enforcement of collection (see box). So while efforts to reverse Argentina's regressive slide appear from time to time (e.g. the introduction of 'export duties'), they achieve only peripheral success.

* Meaning that much like in the USA, income was taxed on all worldwide sources, rather than just Argentine-based sources.

Yet the wider problems in the present Argentine tax system cannot be attributed solely to the above mentioned periods. Rather, they should be understood as the result of the infamous socio-economic and institutional collapse so gruesome that it is known as the 'Argentinean anomaly'; a unique case among the middle-income countries.

Policies aimed at tackling the 'flight' have only recently begun to take effect. The reconstruction of the Central Bank was initiated after the convertibility regime with the US dollar ended in 2001. The initiation in 2002 of an information system on trans-border capital flows reconstructed a system that was terminated at the time of the last military coup (1976). Similarly, policies aiming to control capital flight are currently being adopted, combined with exchange rate measures.

In recent months, however, the 'flight' is increasing again – both due to domestic factors and reasons linked to the global context. Controls may have increased, but the system is still wide-open as a result of 'cracks' created by both gaps and imperfections in the regulatory framework (tax, financial, and corporate), as well as poor coordination and the State's inherent weakness.

Box: A tax structure favouring capital flight

The Argentinean tax system is so weak that it stands as an obstacle to good governance. The results are: considerable losses to the Argentine revenue, hampering the ability of the state to implement effective government, increasing the tax burden on the worst off and, somewhat perversely, benefiting foreign tax authorities and multinational corporations who shift non-taxed profits to other jurisdictions.

The Argentine corporate tax rate is relatively high (35 per cent, similar to 'Mediterranean' economies in Europe), and equal to the maximum marginal personal income tax rate (also at 35 per cent). The system has perverted consequences. First, it creates incentives encouraging multinational corporations (and many local businesses) to intensify their use of tax havens and other instruments designed to reduce their local tax burden. Second, low taxes on company shareholders create another big loss in terms of uncollected tax revenues.

The Argentinean Parliament recently estimated that lost tax capacity stood at US$ 700 million (for 2005). This assumed that the personal income tax rate could be raised from the current 35 per cent, to 40 per cent, while company dividend payments could also be better captured under the national tax net.

Chile's tax system is quite different. The corporate tax rate in Chile is low (at around 17 per cent) while the highest marginal income tax rate is high (at 40 per cent). Companies can reduce their tax burden by claiming a tax 'premium' for reinvesting profits, as long as these profits are not distributed to shareholders. Such rules discourage capital flight. The problem in the Chilean tax system, however, is that it does not redistribute wealth. Disproportionate rewards for reinvested profit tends to encourage wealth accumulation in the hands of the few.

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For a more extensive analysis of these questions see: Gaggero J., Casparrino, C. and Libman, E. 2007 **'La fuga de capitales. Historia, presente y perspectivas'** *Working Paper N° 14. Buenos Aires: Centro de Economía y Finanzas para el Desarrollo de la Argentina (CEFID-AR),*

THE NON-PERILS OF INFORMATION EXCHANGE

feature

Nicholas Shaxson

TJN has been building up material examining the various ways that countries can co-operate to share information with other jurisdictions to help them tax their residents properly and fairly. Unfortunately, current arrangements are dominated by various forms of secrecy.

We strongly oppose the OECD's deeply flawed but predominant "on request" standards for exchanging information, and we prefer instead the far more transparent approach of automatic information exchange on a multilateral basis. (Click **here** for more.)

Secrecy jurisdictions oppose most kinds of information exchange. One argument they often employ is that if they exchange information with unstable developing countries about their clients' holdings, this information will "leak" domestically, leading to kidnapping, extortion, confiscation, overtaxing, and so on.

This argument gets traction. For example, the *Financial Times,* in an otherwise good editorial on August 16 entitled "Closing the havens", opined that "the very real fear of kidnapping in places such as Latin America is one of the few good reasons that might justify allowing the rich to hide their wealth."

So it is important to challenge this false argument head-on. Once you examine it closely, it crumbles under the weight of its own absurdity. Consider the following:

First, nobody is talking about confiscating assets. If you are a Tanzanian with $1 million on deposit in a bank in Jersey, at a 5 percent annual interest rate, say, you would have taxable income of $50,000. If Tanzania's top income tax rate is 40% then you should pay $20,000 in tax this year on that asset. Information exchange gives Tanzania no way to "confiscate" your $1m – it can merely levy the $20,000 you owe towards Tanzania's teachers, doctors and so on, helping Tanzania to wean itself off foreign aid. (Restitution of stolen funds is another matter: a worthwhile issue but not what we are talking about here).

Second, why should a country's wealthiest and most powerful élites be allowed to protect themselves and their wealth through offshore secrecy when the poorer members of their society cannot? TJN is not aware of a single transparency campaigner, anti-corruption fighter, investigative journalist or dissident who has protected themselves from oppression by having a secret offshore bank account or trust. Did Nelson Mandela or Lech Walesa need trusts in Cayman or Jersey to achieve what they did? The suggestion is absurd. Yet we can name any number of oppressors – Augusto Pinochet, Obiang Nguema and Sani Abacha come to mind – who have bolstered their oppressive powers through secrecy jurisdictions, stealing the wealth of the countries they tyrannised in the process.

Third, individuals with large stores of overseas wealth usually have substantial, and far more conspicuous, assets at home. In developing countries wealth tends to be so concentrated into so few hands that naming the 10 richest families – and mapping their ownership through the economy – is often a national pastime. Kidnapping and extortion happen without criminals needing to know the exact amount or location of a victim's wealth; all that needs to be known is that the victim *is* wealthy. The idea that TJN's proposals amount to exposing secret millionaires to hawk-eyed kidnappers is ridiculous.

What is more, the individuals who can afford offshore secrecy will tend to have extensive security protection already, or they will live overseas. So it is once more absurd to suggest that TJN's proposals will somehow enable kidnappers who are presently deterred only by secrecy. Furthermore, it is a myth that the growth in 'kidnapping for money' affects mostly the super-wealthy stuffing their money into tax-free offshore treasure troves. In Latin America, for example, kidnapping for extortion mostly affects the lower and middle classes, because people from these groups are easiest to snatch, and get less attention

> *"Did Nelson Mandela or Lech Walesa need trusts in Cayman or Jersey to achieve what they did? The suggestion is absurd."*

Photo taken in Montevideo in May - LloydsTSB is one of many private wealth management banks operating in Montevideo. Uruguay is the largest tax haven on mainland Latin America.

"Offering élites a secret offshore escape route from tax helps to facilitate the very instability and poor governance that secrecy jurisdiction apologists claim to be worried about."

from the authorities than would be afforded to to high-profile HNWIs (High Net Worth Individals, or Hen-Wees).

Fourth, the argument about information leaking and creating instability is hypocritical and self-defeating. After all, it is strong domestic tax systems that promote better governance. By contrast, offering élites a secret offshore escape route from tax helps to facilitate the very instability and poor governance that secrecy jurisdiction apologists claim to be worried about. It is via the abuse of secrecy that élites dodge tax and facilitate capital flight, thereby causing good governance to wither, and meaning the risk of leakage increases. Thus with no small measure of irony the tables are turned on the apologists: it is *their* proposals which lead to information leakage because of the disastrous effects upon government stability resulting from tax dodging and capital flight via the use of offshore. If anybody can be accused of facilitating kidnapping, extortion and crime, it is not TJN, but the proponents of secrecy jurisdictions themselves.

There is another important point here. Élites are politically the most influential players in developing countries. But at present they only have weak incentives to improve domestic governance because they have the offshore escape route from rules and constraints that they do not like. If this escape route were blocked, these elites would have incentives to constructively promote improvements in their own domestic regimes, rather than destructively undermine them.

Fifth, tax amnesties create conditions that can subject citizens returning their money to the same risks that the secrecy jurisdiction apologists claim. Yet we know of absolutely no evidence that this has led to kidnapping, extortion or "confiscation." The secrecy jurisdictions need to provide systematic evidence that their concerns are real, rather than invoking the spectre of fear to stifle honest and rational debate.

Finally, regarding the specific charge that transparency and information exchange will lead to "overtaxing", developing countries are a very long way away from overtaxing the rich at present: personal income taxes in Central American countries, for example, contribute less than 4 per cent of GDP, compared to about 25 per cent on average in OECD countries. Properly taxing the wealthy, let alone "overtaxing" them, would require nothing short of a revolution.

This article is a shortened version of a longer TJN blog, which contains several other points to consider. The full article is **here**.

INTERNAL TAX COMPETITION AND THE PROMISE OF TAX REFORM IN BRAZIL

feature

Luis Flávio Neto

Among Brazilian legal professionals, tax competition is better known as the 'Guerra Fiscal' – 'Tax War'. Such a war is currently taking place within Brazil, between the states.

Photo taken at a justice and human rights session at the World Social Forum, Belem January, 2009

In 'unitary' States, the only possibilities for tax competition are in the international arena, in other words, between sovereign States and jurisdictions. In federal States, this conflict can take place within national borders. This is what is happening in Brazil.

The Brazilian federal system is based on principles of freedom, justice and solidarity. Development is conceived as a national goal, rather than being limited to individual member-states or municipalities. Eradicating poverty and reducing social and regional inequalities are the constitutive aims of that goal. The economic principles advanced are thus based on recognising the contribution of human labour and that of free enterprise, and to ensure that everyone secures a dignified existence, conforming to principles of social justice. In theory, each federal administration should have the development of the entire nation in mind when it sets tax policies. In practice, the reality has turned out to be different.

The federal model in Brazil is similar to other countries such as Germany and the United States. There are, however, marked differences, such as the presence of municipalities in the federal pact. The Union, states and municipalities all exercise degrees of autonomy over their financial administration, policy, and with some limitations, in taxation.

Limitations are, however, well defined. The Federal Constitution defines the competency, in tax matters, of each entity of the federation. Separate entities possess powers to set their own guidelines and budget targets for investment in strategic sectors. But tax measures, while based on guidelines, in theory have constitutionally prescribed goals: sub-federal authorities are supposed to pursue tax policies that are beneficial to the whole of Brazil, not just locally.

While the Federal Constitution establishes clear limitations on the taxation powers of federal entities, the internal 'Tax War' which has broken out within Brazil is a result of separate entities ignoring the norm of promoting national, rather than merely local, prosperity.

In Brazil, different tax rates may be levied in different federal entities (for example the rate of the ICMS – the Brazilian indirect tax on goods and services – varies between states, and lowering this has been a key weapon in the 'Tax War'). This inter-state tax variation is permitted in the Brazilian Constitution: all 27 federal jurisdictions may grant tax exemptions, incentives and advantages *provided* they do so following meetings, discussions and agreement by all the jurisdictions. In practice, however, this

> *"The internal 'Tax War' which has broken out within Brazil is a result of separate states ignoring the norm of promoting national, rather than merely local, prosperity."*

Determining Factor for Installing Productive Operations

Factor	Positive Answers (%)
Labour costs	41,5
Tax incentives	57,3
Trade union activity in area	24,4
Saturation of type of activity	14,6
Special locational advantages	39,0
Proximity to the market	57,3

Source: Prado and Calcanti (2000)

"In conclusion, Brazil's 'Tax War' is harming individual states and causing them to behave in a way contrary to the Constitution's requirement that the common good of all Brazil is promoted."

requirement is frequently ignored. Hence the Supreme Court has repeatedly condemned member states for granting tax incentives unilaterally.

Why are states motivated to act unilaterally in changing tax rates, in defiance of Constitutional norms and Supreme Court? The table shows which factors influence companies choosing locations for their productive operations. We find that tax features as an important factor in 57.3 per cent of cases, indicating that states perceive alterations to their tax regime as serving to attract private investment:

A distinctive aspect of the Brazilian 'Tax War' is the feature of repeated counter-attacks by affected member-states: that is, states seek to neutralise or counter the tax policies of rival states by taking positive action. This 'revida' (retaliation) happens in at least two ways. First, the granting of similar or more aggressive tax incentives designed to undercut rival states. Second, the aggressive recovery of tax revenues lost to the competing member state.

However, neither of these practices is appropriate in terms of the overarching norm that states are supposed to pursue policies for the good of Brazil as a whole. This is because the tax war forces states to undermine, and compete with, each other in mutually destructive ways. Hence the Supreme Federal Tribunal has already stated that the misconduct of one member state cannot be retaliated against by another member state in similar fashion, since "unconstitutional behaviour cannot be compensated for."

Furthermore, member states that grant such incentives also lose the financial benefits of the forgone taxes. To make matters worse, any gain from increased investment tends to be only short term, as other states retaliate by lowering their taxes too and thus neutralising any initial advantage. This raises serious doubts over the rationality of the practice, when considered from more than a short-term perspective. Taking the states of Paraná and Rio Grande do Sul as examples, in the period between 2002 and 2006, Paraná share of Brazilian GDP fell from 5.98 per cent to 5.77 per cent, while that of Rio Grande do Sul fell from 7.14 per cent to 6.62 per cent. Both had engaged in aggressive 'tax competition' in the 'Guerra Fiscal'.

In conclusion, Brazil's 'Tax War' is harming individual states and causing them to behave in a way contrary to the Constitution's requirement that the common good of all Brazil is promoted. Promises have been made regarding reform of the tax code, yet these promises typically extend over many issues and may take years before coming into effect. Consequently, there is great fear that the promised reforms will either not be delivered, or will fail to achieve the Constitutional ideals that motivate them.

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TAX INCENTIVES AND FOREIGN DIRECT INVESTMENT IN GUATEMALA AND NICARAGUA

feature

Maynor Cabrera

Countries compete fiercely to attract foreign direct investments (FDI). They use many strategies, with mixed results. In the case of Central America, tax incentives and free zones are among the main instruments used for attracting FDI.

Academic studies regarding the effectiveness of tax incentives for attracting FDI are inconclusive. Various studies suggest that some incentives may be effective under certain circumstances, while others show no significant effect. In analysing the factors that determine investment, studies identify other non-tax variables such as economic growth, trade openness, quality of infrastructure, education of the labor force, public sector corruption and economic and political stability.

Tax incentives in Guatemala and Nicaragua

In Guatemala and Nicaragua, the most common tax incentives are tax holidays. These involve both (i) exemptions from tax for a given period, and (ii) indirect tax incentives, which exempt purchases of raw materials and capital goods from tax.

Legislation in Central America provides tax incentives for various sectors such as tourism and the export-orientated non-agricultural production. Recently mining, forestry, services and renewable energy generation have also been included.

Non-traditional exports

As regards non-traditional exports in Guatemala, most exemptions come through the *Promotion and Development of Exporting Activities and Maquilas*[1] *Law* (Decree 29-89) and the *Free Zone Law* (Decree 65-89). In Nicaragua the main instruments are the *Free Zone Law* (Decree 46-91) and the *Temporary Admission for Active Improvement*[2] *and Export Facilitation* (Law No. 382).

Guatemala is the only country in the isthmus with no specific incentives for tourism – a piece of legislation called the *National Tourist Promotion Law* was rejected by Congress in 1997. However, in the case of Nicaragua, a law called the *Incentives for the Tourism Industry Law* (Law No. 306) was approved in 1999. Of all existing tourist incentive laws in Central America, Nicaragua's is by far the one the allows for most tax exemptions.

In Guatemala, the *Incentives for the Development of Renewable Energy Projects Law* (Decree 52-03) grants exemptions from income and other taxes, and the *Forestry Law* (Decree 101-96), offers a subsidy. Other laws grant indirect tax incentives for oil related industries and mining.

Nicaragua offers incentives through the *Promotion of Electricity Generation from Renewable Sources Law* (Law No. 532), the *Conservation, Development and Sustainable Development of the Forestry Sector Law* (Law No. 462) and the *Special Law on Exploration and Utilization of Hydrocarbons* (Law No. 286), which group together a number of exemptions for indirect taxes and incentives.

Estimating "Tax Expenditure"[3] – which brings together what a State does not receive as a consequence of handing out tax incentives – is extremely important for cost-benefit analyses. In Nicaragua there are no official estimates of Tax Expenditure, and even in Guatemala there are serious doubts on the accuracy of the estimated amounts, making it hard to reach conclusions. It is essential for

"Estimating 'Tax Expenditure' – what a State does not receive as a result of handing out tax incentives – is extremely important for cost-benefit analyses."

[1] 'Maquila' industries are assembly factories, located anywhere in the country, to assemble or process, free of duty, imported inputs for subsequent export. These firms enjoy income tax exemption for 10 years.
[2] 'Active Improvement', or 'Perfectionamento activo' in Spanish, procedures allow the receiving of goods in national customs territory, with suspension of all taxes and surrender under warranty for a limited period of time.
[3] 'Tax expenditure' attempts to quantify the fiscal losses due to preferential tax regimes, and understands them as government expenditures rather than incentives to promote investment or competition.

Table 1. Indicators for monitoring incentives

Measure	Guatemala	Nicaragua
Estimation of the breakdown of Tax Expenditure	Yes	No
Value added in Maquila-factories and Free Zones	Yes	Yes a/
Investment breakdown by sector and origin	No b/	Yes c/
Investment promotion agency and central bank cooperate on FDI figures	No	Yes
Employment in Free Zones	Yes d/	Yes
Employment or temporary work in Maquila-factories	Yes e/	No
Tourism revenues	Yes	Yes
Employment in tourism industry	No	No

a/ There is no clarity on the beneficiaries of Law No. 382.
b/ Only Decrees 29-89 and 65-89, not for other sectors.
c/ For FDI, not for domestic investment.
d/ Information only exists on jobs created, but not on the total employment in the sector.
e/ Figures are collected by the Agency for the Promotion of Textiles and Apparel, and are not official.

governments to improve the availability of official information on the levels of investment and other gains, as well as information on Tax Expenditure outcomes in order to be more efficient and effective in attracting FDI (see Table 1).

The cost of tax incentives in Guatemala and Nicaragua

Foreign investment has fluctuated while these incentives have been introduced. In Guatemala, investment benefiting from the *Promotion and Development of Export and Maquila Activities Law* and the *Free Zones Law* averaged just over US$ 190 million in 2004-2006. Meanwhile, investment in Nicaragua that benefited from Laws 306 and 382 reached a total value of US$ 282.3 million in 2006 and focused on the telecommunications, energy and tourism as well as to the development of free zones. In both Guatemala and Nicaragua the increase in investment coincided with an increase in employment generation associated with the scheme.

Also, in both Central American countries, tourism is an important economic activity. In 2006, tourism in Guatemala generated more than $US 1 billion, equivalent to 2.9% of GDP, while in Nicaragua the equivalent was US$ 240 million, representing 4.5% of GDP.

"The analysis shows that tax incentives are not the major determinants of levels of foreign investment in the region. Economic growth, infrastructure and economic openness are what matter most."

The impact of tax incentives in Central America

The Instituto Centroamericano de Estudios Fiscales (ICEFI) has used econometric models to analyze the impact of tax incentives and other variables on FDI, using information from El Salvador, Costa Rica, Honduras, Guatemala, Nicaragua, Panama and Dominican Republic. The analysis shows that tax incentives are not the major determinants of levels of foreign investment in the region. Economic growth, infrastructure and economic openness are the most important determinants on levels of FDI.

It should be noted that stability and predictability of the tax system is important. Changing the "rules of the game" discourages long-term investments, and each additional incentive changes the rules, making the tax code ever more complex. Furthermore, decisions on creating new incentives need to take into account the resulting erosion of the tax base. This may lead to future tax changes to offset the reduced tax collection, which can generate more uncertainty, reducing the likelihood of attracting investment.

Conclusion

These results show that Central American countries should identify alternative tools for attracting FDI, beyond tax incentives. This conclusion becomes even more important, given that, although the WTO has extended the use of fiscal instruments to promote investment in free zones and Maquila-factories until 2015, these extensions will expire afterwards and, as a result, they may be seen as trade distorting practices sanctioned under the WTO.

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ILLICIT FINANCIAL FLOWS OUT OF LATIN AMERICA

feature

Matti Kohonen

Research at Global Financial Integrity (GFI) shows that illicit financial flows from developing countries increased at a compound rate of between 18.2 to 19.4 percent per year for the period 2002 to 2006.

In 2006, the last year for which country data were available from the IMF, these illicit outflows ranged from US$858.6 billion to US$1.06 trillion, with Latin America accounting for almost a sixth of that. The full report is **here** (with executive summary **here**), and the highest rates of illicit financial flows in Latin America are summarised in Table 1.

The global estimates produced by the GFI team, led by former IMF Senior Economist Dev Kar, are significantly larger than other estimates that have been made using more traditional methodologies, which yield strange results: traditional studies would have us believe, for example, that Africa as a whole, and Russia, are net recipients of illicit capital flows. This is a result of differences in definition and analysis, and GFI's innovative methodology here has helped advance the field significantly.

The report makes an analytical distinction between the overlapping categories of capital flight, on the one hand, which contains a legal and an illegal component, and what GFI concentrates on: illicit flows, which do not include any recorded capital flows. GFI defines illicit money as: "money that is illegally earned, transferred or used. If it breaks laws in its origin, movement, or use it merits the label."

The main difference between GFI's methodology, and more traditional approaches, is the way "wrong" signs are treated – that is, inflows and outflows. Traditional approaches look at inflows and outflows, and then simply let them wash out into a net position. For example, a traditional method of estimating illicit flows using the World Bank Residual model based on changes in external debt, might estimate illicit outflows of 100 from Congo, and also, using the trade mispricing model, finds illicit inflows of 150 – then judge the country to have received a net inflow of 50, and leave it at that.

But this approach constitutes an extremely blunt instrument.

For one thing, the flows are illicit in each direction – there are tax losses in both directions – so it makes no sense to subtract one from another. In addition, illicit inflows will tend to drive the growth of the underground economy, making it less likely that the official economy will benefit. Not only that, but economists have not questioned whether it makes sense to have illicit outflows through the balance of payments, then illicit inflows through trade mispricing, in the same year. Furthermore, one would surely need to consider the monetary or exchange rate consequences of these inflows. If basic economic principles

Table 1

	Average annual illicit outflows, 2002-2006, $ billion	
Country	**Normalised[1]**	**Non-normalised**
Mexico	41.7	46.2
Venezuela	15.9	16.8
Argentina	12.1	13.0
Brazil	-	8.4
Chile	7.0	8.2
Panama	4.1	4.1
Colombia	2.6	3.9
Costa Rica	3.2	3.3
Uruguay	2.4	2.6

are any guide, economists should wonder why central banks in developing countries hardly ever complain of the inflationary consequences of illicit inflows, or at least the tendency for substantial inflows, above and beyond recorded capital inflows, to lead to an appreciation of the exchange rate.

While illicit outflows can be verified independently – by looking at the growth of deposits in the points of absorption such as offshore financial centres, tax havens, and onshore banks, and at the growth of the underground economy in developing countries, there is not a single study done by economists that validate the nature, composition, or use of illicit inflows. The traditional approach of netting out flows in both directions does not reflect this simple fact.

GFI's approach, by contrast, does not automatically let flows wash out into a net position, but instead it queries the authenticity of the so-called illicit inflows. It does this by using filters: flows that flip-flop from year to year, or below a certain size, are not counted, as they may be the result of data errors. GFI's techniques offer a much better method for handling flip-flops in signs and estimating these flows realistically.

Previous studies of 'illicit capital flight' take the uncorrected World Bank Residual model, and compound it with the trade mispricing model, as is the case of the **Boyce and Ndikumana study** (which is not comparable to the GFI study, as it covers a different range of countries and timescale) on sub-Saharan Africa from 1970–2004. Even so, their estimates of illicit flows from Sub-Saharan Africa (SSA) are so staggering – even after accounting for all "inflows," most of which are highly suspect – that Governors of Sub Saharan African central banks convened a conference in South Africa in early 2007 (cited in GFI report) to address the problem of capital flight.

World-wide, GFI found, six of the top ten countries with the highest illicit financial flows in 2002-2006 were oil exporters: Latin America's Mexico and Venezuela, as well as Russia, Saudi Arabia, Indonesia and Kuwait. It seems that oil, due to both corruption and distortion of the tax base it tends to create, has a tendency to put economies at special risk of illicit outflows.

Interesting variations can be noted in the data. For instance in the cases of Mexico

> *"While the high trade mispricing figures point out the failures of trade and investment liberalisation in not promoting transparent rules for accounting and financial reporting, capital flight more traditionally measured points to weak financial and banking supervision."*

and Costa Rica, nearly the entire volume of illicit financial flows is due to trade mispricing (US$ 41.7 and $3.2 billion respectively). In contrast, illicit flows from Argentina and Venezuela mainly occur through unrecorded flows from the balance of payments (US$12.1 and US$15.9 billion respectively) rather than trade mispricing.

While the high trade mispricing figures point out the failures of trade and investment liberalisation in not promoting transparent rules for accounting and financial reporting, capital flight more traditionally measured points to weak financial and banking supervision.

The GFI report, and the diverse responses to it open up many questions in term of re-regulating the financial sector and global accounting practices. Raymond Baker, director of GFI, has frequently stated that country-by-country reporting would be a 'magic bullet' in helping tackle illicit financial flows: multiple discrepancies could be immediately detected if accounting standards were clear about the locations of transactions and the beneficial ownership of subsidiaries was revealed. The GFI report thus puts the issue of illicit finance squarely on the global agenda – something that central bankers and governments across Latin America should note, not least because of the potential impact on inflation, as well as on fiscal and domestic investment erosion.

Matti Kohonen, TJN International Secretariat

news

Where on earth?

by Richard Murphy, Tax Research LLP FCA

A small but important **piece of research** by a multi-agency team produced some telling evidence on the use of tax havens by multi-national corporations earlier this year.

Inspired by **a report** from the US Government Accountability Office that looked at how many US corporations had tax haven subsidiaries we sought to replicate this work in the UK, France and the Netherlands, initially. Work is now being undertaken in Germany to extend the research, and researchers from other countries are invited to contribute. A Swiss magazine, Hebdo, has also done its **own research**.

The US research showed that 83 per cent of the largest US companies have tax haven / secrecy jurisdiction[1] subsidiaries. That research was based on the best available data on corporate structuring for any jurisdiction in the world, but teams from Tax Justice Network UK, The UK's Trade Union Congress, Christian Aid and ActionAid also sought to collect similar data in the UK, where information on group structures should, in theory, be put on public record annually by all multinational corporations. Meanwhile, EU-funded research group **SOMO** used database studies to contribute Dutch content. Data for France was researched by **Alternative Economiques**. I coordinated the project, and Markus Meinzer did most of the analysis – for which I offer my thanks.

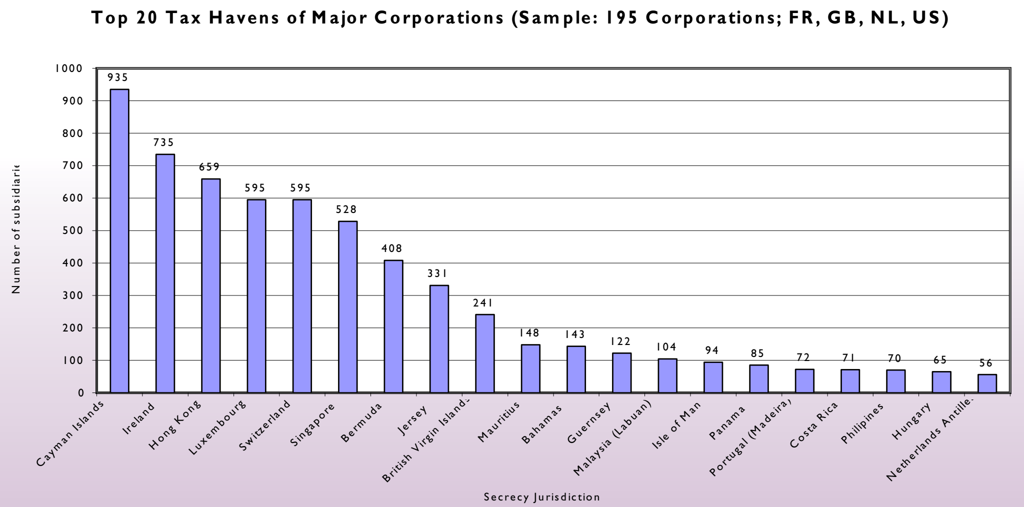
The findings were dramatic in two ways. Firstly, and rather stunningly, 67 per cent of UK companies researched did not meet the legal requirement that they put this data on public record. That is worth repeating: two thirds of UK multinational corporations broke the law on required disclosure in this regard. As a result they could not be included in the survey.

Secondly, regarding those companies that could be surveyed the results were equally astounding. Of the non-US companies covered by the work, all but one had tax haven subsidiaries. That means that in effect 99 per cent of the European quoted companies surveyed have tax haven operations.

As in the USA, the largest user of tax havens in France and the UK was a bank. In the USA the largest user was Citigroup, in France it was BNP Paribas and in the UK it was Barclays plc.

There are regional variations in the use of tax havens. US corporations use the Cayman Islands more than other locations, but also show a bias towards Bermuda, the British Virgin Islands, the US Virgin Islands and Barbados.

U.K. corporations are the biggest users of the UK Crown Dependency



[1] Secrecy jurisdictions are places that intentionally create regulation for the primary benefit and use of those not resident in their geographical domain that is designed to undermine the legislation or regulation of another jurisdiction and that, in addition, create a deliberate, legally backed veil of secrecy that ensures that those from outside the jurisdiction making use of its regulation cannot be identified to be doing so. In this article I use the term secrecy jurisdiction fairly interchangeably with the term tax haven, though in other more complex work it is often appropriate to employ the two terms separately.

news

Where on earth? (Cont'd)

tax havens. French corporations have a bias towards using Switzerland and Luxembourg while Dutch companies show less preference for Luxembourg but more for Ireland and Far East tax havens such as Hong Kong and Singapore.

This shows that major corporations are wedded to the systematic use of tax havens. We have proved it across multiple jurisdictions and with regards to multiple corporations.

Equally, we have shown that this data is absurdly hard to come by: proving the above statements required considerable work by international teams working for months.

And we still have no evidence of what these companies do in tax havens – just that they are using them. That, after all, is the appeal of such places: they keep things secret, away from the prying eyes of legitimate regulators and those demanding democratic accountability.

All of this strengthens the case for country-by-country reporting, which would force multinationals to come clean about what they are doing and where, and who it is they owe money to. In this spirit I draw your attention to **a new report on country-by-country reporting** published by the Task Force on Financial Integrity and Economic Development, entitled "Country-by-Country Reporting: Holding Multinational Corporations to Account Wherever They Are". Written by myself, it is the fullest exploration of this issue published to date that I am aware of.

Richard Murphy is a Senior Adviser to the Tax Justice Network, and is directing its forthcoming Mapping the Faultlines research programme.

The challenge of building a regional network

by Federico Arenoso

Influential approaches to economic thought, led by the Chicago School, have long emphasised the need for an efficient state. The state, it seems, should maximise its performance, as if it were a company. Many developing countries have adopted this mainstream way of thinking, supported by international financial institutions.

Latin American countries, and especially Argentina, have been outstanding students of these ideas. The concept of efficiency in the tax structure was held to be central, while concepts such as equity and social equality have been left aside. Tax reform in the region voraciously expanded indirect tax rates, while taxes on income stayed extremely low. As a result, social inequalities increased.

At the same time a second objective was achieved too: reducing the size of the state. The result of having a chronically underfunded public sector has weakened the state's capacity to enact policies aimed at reducing poverty and social inequality.

This has been exacerbated by the current international financial crisis: as economic activity has declined, governments in the region have increasingly found their hands tied when it comes to cushioning the impact.

The creation of the Tax Justice Network for Latin America is set in this context. The initiative's main target is to build a regional space involving professionals, civil society organizations and individuals working for progressive, democratic and just tax structures; and working against tax evasion and avoidance, regressive taxation and tax competition.

The first activity will be to analyse the tax structures of several countries in the region. Case studies are being developed for Brazil, Bolivia, Peru and Argentina, to name a few. These studies should be finished by the end of 2009, and will describe specific factors in each country while enabling cross-country comparisons to be made, to help build a regional analysis.

A research workshop is also planned for the first quarter of 2010. Poder Ciudadano is raising funds for a country workshop in Argentina to put the tax discussion in the public agenda, and to put together a basic manual aimed at a Latin American audience, based on TJN-International's **Tax Us If You Can**, which will be developed for publication in early 2010.

Meanwhile, a Latin American Network website is being developed. This will create a space to stimulate discussion and raise awareness among various stakeholders about the urgent need to fight for fairer tax systems.

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news

Fiscal Policies in Times of Crisis

by Birger Nerre

At the second **EU-LAC Forum** (EU-Latin America & Caribbean Forum) discussing "Fiscal policies in times of crisis – volatility, social cohesion and the political economics of the reforms" (Montevideo, Uruguay, 19-20 May 2009), high-ranking officials from Europe met with their counterparts in Latin America and the Caribbean to discuss the challenge of how fiscal policy can be appropriately applied to the present economic situation.

The global financial and economic crisis is affecting Europe, Latin America and the Caribbean in different ways, partly due to the differences in the tax structures prevalent in each region (for example, the share of indirect taxes is comparatively higher in Latin America and the Caribbean than in Europe). Nevertheless, the crisis puts huge stress on national budgets in all regions, as decreasing tax revenues and revenues from natural resources are accompanied by skyrocketing expenditure calls for fiscal stimuli.

Governments all over the world appear to be stuck between a rock and a hard place. On the one hand, increases in public (tax) revenues are badly needed to finance expenditure programs to mitigate the effects of the crisis. On the other, demands are made calling for immediate and significant tax cuts to boost investment and consumption. Yet the situation is complicated by the fact that short-term policies may induce undesirable long-term effects: as German ex-Minister of Finance Hans Eichel has pointed out, in Europe short-term tax reductions tend to persist due to the political pressure exerted by beneficiary interest groups.

Accordingly, governments might be wiser to strive for a better use of the existing tax base rather than making short-term tax cuts to stimulate demand; for example by increasing the efficiency of tax administration. However, CEPAL's Executive Secretary Alicia Bárcena and Osvaldo Kacef both argued that due to generally sound budget policies in Latin America over the few last years, the fiscal room for manoeuvre might be larger in this region than in Europe. Thus, temporary tax reductions could be a feasible countermeasure for the crisis in Latin America, though arguably less so in Europe.

TJN Director John Christensen emphasised the importance of tackling tax evasion in overcoming public finance deficits and reducing the acute volatility of tax receipts in many Latin American countries. At the same time, reducing tax evasion is a step towards more tax justice and equity between the developed world and Latin America.

One of the concluding messages of the Montevideo Forum also summarized discussions about the impacts of the crisis: "Governments should not discard the objective of strengthening the State. This implies improving taxation structures in order to make them more robust in times of crisis, strengthen their progressive natures and collecting the revenues needed to fulfill public tasks, whilst minimizing non-compliance with taxation obligations" – which means tackling tax avoidance and evasion.

Panorama of Montevideo's financial quarter. Under pressure from the G20, Uruguay agreed to cooperate with removing its banking secrecy in April 2009

The current crisis might, therefore, constitute more than just a threat to fiscal sustainability and good governance in the short run. It may also represent a chance for governments to initiate long-debated but so-far postponed reforms of their revenue systems, serving to increase fiscal sustainability and good financial governance in the long run. Europe and Latin America may well learn from each other in this process.

Birger Nerre works at the Public Finance Group, German Technical Cooperation (GTZ).

news

Towards Tax Justice

by Maaike Kokke

In many developing countries tax revenues are under pressure for a variety of reasons, such as tax evasion and aggressive tax avoidance by multinational corporations, tax competition between countries, and falling revenues from trade tariffs caused by trade liberalisation. Naturally, the financial crisis also has negative consequences for public finance in developing countries and may distract attention from longer-term development objectives such as a sound and fair tax system. At the same time, the crisis has made the damaging role of tax havens more evident and placed this topic higher on the international agenda.

Despite the clear link between tax and development, attention for tax justice from development agencies and NGOs has been relatively limited so far, especially compared to other themes related to financing for development such as aid volume and quality, debt and trade. For example, while various NGOs are already engaged in monitoring the allocation of government budgets, there still exist very few initiatives to monitor government revenues.

This deficiency is mainly caused by the lack of capacity on this theme amongst NGOs. Taxation is a relatively new topic within the development debate and, because of its rather technical nature, NGOs often lack technical knowledge required to analyse tax issues and their development impacts. More capacity is needed to enable NGOs to work on tax justice and to engage with policy makers and other relevant actors.

The project 'Towards Tax Justice' addressess these needs and raises attention for all aspects of tax justice. It aims to build capacity amongst NGOs or civil society organisations in Africa, Latin America, and Asia for activities on tax and development. In addition, the project aims to reinforce international coordination, and facilitation of engagement with policy makers. This would enable NGOs to address problems related to national and international tax systems more easily and effectively, ultimately contributing to better tax policies. This will be achieved through a range of activities, such as trainings, policy roundtables, research projects and the creation of regional networks.

The funding of the project is for the greater part provided for by the European Commission. The project is coordinated by the Netherlands-based Centre for Research on Multinationals Corporations (SOMO) and put into effect by a team of 7 partner organisations from Kenya, Zimbabwe, Ghana, the Philippines, Argentina and the United Kingdom. The Tax Justice Network (TJN) and several other organisations and networks are also closely involved in the implementation of the project.

The three-year project was launched successfully during the World Social Forum (WSF) in Belem at the beginning of 2009. Here, all partners and several associates came together for a two-day strategy meeting. At the WSF, a workshop aiming to start a civil society network in Latin America to promote tax justice was organised as well. Experts explained the importance of tax justice during this workshop, and organisations working on themes such as budget monitoring, global finance, and corporate accountability exchanged ideas.

In April a workshop was held in Ghana to discuss a country briefing on taxation and a regional seminar was organised in May in Tanzania, with participants from Kenya and Uganda that want to get more involved in tax work. Reports will be made available on **www.taxjustice.net**. Later in 2009, we expect the publication of a research paper from the Philippines and the launch of a website of the tax justice network in Latin America.

Organisations that are interested in joining the network, to take part in activities of 'Towards Tax Justice', or to receive more information are invited to contact us.

For regional information, please contact the following partner organisations:

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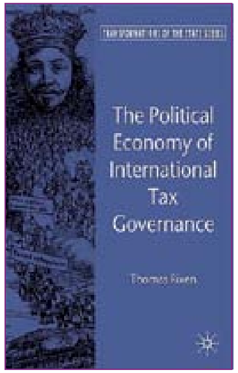
reviews



The Political Economy of International Tax Governance

Thomas Rixen

Palgrave Macmillan

Dr Thomas Rixen has written an important book. Alongside a carefully crafted theoretical line of thought, it walks the reader through a well-documented and accessible overview of the basic mechanisms and controversies in international tax, while providing a firm theoretical, historical and empirical base for understanding the intricacies of international tax governance. It is a first – but long overdue – attempt to approach the double tax avoidance regime from a political science perspective.

Rixen's account begins in 1919, with the International Chamber of Commerce's determination to eradicate the so-called "evils of double taxation" and the report of the "Four Wise Men" to the League of Nations in 1923. The origins of today's international institutional mechanisms regarding "double taxation" – that is, avoiding taxing economic activity twice through cross-border investments – lay in this period. Rixen describes in some historical detail the decisions and discussions that ushered in a fundamentally bilateral system of double tax agreements (DTAs), whose only multilateral feature is a supporting organisation tasked with designing and updating a treaty template for speeding up bilateral negotiations. He also illustrates the widening scope of the DTA network: from around 37 bilateral treaties in 1929, to 333 in 1963, to more than 2000 at present. An outstanding case in this respect is the United Kingdom.

While for many years reluctant to confer any right to tax at source, the UK, very early on, established many DTAs, especially with former colonies and dependent territories, and for a long time had the highest number of DTAs. Rixen convincingly depicts the institutional development over the last 40 years as a story of increasing complexity brought about by stronger cross-border economic ties, the rise of multinational corporations, the spreading web of DTAs, and by the resulting tax avoidance. When the narrative lays bare the unsustainable nature of the present status quo, Rixen insightfully offers a potential solution to this proliferation spiral: "unitary taxation with formula apportionment, under which countries agree on a common tax base, but apply their own tax rates where the national tax bases of multinational corporations would be agreed upon worldwide".

Analytically, the book has three main merits. First, he succeeds in formally deducing the empirical bilateral nature of the double tax avoidance regime from the underlying problem structure -- which relates more to issues of distribution (that is, how taxes and investments are distributed between partner countries), than to enforcement problems. Second, he contrasts this situation with the strategic difficulties inherent in efforts to curb under-taxation through international tax avoidance and evasion. By depicting the latter as an asymmetric prisoner's dilemma, he adds to our understanding of the differences and potential tradeoffs between both issues. In this tax competition "game", it becomes apparent that small states are materially better off by 'defecting', irrespective of whether larger states choose to free-ride or cooperate. For small secrecy jurisdictions, there is a constant incentive to cheat and not to cooperate. However, the good news amid the gloom is that Rixen's analysis argues that it pays for large states to "invite" smaller jurisdictions into cooperating, by sanctioning or compensating them. Thus the prisoner's dilemma can be broken, and continual and retaliatory defection can be avoided.

Thirdly, by firmly embedding the international tax debates within a rational choice framework, tax may now start to receive far more attention from International Relations scholars than it has so far. At the same time, however, the very same theoretical approach the book opts to pursue is likely to foster controversy. In particular, the model Rixen develops and deploys is underpinned by neoclassical assumptions that today – although likely to reflect influential economic thinking – are increasingly disputed worldwide. Some of the generic assumptions Rixen employs are that low tax rates attract desirable investment lows, that states benefit, without qualification, from economic liberalisation, and that removing distorting double taxation would result in more efficient allocation of international capital. In an endnote Rixen concedes that the notion that "tax neutrality" translates into economic efficiency only holds "under the assumption of perfectly competitive markets", which reveals some of the theoretical limitations of his work.

Rixen's historical account of the transition from the League of Nations to the OECD as the multilateral organisation responsible for tax matters surprisingly lacks an equally detailed empirical narrative as regards the origins of the international tax regime in the

reviews (cont'd)

1920s. Similarly, the limited role and resources of the UN Committee of Experts on International Cooperation in Tax Matters is noted, but not further questioned.

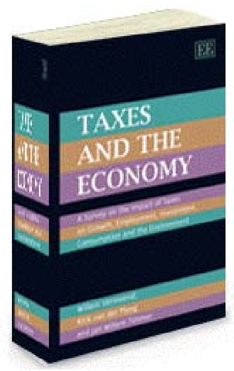
In his attempt to substantiate the claim that power matters in determining tax rates in DTAs, it is not clear why he proceeded econometrically to test double tax agreements among OECD countries when he has already (correctly) flagged up a lack of data with respect to developing countries.

Similarly, Rixen does not seriously tackle the question of why developing countries should enter into DTAs with rich countries at all, if the rich countries already provide unilateral tax relief anyway. To address such questions would have allowed him to embed power more firmly in the centre of his analysis. Finally, whilst Rixen convincingly argues that the OECD's past of marshalling the double tax avoidance regime shaped its campaign against harmful tax competition at the end of the 1990s – and thus offers an alternative to Jason Sharman's account of the failure of the OECD – the question of why the OECD has been chosen in the first place for the campaign against secrecy jurisdictions is, however, left unanswered.

Despite these reservations however, The Political Economy of International Tax Governance offers an excellent entry-point for any graduate economist, lawyer or political scientist who is relatively fresh to the field of international taxation. Apart from making some valid theoretical points, he offers a well-structured narrative of the past 90 years of international tax regulation, and adeptly explains the most pervasive technicalities.

Reviewer: Markus Meinzer, Consultant to the Tax Justice Network International Secretariat

Disclosure: The reviewer is a PhD student of Thomas Rixen.



Taxes and the Economy:

A Survey on the impact of Taxes on Growth, Employment, Investment, Consumption and the Environment

Willem Vermeend, Rick van de Ploeg, and Jan Willem Timmer

The title 'Taxes and the Economy' suggests an overview of more or less all aspects of tax systems. Indeed, the book is very comprehensive and discusses everything from the basic objectives of taxation to the greening of tomorrow's tax systems. The authors explain that this is not a monograph for economic scholars, but a survey of theory, academic studies, and practical experiences written for policy makers and practitioners. It delivers on the promised contents – covering an impressive amount of theory, statistics, and academic studies, complemented with concise examples from the real world – but it does read somewhat as though it were a reference manual. Some text may be hard to grasp for people without an economic background: readers should be familiar with terms such as elasticities, deadweight losses and crowding out (or they could take a dense crash-course in economics in the 70 pages of annexes). They focus heavily on high income OECD countries, mainly in Europe, and particularly the EU-15. Readers should take this limitation into account; applied to developing countries, these recommendations would be somewhat similar to the failed **tax consensus.** Still, anyone who wants to learn how mainstream economists think about specific tax issues will find the book useful.

While all three authors have an academic background, the first two are also prominent members of the Social Democratic Party and have served in previous Dutch cabinets. On taxes, their perspectives may be characterised as mainstream neo-liberal economic. For example, as Deputy Minister of Finance, Vermeend was responsible for the introduction in 1997 of the Group Financing Activities regime – a rather aggressive effort to attract treasury operations of large multinationals – which the European Commission prohibited in 2003. The authors are highly critical of the present Dutch government coalition (which includes the Social Democrats); in a radio debate last September, Vermeend said that after 2002 *'everything'* went wrong with the Dutch tax system, referring to inconsistent tax policy that made the system more complex and less coherent. The book seems partly intended as a statement against this development.

The authors emphasise the potentially distortionary effects of taxes. Their central message is straightforward: *'broad, low, simple, and a shift from income to consumption taxes.'* We have heard this before, of course, but the

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presentation of empirical findings in this book is relatively balanced and fair. The authors discuss the Laffer curve, a model showing that government revenues actually fall if tax rates increase beyond a certain point because tax evasion will be encouraged and economic activity discouraged. Yet the authors implicitly acknowledge that this effect occurs only at very high tax rates, mentioning empirical evidence from Sweden in the early 1980s for maximum tax rates well above 80%. They also note that (in contrast to theory) the elasticity of hours worked with regard to taxes is in practice near zero, that is, workers don't work fewer hours if the tax burden on labour increases. Moreover, while the authors do support a higher Value Added Tax (VAT), they acknowledge that this is 'moderately regressive' and propose a mere 5% VAT on basic necessities.

However, they do not always make clear where they are talking about theory, empirical findings, or policy positions. The reader needs to be careful: some things are treated as if they were simple facts, and this may be misleading. For instance: *'Optimal tax theory concludes that since capital is mobile in the long run the efficient tax rate on capital income is zero'* fails to mention that economic theories do not necessarily predict real-world outcomes accurately. Or take *'Empirical evidence demonstrates that the tax system is an important factor in the location of foreign investment and MNCs'*: this is not equally true for all types of foreign investment. Some summaries seem inconsistent with the main text: the summary of chapter eight states, for example, that *'The OECD's Forum on Harmful Tax Practices has been successful in curbing harmful practices by tax havens and preferential tax regimes in OECD member states'*, does not follow from the chapter – nor does it reflect the opinion of many OECD countries either.

Reviewed by Francis Weyzig of SOMO in the Netherlands.

CALENDAR

4 September
Put People First Campaigning Day, London. Timed to coincide with the G20 Finance Minister's Meeting to discuss the financial crisis ahead of the Pittsburgh Summit. More details **here**.

14 September
Launch of the Ghana Tax Justice Country Report, during Ghana Tax Week, Accra

14–15 September
World Bank Conference on The Dynamics of Illicit Flows from Developing Countries, World Bank, Washington D.C.

16–18 September
Annual Conference and General Meeting of the Task Force on Financial Integrity and Economic Development, Washington D.C. More details **here**.

21–22 September
Transfer Pricing and Treaties in a Changing World, OECD Conference, Paris

24–25 September
G20 Pittsburgh Summit. More details **here**.

October 13-14
Tax justice briefing and public meeting in Luxembourg, organised by **Cercle de Coopération**.

19–23 October
Fifth Session of the UN Committee of Experts on International Cooperation on Tax Matters, Geneva. More details **here**.

26–30 October
West Africa Regional Conference on Tax Justice, Ghana. More details **here**.

7–8 November
G20 Finance Ministers and Central Banker Governors Meeting, Saint Andrews, Scotland

2–3 December
Conference on Illicit Financial Flows and Human Rights, Yale University, Conneticut