DEMOCRACIES IN DANGER: THE HIGH COST OF GLOBAL TAX LIBERALIZATION

by

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I. INTRODUCTION

Academics have long argued that the collection of tax revenue lays a foundation for the development of accountable, democratic and responsive governance. Taxation supports the relationship between a nation and the citizens and a government seeking greater tax revenue is likely to face demands from these citizens for reciprocal services and expanded accountability.[1] As more and more citizens complain about globalization,[2] it is sensible to ask why it isn't working as anticipated for such large numbers of people and how taxation contributes to this growing discontent.

Despite the growing academic and public attention, the understanding of the relationship between globalization, democracy and taxation in developing nations has remained limited. Research has provided an increasing but still fragmented amount of evidence on the specific links between

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taxation, globalization and governance.[3] This paper seeks to help fill the gap through an examination of the links between taxation, globalization and democracies in the developing world.

II. GLOBALIZATION AND TARIFFS

How would globalization trigger a revenue crisis in a substantial number of developing nations? The answer lies in how the governments of the developing nations that joined the wave of globalization raised their money prior to the 1990s.[4] These governments collected extensive revenues from taxes on imports and exports. Tariffs on consumer goods produced domestically on average accounted for 40 percent of all tax revenues in developing economies and 35 percent in lower, middle-income economies. Combined, they comprised almost 33 percent of tax revenues in the full sample of developing economies.[5]

Reliance on trade taxes continued through the early 1990s, mainly because they are generally easy to collect. Trade taxes include import duties, export duties, import monopolies, export profits, exchange profits and exchange taxes. They can be monitored and solicited at centralized locations, such as border areas and don't require a complex bureaucracy to manage.[6]

Starting in the late 1980s, after the Latin American debt crisis, there was a growing movement towards opening up international markets. In order to obtain structural adjustment packages, nations would have to become members of the World Trade Organization (WTO), which encouraged the lowering of tariffs. For many developing nations, this lowering of tariffs led to a loss of a primary source of tax revenue.[7]

Developing nations now needed to replace almost a third of their tax revenue with domestic taxes, which are more difficult to collect. Many had to increase income taxes on individuals and corporations and implement a value-added tax (VAT). The VAT involves fees at various level of productions and can be quite complicated to collect. Broadening income taxes is even more difficult since a large percentage of individuals and corporations in poor nations are logistically difficult to tax. Inefficient bureaucracies, untrained staff and weak technologies only amplify the problem of domestic tax collection. Besides, governments feel the pressure to keep domestic income taxes low so that domestic firms can survive in the global market competition. All of this can lead to a tax revenue shock for developing nations with poor revenue streams to begin with.[8]

III. GLOBALIZATION AND TAX HAVENS

The basic tax problems faced by the governments of developing nations are similar to those faced by tax collectors anywhere. Governments want to tax the profits of corporations and wealthy individuals, while many of these potential taxpayers want to hide as much of their profits and wealth as possible. The challenges of taxing global financial transactions are even more difficult because of the complexity of the global tax system.[9]

In a world where capital can flow easily across national borders, multinational corporations and wealthy individuals find numerous opportunities to hide their wealth from their own national governments. Effective global cooperation could overcome the challenges national governments face in collecting revenues from multinational corporations and wealthy individuals but such cooperation has been limited in practice.

Technically, there is no global tax system. Instead, there is a network of overlapping national arrangements, principles endorsed by global organizations, bilateral treaties, international agreements in addition to custom and practice. The effectiveness of these arrangements depends on willing compliance, which changes based on the political environment at the time.[10]

The so-called rules governing global taxation have largely been made by the richer and more powerful nations. This means that the rules have been broadly designed to benefit their creators and the powerful interests located within their arenas. Initial debates about the right to tax focused on the difference between "residence nations" and "source nations"; that is, where the corporate entity was owned (residence) and where it sourced its profits (source). The rules were designed to enhance the taxing rights of those who were based in the residence nations. These rules were also applied to the arrangements for taxing wealthy individuals. Wealthy individuals from both rich and poor nations began to place their wealth in foreign bank accounts in order to avoid the reach of their national governments.[11]

While international tax rules may be unequal, they usually do not authorize tax abuse; however, they do create opportunities for tax abuse. While tax secrecy has always been around, in the last half century it has been frequently facilitated by a network of offshore financial centers, more popularly known as "tax havens." Tax havens are legal jurisdictions offering a combination of extreme secrecy, limited regulation and low tax rates for foreign corporations and individuals. These tax havens have been achieved with bank secrecy laws designed to prevent the sharing of information about bank clients with national authorities.[12]

The use of tax havens is basically a beggar-thy-neighbor strategy. In tax havens, financial institutions achieve economic gain by offering services to foreign capital and the do so by

undermining tax laws elsewhere around the globe. The largest recipients of offshore financial wealth are Switzerland, the United States, Luxembourg and Singapore. Table 1 reveals the top 40 nations in the Financial Secrecy Index.[13]

Table 1: Top 40 Nations in the Financial Secrecy Index[14]

Rank	Jurisdiction	Rank	Jurisdiction
1	Switzerland	21	Canada
2	USA	22	Macao
3	Cayman Islands	23	United Kingdom
4	Hong Kong	24	Cyprus
5	Singapore	25	France
6	Luxembourg	26	Ireland
7	Germany	27	Kenya
8	Taiwan	28	China
9	United Arab Emirates	29	Russia
10	Guernsey	30	Turkey
11	Lebanon	31	Malaysia
12	Panama	32	India
13	Japan	33	South Korea
14	Netherlands	34	Israel
15	Thailand	35	Austria
16	British Virgin Islands	36	Bermuda
17	Bahrain	37	Saudi Arabia
18	Jersey	38	Liberia
19	Bahamas	38	Marshall Islands
20	Malta	40	Philippines

While it is generally well known that Switzerland is a major tax haven – and has been for quite some time – not as many are aware that the USA is ranked second right after Switzerland when it comes to financial secrecy. In the U.S., the largest recipient of offshore financial wealth is New York; however, Delaware is the easiest place globally to create a secretive corporate entity. It is not surprising that many global entities will register a secretive corporation with Delaware and

then deposit their funds in New York banks, where the funds will be kept secret.[15]

It should be noted Switzerland may be the largest destination for global financial wealth in terms of bank accounts. A lot of wealth is also transferred to tax havens in the form of stocks and bonds and tangible assets such as art, jewelry, precious gems and other luxury goods that are difficult to track.[16] This makes the loss of potential tax revenue even more potent.

The numbers associated with the transfer of wealth to tax havens is large. One research estimate is that $8 trillion of personal financial wealth is held in tax havens and this number is considered to be very conservative[17] (Zucman 2014). This estimate does not include tangible assets such as art, jewelry or other movable property. Other estimates of total global wealth held in tax havens are $32 trillion and implies that about 20% of total global wealth is held in tax havens.[18]

Meanwhile, the percentage of total global wealth transferred to tax havens is higher for Africa. The estimate is that Africans hold $500 billion in offshore financial wealth, which amounts to 30% of all financial wealth held by Africans and once again, this is a conservative estimate. The fact that there is mounting evidence of massive sums of foreign wealth transferring into global property markets, often through shell companies, makes this higher percentage more plausible.[19]

So how much tax revenue is lost by African governments? There are studies that assume that about 80% to 95% of offshore wealth remains unreported to governments, which means that financial returns such as capital gains, dividends and interest go untaxed by national governments. Estimates are that African governments lose about $15 billion to

$45 billion annually in tax revenues.[20] This has led to a globalization-induced tax revenue loss.

IV. CONSEQUENCES OF THE GLOBALIZATION-INDUCED TAX REVENUE LOSS

The globalization-induced tax revenue loss (GTRL) permanently reduces the revenue supply from longstanding sources, such as tariffs and income taxes.[21] As expected, the first big shock for developing nations occurred in the 1990s, immediately after initial trade reforms and World Trade Organization accession. On average, trade increased by 24 percent while trade tax revenues fell by 40 percent between 1990 and 2010.[22]

This GTRL poses serious challenges for developing nations. In addition to losing important tax revenue sources, overall revenue levels in developing nations have always been suboptimal. They have hovered around 22% of gross domestic product compared with 33% of developed nations. This has led developing nations to implement deficit spending policies, which have decreased the quality of public goods and services.[23] The United Nations Conference on Trade and Development estimates that achieving the Sustainable Development Goals requires developing nations to raise their current tax/gross domestic product ratios by close to 4 percentage points.[24]

Nations such as the Philippines, Nicaragua and India have made great progress in global market expansion but minimal improvements in tax revenue.[25] In particular, undeclared revenue is costing India billions of dollars. The informal Indian economy is very extensive and paid mostly in cash; therefore, it is difficult to tax. One report suggests that the

informal Indian economy is 23 percent of its gross domestic product for a total of over $270 billion.[26]

In order to recover some of the lost tax revenue, India launched tax amnesty schemes and a widely criticized "demonetization," where 500- and 1,000-rupee notes were removed from circulation with no warning, just to uncover this untaxed revenue.[27] According to the Indian government, under one amnesty program, nearly 700,000 people were contacted and offered immunity if they came forward and paid the appropriate taxes and penalty. Included among those who came forward were Mumbai street food vendors who declared almost $7.5 million in untaxed assets. Within 4 months of this amnesty, 64,275 declarations were made according to the Indian finance minister, Arun Jaitley. This amnesty unearthed $9.5 billion in undeclared income but this isn't much considering the size of the informal Indian economy.[28]

Then again, not all developing nations are suffering from the GTRL. Government revenue levels appear to be rising in a subset of developing nations that includes China, Tunisia and Morocco. This group of developing nations show improvements in trade and total revenue.[29] How are these developing nations doing this? Recovering from a GTRL requires the successful generation of domestic tax revenues so how are these developing nations doing that?

V. THE CHALLENGE OF DOMESTIC TAX BARGAINING

The GTRL, which struck the hardest in the 1990s, requires governments to immediately replenish their domestic treasuries. If free global trade can't increase the tax revenues of

many developing nations, then what can? The answer is domestic tax reform.

A lot of developing nations have been facing obstacles substituting their tariff (trade tax) revenues with domestic tax revenues. On average, low- and lower- middle-income nations lost 2.83% of gross domestic product in trade tax revenues while gaining only 2.4% of gross domestic product from domestic tax revenues. Overall, the marginal increases in domestic taxes in many developing nations have been unable to offset the loss of trade tax revenues over time.[30]

When it comes to tax revenue policy, today's developing nations are facing an entirely different set of circumstances than their predecessors did. Today's developed nations faced a different state of affairs when they abandoned trade taxes in the 19th century. These developed nations had greater latitude to implement tax reforms both domestically and globally. They adopted tax reforms in response to their own domestic calculations, rather than to external pressures from other nations. Today's developed nations had strong state capacity, a more advanced tax bureaucracy and an abundant supply of public goods; therefore, domestic tax bargaining was more expedient for them.[31]

Another distinction is that today's developed nations had strong capacity to tax before they became democracies. In pre-modern Europe, the powerful authorities imposed and enforced tax compliance before the establishment of representative institutions. The authoritarian capacity to tax existed prior to effective tax bargaining in developed nations. This is different from today's developing nations that are trying to democratize and impose domestic taxes all in the face of inefficient state capacity.[32]

In political science, a generally accepted premise is that leaders are incentivized to remain in power.[33] The difference across regimes depends on how adept leaders are at retaining power while pursuing goals, such as implementing unpopular tax reforms in the face of globalization. Democratic leaders depend on voters.[34] Non-democratic leaders basically need to satisfy a small group of loyal resource-providers, which they do with tax breaks and exemptions. Of course, nondemocratic leaders must also prevent the general population from rebelling against the needed tax reforms.[35]

VI. THE UNDERMINING OF DEMOCRACY

In general, leaders have two main strategies for overcoming the public's resistance to taxes: (1) quasi-voluntary compliance; and (2) coercion.[36] Taxpayers are more likely to pay taxes when they are confident in their leaders and believe that the tax system is fair. The taxpaying public is confident in their leaders when the leaders deliver their promised benefits such as solid infrastructure and public goods. Simply put, taxpayers support higher taxes when they receive competent government services. It is quasi-voluntary compliance because the choice to comply is backed up by enforcement and/or the expectation that others will also comply.[37]

When leaders can't provide competent government services, the taxpayers are less likely to pay taxes; therefore, quasi-voluntary compliance becomes more difficult to achieve. When leaders can't collect taxes through quasi-voluntary compliance, they may have to resort to coercion, which undermines democracy.[38]

There are two basic nondemocracies: (1) liberal authoritarian regimes and (2) conservative authoritarian

regimes.[39] Dictators in liberal regimes usually coopt opposing groups by offering some social benefits in exchange for higher taxes. Dictators in conservative regimes usually don't cooperate with the opposition and engage in coercion to prevent rebellion.[40]

When taxpayers feel that a new tax policy is no longer in their favor, quasi-voluntary compliance unravels.[41] During the recession of the early 1990s, many governments simultaneously levied new taxes on businesses. But with more global competition and tax havens, businesses were well positioned to demand tax cuts. Businesses with fewer resources in particular demanded tax decreases in order to stay afloat.[42]

When a nation has fewer resources to bargain with, quasi-voluntary compliance tends to unravel immediately. During a 2013 nationwide protest in Brazil, 26-year old Jairo Domingos said, "They don't invest in education, they don't invest in infrastructure, and they keep putting makeup on the city to show to the world that we can host the World Cup and Olympics," referring to the 2014 World Cup and 2016 Olympic Games. "We work four months of the year just to pay taxes and we get nothing in return."[43] When citizens have low confidence in their government, collecting much-needed domestic tax revenue becomes an extreme challenge.

When a nation needs more tax revenue after a revenue shock and quasi-voluntary compliance is a challenge, an alternative means of collecting tax revenue would be through state coercion.[44] Coercion can be implemented through specific forms such as passing tax laws by executive decree, harsh penalties for tax evaders and collectors and even the use of arbitrary and extreme punishments.[45] For example, tax collectors have been executed in China for accepting bribes in exchange for tax evasion.[46]

Empirical analysis suggests that authoritarian nations are more effective than democratic nations in raising domestic revenue after trade tax liberalization.[47] Bastiaens and Rudra (2018) examined the changes in trade tax revenues and domestic tax revenues in 133 developing nations between 1990 and 2012.[48] The results are summarized in Table 2:

Table 2: Effect of Declining Trade Tax Revenue on Domestic Tax Revenue[49]

Type of Government	***Empirical Results***	***Interpretation***
Democracies	Decrease in trade tax revenue leads to decrease in domestic tax revenue	Unsuccessful domestic tax revenue reform as citizens resist higher domestic taxes
Nondemocracies	Decrease in trade tax revenue leads to increase in domestic tax revenue	Successful domestic tax reform generates higher tax revenue as governments overcome citizens' resistance to higher domestic taxes

Compared to democracies, nondemocracies show consistent improvement in collecting goods and service tax revenues after trade taxes are liberalized.[50] When trade taxes are reduced or even eliminated, democracies face an uphill battle when it comes to replacing the lost trade tax revenues with the collection of more domestic tax revenues. This can destabilize democracies, particularly in developing nations.[51]

Nondemocracies in developing nations have two advantages when it comes to governance. One, they can impose unwanted reform on the population and enforce it by severe punishment.[52] Two, they don't need to win the confidence of the entire population; they only have to win and maintain the confidence of a small group of loyalists by providing loopholes,

subsidies or other exceptions to the law. Furthermore, nondemocracies can buy support from external groups as well.[53]

Democracies in developing nations are limited in dealing with taxpayers who resist higher taxes, especially when those taxpayers don't believe that the democratic governments will use the tax money in an effective way. Democratic governments can't use fear and coercion to impose tax reform on the population and catering to internal as well as external elite groups will only make things worse.[54] When the citizens of democracies have low confidence in their governments, they are more likely to rebel against these governments and this rebellion could range from tax evasion to protesting and ultimately, to the removal of the democratic leaders.[55]

VII. CONCLUSION

While academics have been arguing that tax revenue is the foundation for a democratic society, little attention has been given to how global tax policies affect democracies around the world. More research is needed to examine how global tax liberalization affects the domestic tax collection systems in sovereign nations, particularly those with developing economies.

Recent research suggests that when trade taxes (tariffs) are liberalized, nondemocracies do a better job than democracies do of replacing the lost trade tax revenues with domestic tax revenues. Since democracies can't easily coerce the population into accepting the imposition of more taxes, they may be undermined by the loss of trade tax revenues, especially when the population has low confidence in their democratic leaders.

The so-called global tax policies have largely been created by the richer and more powerful nations so eliminating global trade taxes favors the wealthier nations at the expense of

the poorer nations. Before implementing a global tax policy, the global creators should consider how the policy will affect the democracies in developing nations. Any global tax policy that places democracies in danger should not be implemented because when democracies are in danger, global stability could wind up in danger as well.

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