Paper 4 of the Introduction to the Project “Tax Justice & Poverty”

Concepts and Context of the Project= Short Version

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Content

Introduction

The goals of the project “Tax Justice & Poverty” are narrowing of the wealth gap and reducing governmental dependence on external financing, by means of a more just taxation system, in order to alleviate poverty. This endeavor requires first an answer by the researchers to (a) why we think that a growing wealth gap and governmental dependence on external financing exist, (b) why they pose a problem in relation to the situation of the poor, and (c) what causes underlie these developments. Only if we know the facts and figures we can develop proposals for a more just taxation system, proposals which are not merely driven by ethical imperatives, but also look into the way things are de facto being done and occurring and are therefore able to indeed narrow the wealth gap, reduce governmental dependence and improve the situation for the poor. In this chapter, developments and trends are presented which apply globally and therefore need to precede our country reports from Germany, Kenya and Zambia.

Wealth Gap

We start by distinguishing between income inequality and wealth inequality. To put it simply: income is the total amount of money which you receive and which gives you financial liquidity; wealth is that which you own, which promises you reliable future income and which gives you a position of power in society, e.g. houses, disposable financial assets, a business, real estate, real property etc. Most people derive income from labour, but there is also income from non-labour, such as interest from capital, shares, derivatives, rent from real estate and houses.

Capturing the extent of wealth is difficult both in Germany, Kenya and Zambia because of the lack of transparency and/or problems to access existing data and statistics. Nevertheless: there is widespread agreement among scholars, governmental, non-governmental and intergovernmental institutions as different as Thomas Piketty, Christian Aid, OECD, IMF or UNDP that both income and wealth inequality are rising since the 1970s, and that this is a trend both within nations and among global regions. There is further agreement that this growth has been occurring faster over the past two decades, the reasons for which are neoliberal influences upon globalization, the importance of capital in the wealth portfolio, its use by corporate and private wealth owners and the truth behind Piketty's formula r>g: Returns of capital are always higher and rising faster than the growth of the "real economy" and, accordingly, income from wages for dependent labour.

There would be no major problem in this development if the popular neoliberal hypothesis were correct that "the rising tide lifts all boats," meaning, that at the end of the year the gap would perhaps widen, but that the material situation of all households would be better de facto and in real terms than at the beginning of the year. This hypothesis seems to be disproven: while income and wealth at the top end of society is de facto rising overproportionally and with it the number of millionaires and billionaires, income at the bottom end of society is stagnant or sinking, a growing number of households and businesses fall into debt.

There are three more worrisome features: first, income and wealth are increasingly concentrated among the top 1 percent of society nationally and globally. Second, there is a growing awareness about the importance of gifts and inheritances when it comes to acquiring or keeping a position among the world's top wealthy. Here one can justifiably talk of earned and unearned income, putting the owner of "patrimonial capital" widely ahead of all others. Thirdly, the previous developments are worrying because, along with growing wealth, concentration increases the influence of the few top corporate and private wealth owners over governments which then undermines democratic governance and control.

One needs to be mindful, however, of the fact, that the measure and extent of wealth is influenced by a number of factors which are difficult to calculate. A lot of wealth, for example, is linked to private, corporate and/or governmental debt. If then somebody cannot repay the loan which helped them to buy a house, a machine or a bankrupt systemic bank, then bonds obligations are not worth their paper; and whatever "wealth" there is will evaporate.

Governmental dependence on external financing

The problem in this chapter is not governmental dependence on external financing as such. In certain situations acquiring credits to finance important projects in times of need is helpful and necessary. And: state bonds are a safe investment for private, corporate and state investors. However, decisive questions are: who is the creditor? What is the timeline of the credit and its interest rate? Is it possible for public households to get out of dependence again? There is, obviously, a difference between the creditor being a Central Bank or a government or a "Vulture Fund." While, for example, credits and loans for developing countries in the form of Official Development Aid are carried over a lengthy period of time with low interest rates or while Foreign Direct Investment in businesses is normally guided by long term interests of the investor, Portfolio Investments are characterized by large amounts of money, short lending periods and high interest rates, contributing to high volatility.

The situation worsens in times of national, regional or global crises, which are triggered by the global volatility of the financial system as a whole. The most disastrous recent crisis was the World Financial and Economic Crisis 2007/2008, which struck at a time when private, corporate and public entities were already in a difficult situation due to long-term developments within neoliberal globalization, some of which are: (a) growing indebtedness of private, corporate and public entities (which were “seduced” into taking credits when there was a lot of “liquidity” around in search for investment); (b) privatization of public services; (c) selling of public assets; (d) reducing tax revenue because of tax competition between states in the attempt to attract businesses; (e) the fragmentation of labour markets with the resulting emergence of a low wage sector whose labourer were no longer able to pay a noticeable share of taxes and social security contribution, but at times even require public subsidies for enabling them to lead a decent and dignified life in the first place.

When, in such situations, the sudden need arose in both developed and developing countries to intervene and stabilize the financial sector, they resorted to two remedies: They raised indirect taxes, especially VAT (hitting over proportionately low and middle income households) and they raised even more credits from capital markets, which in turn caused obligations to pay interest.

To make things worse: for many years, both in Africa and Europe, tax rates for progressive taxation of private and corporate income were decreased, indirect taxes were increased: Both moves profit the wealthy rather than middle- and low-income households. Beyond that, experts nowadays agree from OECD, Eurostat or IMF, there is today no adequate taxation of capital, wealth, property, rent, inheritances and other areas targeting specifically private and corporate wealth. Moreover and at the same time there is plenty of tax avoidance and tax evasion by representatives of those groups.

Not surprisingly and accordingly, there is an interesting parallel between the growth of private capital and the decline in public capital, which can be demonstrated at least for some OECD states. This suggests that there is in principle a lot of money which could be taxed for the public and common good, but that somehow states are not or no longer able (or willing?) to collect their fair share. Why this is the case and how this can be improved will be an important aspect of this research.

Even though the research emphasis is on governmental dependence, we follow those who argue that one needs to keep private, corporate AND governmental debt in view in order to understand the entire picture (i.e. the stability of the present global financial and economic system): due to the interconnected financial markets, default in the private sector OR corporate sector OR governmental sector can bust the entire system.

Poverty

While it is true that the course of globalization has, over the past years, increased the average GDP and average income in many countries, this research follows those who argue that, in order to get a realistic insight into poverty it is more important to see the development of actual household situations at the top and bottom deciles of national and global societies.

We are aware of difficulties in comparing poverty levels and situations worldwide and between different countries: while in some sub-Saharan countries persons with a monthly income of US$10 per day may belong already to the middle class, this is about the wage a

German worker would obtain within one hour. Furthermore, social security systems and other publicly financed and maintained assets accessible for the poor are also important for assessing poverty levels. However, if one looks at the de facto situation at household levels it needs to be stated that not only inequality rose, but that the situation of the poor did not improve in many countries.

Generally, this research project follows those who understand poverty by following that which has been internationally "popularized" by A. Sens "capability approach". It describes not only existing material situations of poverty, but also assesses the likelihood with which persons can free themselves from this situation. Here, however, another problem comes into view: Along with increasing inequality in income and wealth often goes inequality of opportunity and therefore a decrease of social and economic mobility: the family a person is born into is getting more and more important for somebody's place in society.

Important achievements of modern states are social welfare systems which, by providing assistance in cash, benefits and public services, ameliorate poverty. These systems have become less redistributive since the mid-1990s. This is because of a decrease in revenue, the need to re-direct revenue into areas not related to pro-poor policies, outright cuts in assistance to the poor or changes in eligibility criteria. All this, of course, applies only to states having such redistributive systems in the first place, which is not adequately the case in many developing countries, especially in sub-Saharan Africa.

This research project is not only concerned about the situation of the present living generation, but equally about the foreseeable living conditions of future generations: their room to manoeuvre will be severely infringed due to today's public debt, resource exploitation, environmental degradation and climate change. To act here, too, a lot of money is needed.

Thus it seems indeed that developments underlying both the growth of the wealth gap and the persistence and/or growth of governmental dependence on external financing both contribute to persisting and/or growing poverty in Germany, Kenya and Zambia and many other countries in the world.

Before recommending any changes, however, a careful examination of causes is called for in order to understand why the present form of globalization is (co-)responsible for the situation which has been described so far. Only if we succeed in identifying links between causes underlying current developments and present situations, we can argue convincingly that changes in taxation are among promising avenues with which a narrowing of the wealth gap, a reduction of governmental dependence on external financing and an alleviation of poverty can be aimed for.

Context 1: Globalization and financial integration

Research by UNDP, OECD, IMF and others indicate that globalization over the past decades was a mixed blessing. They agree that the following four drivers are most influential for both global inequality and the situation of public finance: globalization of trade, financial integration, technological progress and domestic policies.

While the globalization of trade and some areas of technological advance seem to be at times beneficial for the lower segments of the population and have therefore the potential to lower poverty levels, there are numerous indications that financial integration and the need of states to adjust their domestic legislation both increases the wealth gap and negatively affects public finances.

Globalization of trade takes place in the world's real economy, generating products and services and therefore generating jobs for worker, who, by means of technological advance can be more highly qualified and therefore increase their salary. Financial integration, on the other hand, builds upon some known advantages of capital over labour and added, over the past decades, some new, unprecedented ones: a known advantage is its global mobility and its ability to go wherever profits are highest. Human labour, on the other hand, is not as mobile. If states therefore want to keep capital investment in their country (or induce it to come), they have to "reform" their domestic labour laws and markets in order to make their labour force attractive to capital. A consequence is the emergence of highly qualified, well-paid and well- insured jobs on the one hand, and of flexible, mobile, badly paid and badly insured jobs on the other.

But private and corporate wealth are rising fast for a second reason: because of the mobility of capital, states are competing for residences of the wealthy, investment and the registration of head offices of businesses by offering lower tax rates, more tax privileges or higher tax- funded incentives than other states. This not only lowers tax revenue generated by the wealthy; it also re-directs tax revenue collected from the average citizen into areas benefitting the wealthy.

But there are more effects of financial integration regarding the increasing wealth gap and dependence on external finance, for example: over the past decades, a separate financial industry emerged which got increasingly detached from the "real economy." A whole range of products, services and practices emerged which enable traders to generate huge profits and are, at the same time, not subject to turnover tax or even explicitly used for tax- dodging. Along with the emergence of this industry comes a culture of risk- taking and speed- trading. While investment in the real economy requires patience until the capital owner is able to reap profits, this is different in the financial industry. Here the highest profits are available for whoever is prepared to accept some risk over a very short period of time. Technology contributes to the increasing speed of trading by computerization which is why huge amounts of money can be invested, won or lost in milli-seconds. It is in this segment of jobs, where some of the highest salaries in the world are being paid. Because of the higher profitability, financial capital is increasingly withdrawn from the "real economy"; but it is exactly dependent labour working in the latter which generates a large and most reliable share of tax revenue, not taxation of capital income or financial products and activities!

Risks and speed of trading are among the main factors contributing to the increasing volatility of the global financial system, which is why the number and intensity of financial and economic crises have increased over the past decades and affect nations, global regions and the world as such in three ways:

First, assets such as shares and funds are destroyed in which people might have invested to insure life risks or secure their pension plans. If this is the case, tax- funded social welfare is called upon to take care of those who have lost all.

Second, the imminent collapse of "systemic institutions" that were "too big to fail" threatened to pull other businesses and jobs into the abyss. For that reason, states had no choice but to intervene in order to stabilize the financial and economic system or to maintain or induce economic growth by offering incentives to businesses and consumer. Both African and European states spent billions of taxpayers' money during and after the last World Financial and Economic Crisis: Private gains were followed by public losses and expenditure.

Thirdly, because jobs and businesses are destroyed by those crises, tax revenue is sinking while public commitments towards creditors via the obligation to repay credits and to pay interest are rising.

All this leads to a taxation relevant conclusion: against the over-heated financial markets, the Financial Transaction Tax is among the recommendable instruments.

However, given the increase in private and corporate wealth, the question is why it is not possible for states to recover parts or all of that which has been spent during those times of crises and/or why states do seem to be unable to collect an adequate amount of tax from the wealthy in order both to rehabilitate public finance and to improve the situation of the poor by increasing the equality of opportunity and social mobility? It is here, where the question of tax avoidance, tax evasion and illicit financial flows comes in.

Context 2: Illicit financial flows, tax evasion and tax avoidance

Due to global financial integration and technological innovation, nowadays an increasing number of options arise for wealthy and well-advised individuals or corporations to avoid and evade taxation and transfer money into secrecy jurisdictions a.k.a. tax havens where states cannot tax them. Those problems are discussed within the emerging concept of international Illicit Financial Flows, referring to financial transfers which are done illegally or illicitly both within and outside formal financial institutions. To understand that phenomenon better, conceptual clarification and explanation here are important:

The formal financial sector consists of those banks and financial institutions which are making headlines and are well known to many people. They are, at least to some degree, under the regulation of national and international law or, in the absence of laws, self-imposed regulations symbolized e.g. in stock exchanges. However, there are also financial transfers outside this regulated area in the so-called "shadow- banking" sector, where one finds hedge funds, private equity or other financial intermediaries. In addition to that are modern, decentralized systems such as Western Union or M-Pesa, more traditional banking systems such as Islamic banking, Hawala or Hundi banking, and classic courier systems – all of which, thanks to technological innovation, enable money transfers across borders and around the world which are difficult to control by tax authorities.

Illegal financial transfers done via those networks are clearly opposed to national and international legislation, for example the transfer of bribes, money laundering, tax evasion or proceeds from other criminal activities. More difficult to capture are *illicit* financial transfers which are – simply speaking – not strictly against the letter of the law, but against the spirit of the law. In other words, the act may contradict the intention of the lawgiver or other widely accepted legal and ethical norms of a given society. It is here where aggressive tax avoidance comes in, where hordes of lawyers search relevant laws, their application and relevant jurisdiction for loopholes they can use for hiding money from tax authorities with tax planning schemes.

The use of tax havens is a cornerstone of today's system of illicit financial flows. By registering subsidiary companies, trusts, shell companies and other legal constructs it is possible to hide private and corporate wealth and assets in a way that tax authorities are no longer able to trace the beneficial ownership of wealth, thus being unable to determine the amount of taxes and identifying the tax authority in charge of collecting them. Recent research and attempts to increase transparency in international financial flows reveal the huge amount of private and corporate wealth kept offshore. Existing quantitative "guesstimates" vary widely, depending on there underlying methodological assumptions and accessed data bases; one finds figures describing annual losses between US$ 189 billion and EUR 1 trillion.

Two more important points to note: Tax havens are not only exotic Caribbean islands, but also entities within the jurisdiction of developed countries, thus enabling transfer and investment of funds from poor countries to developed economies where they bring more profit. Research indicates that Africa looses billions of dollars every year, while the main beneficiaries are the USA, the UK and Germany. Beyond that, illicit financial flows are not merely a loss in terms of revenue. The larger damage is that money is withheld from poor countries where it would be urgently needed for investment in infrastructure, businesses and the creation of jobs.

This research will demonstrate, however, that tax evasion and avoidance is not merely something done by the top 10, 1 or 0.1% of society. Also black labour and many activities in the informal economy done by the "small" and "average citizen", avoids and evades paying taxes and, since a large number of offenses occurs here, it accumulates annually to very large amounts of money withheld from the community as well.

For this research, the core criterion is whether illicit financial flows damage the common good of all or not. Therefore findings from a number of sources need to be combined: Damage arising from the shadow economy, illegal tax evasion, aggressive tax avoidance, criminal transfers such as money laundering, tax fraud or bribes.

Tax Justice issues

The main question which this research tries to answer is: how far is taxation (and what kind of taxation is) a justified and justifiable means to reduce the wealth gap and governmental dependence on external financing and to alleviate poverty? This question is particularly urgent when regarding the spread of costs for the recent World Financial and Economic Crisis, which is over- proportionately borne by ordinary citizens. Costs for labour went up, as did costs for everyday life because of hefty increases in VAT. At the same time, (a.) no comparable changes were introduced regarding progressive taxation of income, taxes of corporations, capital, rents, real property, wealth or inheritances, (b.) known loopholes and weak spots assisting tax evasion and aggressive tax planning were not closed, (c.) investment in infrastructure, public services and programs benefitting the poor were cut.

Many reforms in taxation and labour markets over the past decades were justified with competitiveness and in order to attract capital and investment. This might be the case, but if at the same time the result is that owner of capital profit over proportionate from these policies, it is even more important to strengthen redistribution within national societies by means of taxation in order to prevent skyrocketing inequality and to preserve social justice and the cohesion of society.

And indeed: there is an increasing call among academic researchers, governmental, non-governmental and inter-governmental institutions for changes in tax systems. Among those are the EU, OECD or IMF who for many decades championed neoliberal policies such as deregulation, privatization and cuts in taxes and social assistance. They now argue for investment into the "real economy", decent salaries, improved redistribution of wealth and income as well as a higher contribution of the private and corporate wealthy via taxation to safeguard and improve public and common goods.

How this should be implemented and enforced, need, of course, a careful debate, also depending on the principles, norms and values of participants' world views. But the analysis so far suggests already the following directions:

First: if there were more transparency about what exactly is owned by the private and corporate wealthy, a more appropriate taxation based upon existing tax laws and rates could occur. Second: if present taxation laws could be enforced, higher tax revenue could be collected. In order to implement the two preceding points, however, it would be required that tax competition between states be replaced by their cooperation.

A third step is more difficult both to decide and to implement: change of tax laws and rates. In earlier times, wealth tax, inheritance tax, corporation tax, income tax, etc. were much higher than today. At the same time, income, wealth and welfare was more evenly spread, e.g. by means of redistribution. Those who owned more carried a heavier tax burden and contributed more adequately in proportion to their ability to the common good. Would it be justified to go back to those earlier laws and rates? Or have circumstances changed in such a way that new answers need to be found to secure the proportionality of taxation?

Clearly, in spite of all the positive changes since the World Financial and Economic Crisis, real progress is still wanting even in the first two areas. While states struggle to find agreement about common proceeding, a well organized lobby of private, corporate and especially financial wealth is trying to delay and obstruct any move towards more transparency and a more efficient cooperation among states.

This illustrates a problem which all institutions quoted so far and many others state, namely, that the present and rising concentration of wealth in national and global society poses a serious threat to democracy. Here, the wide range of persons, governmental, non-governmental and intergovernmental organisations waking up to the problem is encouraging.

It is hoped also that this research might contribute to a better, more efficient, fairer and more just taxation which could make the strong in society to carry once more a tax burden for the common good which is more in proportion with their ability.

For more information:

Whoever wants to read a more extensive, but still easy-to-read treatment of this topic is referred to the "Simplified Version" of this text of 26 pages length, containing also selected graphics, tables, quotes and bibliographic citations, which can be retrieved from **http://tinyurl.com/tjpI4-simple**

Whoever wants to look up issues addressed here in even more detail is referred to the "Technical Version" of this text of ca. 200 pages length. Chapter 1-4 (2.6 MB) can be retrieved from **http://tinyurl.com/tjp-I4technical-1-4** and Chapter 5-8 (2 MB) can be retrieved from **http://tinyurl.com/tjp-I4technical-5-8**