

Globalization, Tax System, and the Architecture of the Global Economic System

by

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I. Introduction

Modern tax systems developed largely in the period between 1930 and 1960 when there were: (a) major restrictions on trade erected at the time of the Great Depression and during World War II and its aftermath; (b) limited capital movements; (c) little cross-country investment and, consequently, a limited role for multinational enterprises; (d) little international mobility of people except as emigrants; and (e) almost no cross-country shopping by individuals. During these decades, the tax burdens of most countries were relatively low because governments had not yet assumed many social and economic responsibilities that they would assume in later years and especially in the period after 1960. The tax burdens were generally lower than 30 percent of the industrial countries' gross domestic products (GDP) and half that level in developing countries. For example, in Brazil, where in 2004 the tax burden would exceed 36 percent of GDP, it was less than 16 percent of GDP before 1961.

Between 1930 and 1960 two important "technological" innovations were introduced in the tax area. They would have a great impact on the tax systems of most countries. These were: (a) the introduction and the affirmation of the concept of the "global and progressive" income tax; and (b) the introduction of the value added tax. The first of these developments would be especially significant in industrial countries. The second would be significant in all

countries. In later years these two developments contributed a great deal to the rise of tax levels which in many OECD countries exceeded 40 percent of GDP. Of course, some incomes had been taxed for a long time in various countries. For example, wages, presumptive profits, or rents from properties (imputed or not) had been taxed separately with low and proportional rates. This was the “schedular approach” to income taxation that had been popular in some of the continental countries of Europe. A century ago, De Viti De Marco, had argued that, for various reasons (facility of evasion for some forms of income, differential efforts required to earn the income, durability of income flows, different costs of earning incomes), the rates that were applied proportionally to the various income categories (the schedules) should be differentiated among them.

In a very influential book published in 1938 Henry Simons, a professor at the University of Chicago, made a strong case for taxing all sources of income of individuals as a whole (the global income) and for taxing this total with progressive rates. This approach, it was argued, would better satisfy equity considerations. Coming during the Great Depression and soon after the New Deal (and just before World War II) this tax became very popular in the United States where the “global income tax” helped finance the Second World War. The concept was exported to other countries, and in the 1950s and 1960s, American tax consultants were active in trying hard to promote this tax in developing countries.

The value added tax originated in France and is, thus, a European invention. This tax replaced the turnover (cascade) taxes on transactions that had existed in many European countries including the six members of the Coal and Steel Trade Community. It was welcomed by the members of that Community, because it allowed the zero-rating of exports and the imposition of imports without discord. The countries were thus free to impose the tax rate they liked or needed without interfering with trade flows. This feature made the value added tax welcome in countries that formed part of customs unions. The value added tax has proven itself to be a major revenue source for all countries.

In industrial countries, the two developments mentioned above, added to the taxes on labor income levied to finance pensions (the so called “social security contributions”), made it possible for the tax systems of many countries to finance the large demands for public revenue that the growing functions of government, especially in the so-called welfare states, were creating.

II. The Growing Role of Globalization

In recent decades and especially since the 1980s, important developments have been changing the economic landscape that had characterized earlier decades. These developments have potentially great implications for tax systems. The most important among these developments are:

- (a) The opening of economies and the extraordinary growth of international trade. World trade has been growing at a rate double that of world GDP so that the world economy is now much more integrated than it was in the past.
- (b) The growth in trade has been accompanied by a phenomenal increase in cross-border capital movements. This increase has been promoted by the removal of obstacles to capital mobility imposed by policy and by technological innovations such as powerful computers and the Internet that have made communication cheap and rapid. Therefore, there has been an extraordinary growth in the amount of capital that now crosses frontiers on a daily basis, to finance direct investment, to feed portfolio investments, to cover current accounts imbalances, and to provide needed currency to travelers.
- (c) The importance of multinationals has grown enormously both in the financing of direct investment or in promoting trade among parts of the same enterprises located in different countries. Time is long past since most enterprises produced and sold their output in the same country or region where they were located. Trade among related parts of the same enterprises located in different countries

has become a large part of total world trade. This trade creates special problems for the tax authorities.

- (d) These international activities, accompanied by higher per capita incomes, falling costs of transportation, and policy changes have led to a high mobility of individuals, either in their role as economic agents or as consumers. A large and increasing number of individuals now earn all or parts of their incomes outside the countries where they have their official residence. Also a large and increasing number of individuals spend part of their income outside the countries where they live.

The implications of these developments for the countries' tax systems are not yet fully understood by policymakers or economists. However, there is increasing evidence and much theory to suggest that the developments described above are creating major difficulties for the tax administrators of some countries and opportunities for those of others. Because of these developments, a country's potential tax base is now no longer strictly limited by that country's territory, but, in some sense, it has extended to include parts of the rest of the world. A country can now attract and tax: (a) foreign financial capital; (b) foreign real capital in the form of foreign direct investment; (c) foreign consumers; (d) foreign workers; and (e) foreign individuals with high incomes, including pensioners. These possibilities are fueling 'tax competition' among

countries. Tax competition implies that, to some extent, a country's tax burden can be exported. A country, and especially a small country, may now be able to "raid" the tax bases of other countries in a way that was not possible in earlier times. Like the ocean and the atmosphere, the "world tax base," is becoming a kind of "commons," a common resource that all countries can try to exploit to their advantage. As of now there is no global institution that, like a government, can establish some rules to regulate this competition. The process is so far very messy and clearly incomplete.

Tax competition is in part related to the importance of taxation for location. By lowering the burden of taxation, on some sensitive activities, tax competition aims at making a particular location (say Ireland or Lichenstein) more attractive than other locations for those activities. The attraction of a location depends on several elements such as: (a) nominal or statutory tax rates; (b) tax burdens, that is the ratio of taxes to gross domestic product (GDP) or to other specific tax bases (profits, sales, payroll, etc.); (c) tax practice (administrative and compliance costs); (d) predictability of the tax system, or "tax certainty" over time to limit time consistency problems; (e) legal transparency, that is clarity of the tax laws; (f) use of tax revenue, that is the services that the residents or the enterprises get from the government in exchange for the taxes paid; (g) fiscal deficits and public debt, because these may forecast

tax increases in the future; and more generally, (h) the economic or investment climate of the country.

Ceteris paribus, a low level of taxation can attract business activities and financial capital, or even consumers or pensioners, to a particular location by making it more attractive to them from a tax point of view. However, the ceteris paribus assumption often does not hold. There are other elements that can neutralize a low tax level. For example, the predictability of the tax system and compliance costs are important elements. The “tax climate” of a particular location can influence: (a) the amount of investment in that location and the choice of investment; (b) how that investment will be financed; and (c) the legal form that the enterprises will choose.

When people face high tax rates or an unfriendly tax climate in today’s environment, they may: (a) “vote with their feet,” thus moving to a friendlier tax environment as long as the ceteris paribus condition holds; (b) “vote with their portfolio,” by sending their financial assets abroad, to safer and lower taxes jurisdictions; (c) remain in the country, but exploit tax avoidance opportunities, and (d) engage in, or increase, explicit tax evasion. Tax competition is making it easier to engage in all these options.

Tax competition is creating frictions and diplomatic problems between countries and between groups of countries. It has been a hot topic: (a) within the European Union; (b) between some countries of the Union and Switzerland;

(c) between the European Union and the United States; (d) between China and Europe and the United States; (e) between the Caribbean countries and OECD countries; and so on. Clearly it is slowly poisoning the diplomatic environment.

A question often raised is whether tax competition is ultimately a positive or a negative global development. Should policymakers welcome it or not? On this question views diverge sharply. Some and especially theoretical economists and those with a public choice bent, for several reasons, tend to see it as a beneficial phenomenon. On the other hand, ministers of finance, directors of taxation and policy-oriented economists often tend to see it as a problem. Minister of finance of France, Germany and Italy have at times been sharply critical of this phenomenon.

The arguments in favor of tax competition are the following:

- (a) It forces countries to lower their high tax rates especially on mobile tax bases, such as financial capital, highly skilled workers, and so on. The very high rates on these incomes that had been applied in previous decades would be impossible today. Theory has taught us that lower tax rates imply lower welfare costs. Thus, they contribute to more efficient economies.
- (b) By reducing total tax revenue, tax competition would force governments to reduce inefficient public spending. Several studies have shown that in some countries public spending is very

inefficient. This “starve the beast” theory was favored by, and made popular during, the Reagan Administration.

- (c) It allocates world savings toward areas where, it is claimed, the savings are used more productively. This was a common claim made by representatives of the U.S. government in the first half of the 1980s and in recent years.
- (d) Because of lower tax revenue, it may force policymakers to rethink the economic role of the state, to make it more focused and efficient.
- (e) It leads to a tax structure that is more dependent on immobile tax bases. Economic theory considers the taxation of these bases less distortional for the economy.

Naturally against these arguments, that favor tax competition, there are others that find it damaging. The main ones are the following.

- (a) Because public spending may be politically or legally inflexible downward, especially in the short run, tax competition can lead to increased fiscal deficits and high public debts.
- (b) When governments are forced to cut public spending because of revenue reduction due to tax competition, there is no assurance that they will cut the inefficient part of public spending. Inefficient spending may have strong political constituencies that protect it.

- (c) Tax competition may lead to “tax degradation” because government may try to maintain public revenue by introducing bad taxes to replace lost revenues; or it may replace public spending with inefficient public regulations recognizing that at times regulations can be substituted for spending..
- (d) The shift of the tax burden from mobile factors (such as financial assets and highly skilled individuals) to immobile factors (largely labor income) will make the tax system less fair and may increase pressures for redistributive public spending.
- (e) The increased taxes on labor income obtained from employment in the official economy are likely to stimulate the growth of the underground economy and, as a consequence, the growth of tax evasion and different kinds of distortions.
- (f) Tax competition (and reactions to it) could make tax administration and tax compliance more difficult. It could also reduce the predictability of the tax system of specific countries, thus affecting negatively the investment climate.

In a quantitative sense, it is still difficult to identify fully the impact of globalization on tax revenue because that impact is, so far, not strong or obvious in terms of total tax revenue. But closer observation reveals effects that point to potential future difficulties:

- (a) For example, in OECD countries, where the ratio of tax revenue to GDP had in earlier decades grown at a significant pace, that ratio stopped growing in more recent years even though large fiscal deficits called for higher revenue. Furthermore, in an increasing number of OECD countries, the average tax ratio has started to fall.
- (b) The rates of both personal income taxes and corporate income taxes have been reduced substantially in most countries, in part because of tax competition.
- (c) The rates of excise taxes on luxury products have been sharply reduced in most countries leading to substantial falls in revenue from these taxes. These reductions are in part the consequence of the increased foreign travel by taxpayers and the possibilities that it offers for shopping in places where excise taxes on expensive items are lowest.
- (d) The “global income tax,” that had been very popular among tax experts and that, for many years in the 1950s and 1960s had been considered the “fairest” of all taxes, has been losing popularity. A progressive return to a schedular tax system, that makes a distinction between taxes on labor (a non-mobile factor) and taxes on capital (a mobile factor), can be observed. The dual income taxes introduced

by the Scandinavian countries and by some other countries are an example of the losing attraction of global income taxes.

- (e) There is a growing interest in flat rate-taxes and several countries (Russia, Ukraine, Estonia, Latvia and some others) have introduced such a tax while other countries (Belarus, Georgia, Guatemala, the Kyrgyz Republic, El Salvador, Paraguay and Poland) have been considering its introduction. In the United States, there is also increasing talk of replacing income taxes with “consumption taxes.”

III. The Rise of Fiscal Termites

In several papers written over the past few years, I have discussed the rise of “fiscal termites.” These “termites” result from the interplay of globalization, tax competition and new technologies. Like biological termites, fiscal termites are weakening the foundations of current tax systems. They are making it progressively more difficult for countries to maintain high levels of taxation. Evidence of them is almost seen daily. I will list only some of these termites without much elaboration. For more elaboration see Tanzi (2001).

The first of these termites is Electronic Commerce. Electronic commerce has been growing at a fast rate both within countries and among countries. It has been growing for consumer goods and services, as well as for trade in inputs of

intermediate and capital goods. Its growth has been accompanied and facilitated by the growing shift, in the countries' gross domestic products, from physical to digital products. This kind of commerce leaves fewer traces than the previous invoice-based commerce and is much more difficult to tax. The growth of electronic commerce is creating enormous difficulties for tax administrators as well as for legislators who seem to be at a loss on how to deal with it.

A second termite is Electronic Money (credit cards, bancomat, other cards). Progressively real money is being replaced by electronic money embedded in chips of electronic cards. A "purse" software may be purchased especially through deposits in foreign banks or even from secret bank accounts. This makes it difficult to trace and to tax various transactions.

A third important termite originates in transactions that take place between different parts of the same multinational enterprises (i.e., Intra-Company Transactions). Since these transactions are internal to a company they require the use of "transfer prices" that is of the prices at which one part of the enterprise located in a given country "buys" products or services from another part of the same company located in another country. These different parts of a multinational company are obviously located in countries with different tax systems and different tax rates. Furthermore, the products or services bought may not be traded in the open market, so that they may not have a market or "arm's length" price that can be used as a reference. These are almost like transactions

between members of the same family. Some items may have just family values and family prices. Problems arise especially (a) with inputs that are made specifically for a final product (say a particular jet plane). There may not be an arm's length price established by the market for these products; (b) with use of copyrights, trademarks and patents for which a value must be assessed; (c) with the allocation of headquarters R & D costs; (d) with interest on loans made from one part to another part of a multinational corporation for which a determination of a market rate is difficult. The determination of these costs or of the prices of the goods and services traded within the enterprises is often difficult and arbitrary. It lends itself to manipulations by the enterprises aimed at showing more profits in those countries (such as Ireland), where taxes on enterprise profits are low and less profit in countries such as Germany and Italy, where the taxes on enterprises are high. The strategic use of "transfer prices" by enterprises can significantly reduce the total taxes paid by multinational enterprises.

Another termite is the existence and the rapid growth of off-shore financial centers and tax havens. Various studies have estimated the total deposits in these tax havens at levels that may approach the annual GDP of the United States. The distinguishing characteristics of these tax havens are: (a) low tax rates to attract foreign financial capital; (b) rules that make it difficult or impossible to identify the owners of the deposits in these countries; (no name accounts, banking secrecy, etc); and (c) lack of regulatory powers and of information on those

deposits on the part of the countries where the real owners of the deposits reside. These tax havens allow individuals and enterprises from the countries where the capital originates to receive income in ways that make it difficult for national authorities to tax them.

Still another termite consists of new, exotic and complex financial instruments that continually enter the financial market. The day is long past when a normal citizen could understand, and easily choose from, the financial instruments in which he/she invested savings. New financial instruments, such as various categories of derivatives, are far more complex. Many of these new instruments are specifically designed to avoid (if not evade) paying taxes. As a consequence, it is more and more difficult for the employees of tax administrations, who have a normal training and modest salaries, to keep up with these developments. Just think how difficult it must have been for the tax authorities to determine the income of Parmalat and Enron.

Increasing foreign activities of individuals, both as workers and as consumers, are also creating difficulties for national tax administrations. Incomes earned abroad are often not reported to the national or home country tax authorities. Foreign travel allows individuals to buy expensive items (jewelry, cameras, etc.) in countries where excise taxes are lower. Competition for mobile consumers has encouraged some countries, and especially small countries, to lower these excise taxes in order to attract foreign consumers. Airports have

become huge shopping centers. The consequence of these trends is, once again, greater difficulty for many countries to raise the high tax revenue that they raised in the past.

In addition to the termites mentioned above, there are other developments that would merit to be added to the above list. Furthermore, it is possible that some of the above termites may combine or mutate to create even greater difficulties. These developments will, over the years, have a progressively larger impact on: (a) tax revenue; (b) tax structures; and (c) the use of particular tax bases. The net result will be a world with lower tax revenue and different tax systems. It would be wise for the governments of many countries to anticipate these developments and take the necessary compensating actions.

IV. Need for a New Global Architecture for Tax Systems

The previous discussion has called attention to the growing gap between the tax systems that the policymakers of some countries might wish to have and those that global forces are forcing them to adopt. For a growing number of countries the latter are less now, or will soon be, capable of generating the same level of tax revenue as in the past. These countries will be forced to scale down the economic role of the state, at least as that role is manifested through public spending. Many observers, including myself, would feel that this reduction in

public spending would be desirable but not all policymakers would agree. This is happening at a time when social global needs are becoming more urgent and visible. These needs refer to global poverty, pandemics, multicountry catastrophes, major catastrophes in poor countries, genocides and civil wars, need to eliminate atomic material that could be acquired by terrorists, environmental disasters, and so on. The cost of dealing with these social global needs are now covered through the generosity of individual governments. However these governments inevitably pursue their own political interests which may not match those of the world. And the resources made available seem to fall well below the needs. The bottom line is that some of these global social needs are not met or are met only partially.

A striking aspect of this situations, and one that goes directly to the core of the architecture of global economic and social arrangements, is that, as of now, there is no international institution charged with the surveillance of fiscal developments in the world to prevent “tax degradation” and to contain the more damaging aspects of tax competition. There is no global organization with the power to levy taxes, even if limited on activities that generate global negative externalities, so as to help in the financing of global public goods and in reducing the generation of negative externalities.

About two decades ago and then again a decade ago, I suggested that there was a need for the creation of an International Revenue Service, or perhaps a

Global Tax Organization, that could help close this important gap in the existing global economic architecture. If there were a world government, there would not be a need for such an institution because that government would deal with the problem. But, perhaps, a world government will never come into existence while global social needs are becoming more evident every day. In the absence of a world government, the international community has created various international institutions that are charged with fulfilling some of the roles that a global government would fulfil if it existed.

The role that could be assigned to a Global Tax Organization (GTO) could be a modest or an ambitious one. The more ambitious would that role be, the more difficult it would be to get the agreement of, especially, the largest countries. A modest, but still important role would be one of providing a forum where countries tax actions which have significant cross-country's implications could be debated. Thus, a modest role for a GTO would be to follow fiscal developments around the world, identify trends, collect statistics, and provide a global forum for discussion of these developments. In this modest version, the GTO would have no power to impose taxes or even sanctions against countries. Its role would be strictly one of surveillance over national tax systems to assess their international implications and perhaps to exercise some moral suasion to discourage countries from using taxes that can damage other countries. As strange as it may seem, there is now no international organization that performs this

function. A more ambitious role for the GTO would of course involve tax collection. The revenue would be earmarked for the provision of global public goods or the reduction of global “public bads.” The possibilities are many but the most defensible would be the imposition of taxes on activities that have clear cross-country, negative externalities.

Many years ago James Tobin proposed a tax on exchanges between the currencies of different countries. Over the years this so-called “Tobin tax” has attracted a lot of attention, support, and criticism. A very small tax levied on the growing and enormous tax base created by foreign exchange transactions would generate large tax revenue. A problem with this tax (and there are several problems) is that many economists do not see it as a tax on a negative externality. They do not accept the view that cross currency transactions are necessarily speculative and, thus, involve negative externalities.

An alternative that has been attracting some political backing is a tax on airplane tickets. This tax, promoted by a so-called “quintet against anger” (Brazil, Chile, France, Germany, and Spain) would tax airplane tickets and use the proceeds to fight global anger. There is no question that airplanes generate negative externalities (pollution of the atmosphere) but the link between the tax cost of the ticket paid by a passenger and the amount of pollution that his or her travel creates is very indirect at best. Thus it is easy to criticize this tax. Another alternative could be a tax on energy use, on the grounds that most energy uses

generates some negative externalities. There are other options, all with some justification and all with some shortcomings. It is also clear that any of the possible alternatives will meet the opposition of some countries. If the opposing countries are powerful, they will be able to prevent the introduction of the tax. The United States is likely to continue to have a de facto veto power on these issues.

IV. Concluding Remarks

This paper has discussed the relationship between various global trends and national tax system. It has argued that the existing tax systems were created in a period when the world was very different. Thus modern tax systems have started to reflect the effects of these global trends.

At the same time many “public goods” or “public bads” have crossed national frontiers becoming global. Thus while governments will have growing difficulties in financing their current national public needs, there seems to be no mechanism that guarantee that global public needs will receive the financing and the attention that they deserve. It is clear that the current architecture of the international economic system is deficient on two grounds. It provides no monitoring or coordination of reforms of tax systems that may impact negatively other countries. and it provides no mechanism to finance international public goods.

An option would be to create a new international organization that would be given specific responsibilities over tax developments. This responsibility might be limited to the surveillance over tax reforms with international implications; or it could extend to the collection of particular taxes with the revenue earmarked for the financing of particular public goods.

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