

Paper 4 of the Introduction to the Project "Tax Justice & Poverty"

Concepts and Context of the Project= Simplified Version

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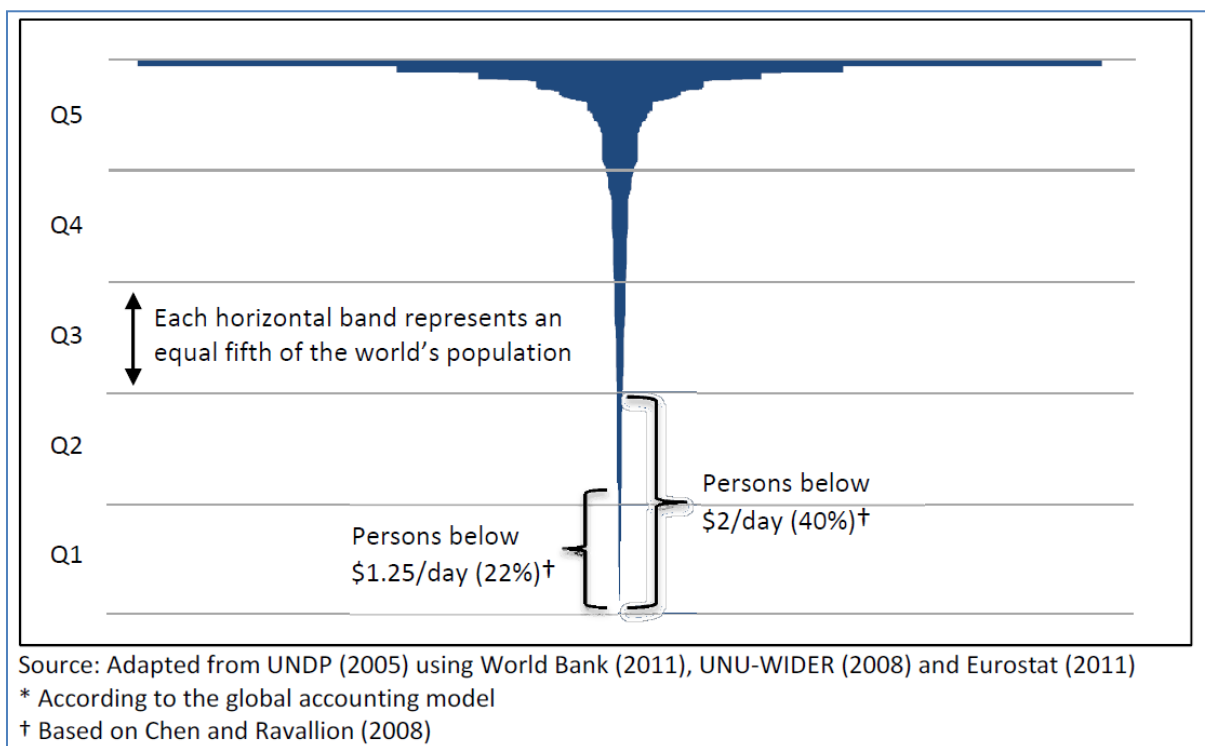
Introduction

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 researcher to (a) why we think that a growing wealth gap and persisting or growing governmental dependence on external financing exist and (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 therefore are 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 right now. Wealth, on the other hand ‘– including saving, investments and property ownership – tells us about enduring power, stability and security’ (Collins, 2012, p. 22) and, we might add, promises reliable (financial) income in future. Most people today derive income from labour, but there is also income from non-labour, such as interest from capital, shares in businesses, options, derivatives, rent from real estate or owned houses. Regarding the distribution of income, global inequality looks like this:

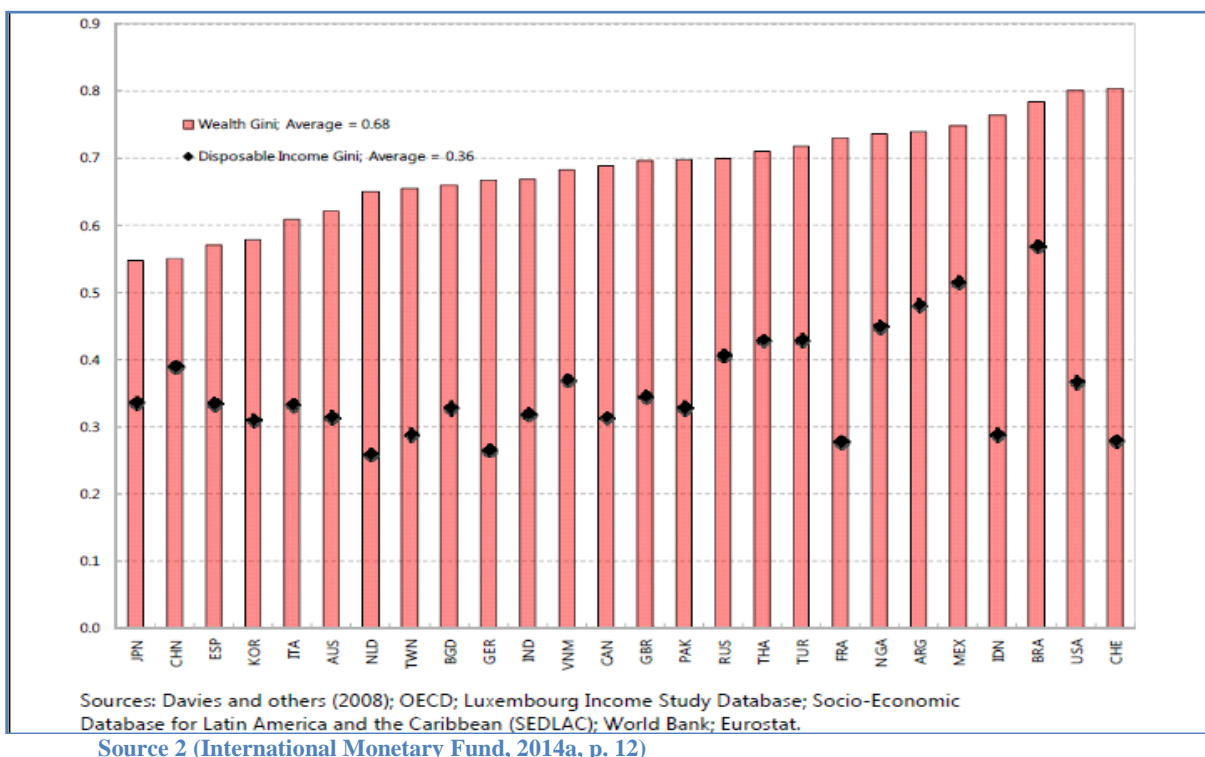
Graphic 1 Global Income Distributed by Percentiles of the Population in 2007 (or latest available)



Source 1 (Ortiz & Cummins, 2011, p. 21)

Beyond income, however, there is wealth in form of possessions e.g. houses, businesses, real estate, real property, “investment of passion” etc.; its worth is measured at market value even though you might not want to sell it at all, or even though you might not get the market price which is reflecting right now the value of it right now. Wealth-inequality is more pronounced than income-inequality alone.

Graphic 2 Inequality regarding wealth and income in selected countries



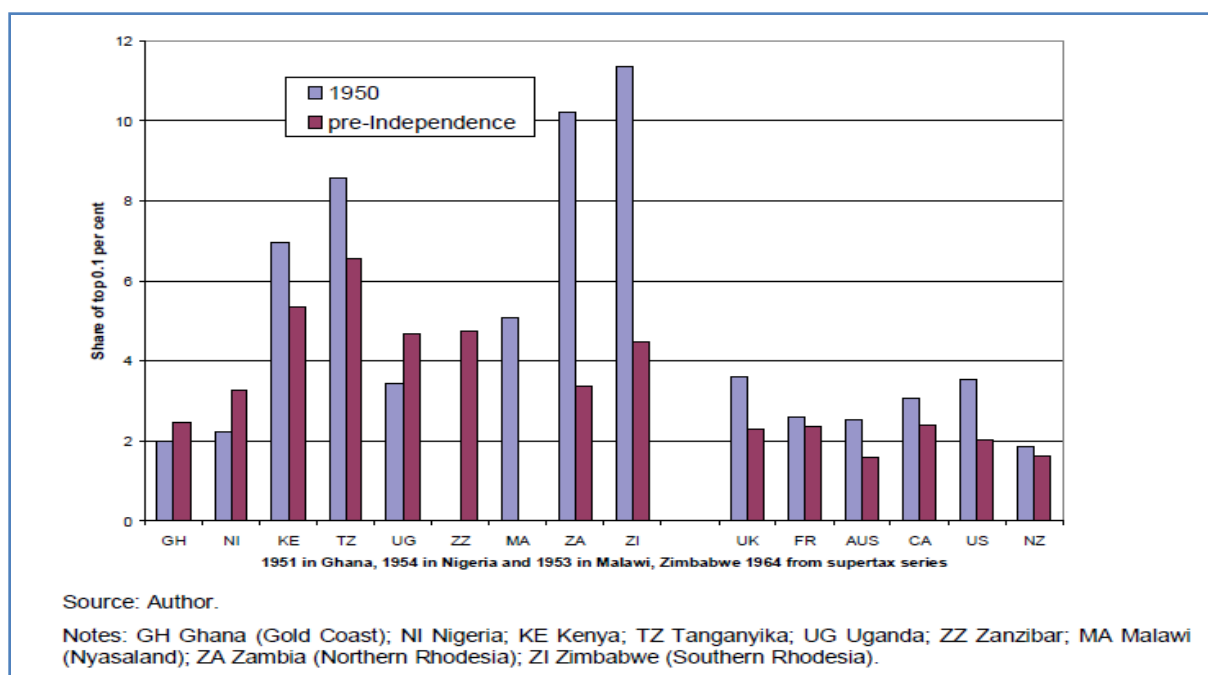
Source 2 (International Monetary Fund, 2014a, p. 12)

One needs to be mindful of the fact that the measure and extent of wealth is influenced by a number of factors which are difficult to calculate. For example currency exchange rates, development of share prices at Stock Exchanges. Equally, a lot of wealth is linked to private, corporate and/or governmental debt. However, if those debtors cannot repay loans which helped them to buy a house, a machine or a bankrupt systemic bank, then obligations are not worth their paper and whatever “wealth” there is will evaporate quickly over night.

Capturing the exact 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. But since there are at least some potential avenues to proceed in Germany, the situation in Kenya and Zambia is extremely intransparent: Even though nobody doubts that there are wealthy persons in Kenya and Zambia, the countries have hardly started to develop methods with which to capture the extent of wealth. Therefore it is much easier for the Kenyan and Zambian partners of this project to talk rather of income inequality than wealth inequality for the time being.

Here, too, the data situation in Africa is obviously not as good as for OECD states, but modern research improves the picture. As the following graphic demonstrates: Income inequality in Africa around the time of independence was even more pronounced than in Europe.

Graphic 3 Income share of the top 0.1 per cent at 1950 and year prior to independence



Source 3 (Atkinson, 2014)

Research indicates further that, while in post-independence time some policies were (successfully) applied to narrow the income and wealth gap in Africa, inequality is once more on the rise in the wake of neoliberal globalization.

There is widespread agreement among (groups of) 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 agree-

ment that this growth has been occurring faster over the past two-three decades, the reasons for which are neoliberal influences upon globalization, the importance of capital in the wealth portfolio, its use by the top global corporate and private wealth owners and the truth behind Pikettys 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. ‘Throughout most of human history, the inescapable fact is that the rate of return on capital was always at least 10 to 20 times greater than the rate of growth of output (and income).’ (Piketty, 2014a, p. 353). The following table shows the differences in average increase worldwide:

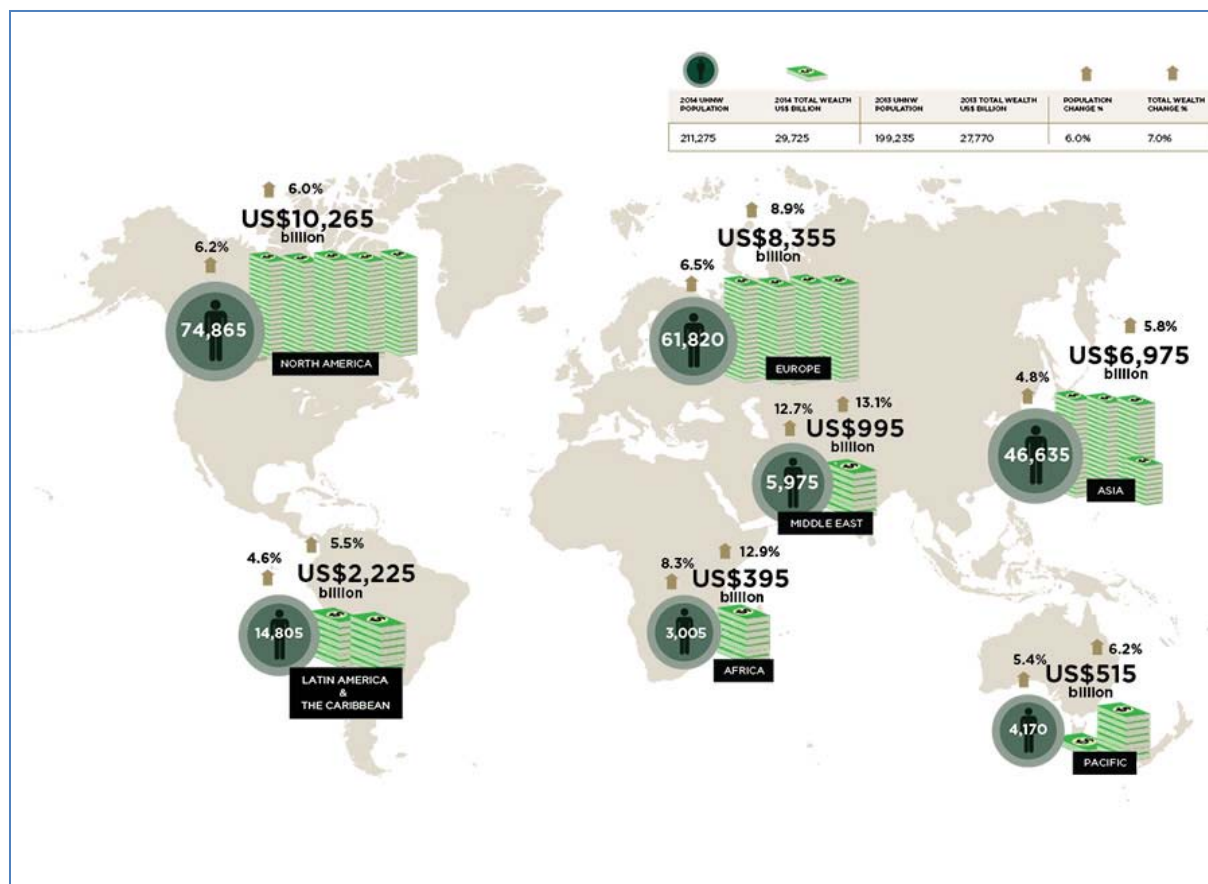
Tabelle 1 Growth of wealth 1987-2013

Average real growth rate per year (after deduction of inflation)	1987-2013
The top 1/(100 million) highest wealth holders (about 30 adults out of 3 billion in 1980s, and 45 adults out of 4,5 billions in 2010s)	6.8%
The top 1/(20 million) highest wealth holders (about 150 adults out of 3 billion in 1980s, and 225 adults out of 4,5 billions in 2010s)	6.4%
Average world wealth per adult	2.1%
Average world income per adult	1.4%
World adult population	1.9%
World GDP	3.3%

Source 4 piketty.pse.ens.fr/capital21c

Not surprising, therefore, that the number of so-called Ultra High Net Worth Individuals is rising worldwide, and in 2013, nowhere else as fast as in the Middle East and in Africa:

Graphic 4 Ultra High Net-Worth Individuals - Estimated numbers and wealth in 2013



Source 5 (Wealth-X and UBS, 2014, p. 15)

There would be no major problem in this development if the popular neoliberal hypotheses were correct that “the rising tide lifts all boats,” or “inequality has to increase first before all will profit,” meaning, that in the end the wealth gap would perhaps widen, but that de facto and in real terms the material situation of all households would be better in the end, if compared with that at the beginning. These hypotheses seem to be disproven for Europe by the OECD (2011a+2013d) and Africa (Christian Aid, 2014a). While income and wealth at household level at the top end of society is de facto rising over-proportionally and the number of millionaires and billionaires with it, income at household level at the bottom end of society is stagnating or sinking, a growing number fall into debt. This can be demonstrated best in national contexts, which will be done in the country reports of this research.

There are three more worrisome features seen in this development: first, that income and wealth are increasingly concentrated among the top 1 percent of society nationally and globally: more often than not the income of CEOs is a many hundredfold of the average worker. The US Federation of Trade Union calculated the CEO-worker pay-ratio, based on national and OECD statistical data available. Result: The wage gap between a CEO and an average worker is: In the USA 354:1, in Canada 206:1, in Germany 147:1, in the UK 84:1, in Poland 26:1.¹

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. The database developed by Thomas Piketty and his team backs up the conclusion of an emerging “patrimonial capitalism” putting people with inherited wealth wide ahead of all others: ‘People with inherited wealth need save only a portion of their income from capital to see that capital grow more quickly than the economy as a whole. Under such conditions, it is almost inevitable that inherited wealth will dominate wealth amassed from a lifetime’s labor by a wide margin, and the concentration of capital will attain extremely high levels—levels potentially incompatible with the meritocratic values and principles of social justice fundamental to modern democratic societies.’ (Piketty, 2014a, p. 26). While a CEO with “supersalary” at least does some work for his income, which can therefore be called “earned income”, we are allowed to talk here of “unearned income”, and it is this generational passing on which contributes greatly to the concentration and distribution of wealth within society.

Thirdly and as indicated already in Piketty’s quote: these developments are worrying because, along with growing wealth go increases in the influence of the few top corporate and private wealth owners over governments which then undermines democratic governance and control.

Governmental dependence on external financing

The problem in this chapter is not governmental dependence or debt as such. In certain situations acquiring credits to finance important projects or bridges in times of need is helpful and necessary. Beyond that, state bonds are a (comparatively) safe investment for private, corporate and state investors and one should further be mindful that there are many reasons

¹ See interactive website <http://www.aflcio.org/Corporate-Watch/Paywatch-Archive/CEO-Pay-and-You/CEO-to-Worker-Pay-Gap-in-the-United-States/Pay-Gaps-in-the-World>

why a state can get indebted in the first place, e.g. mismanagement by the government, which put place a fair share for the situation upon those who borrow.

However: if the need to acquire loans arises, a decisive problem is: 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 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.

The situation worsens in times of national, regional or global crises, which are triggered by the increasing volatility of the global financial system. 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 since the beginning of the neoliberal globalization, some of which are: (1) growing indebtedness because private, corporate and public households were “seduced” into taking credits when there was a lot of “liquidity” around in search for investment, (2) privatization of public services, (3) selling of public assets, (4) reducing tax revenue because of tax competition between states in the attempt to attract businesses, (5) 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 rather required public subsidies for enabling them to lead a decent and dignified life in the first place. When, therefore the sudden need arose in both developed and developing countries to intervene and stabilize the financial sector, there was hardly any way out other than financing those interventions by raising even more credits from capital markets.

Due to state intervention, the effects of crisis were not as severe as was feared in the immediate aftermath. But even though these interventions of course also rescued savings and jobs of ordinary citizens, there are indications that the wealthy profited over-proportionately not only from these interventions, but also ‘from declining overall tax burdens’ (OECD, 2011a, p. 293) due to tax competition in previous decades.

This being the case, however, it poses questions why so little was done to recover money from where it is: so far only the United States were able to recapture most of that which they spent on rescuing their financial sector while many other are seemingly unable to do so – in spite of the fact of rising private and corporate wealth soon after the crisis.

Table 2 Selected Advanced Economies: Financial Sector Support (percent of 2012 GDP)

	Impact on Gross Public Debt	Recovery to date	Impact on Gross Public Debt and Other Support after Recovery
Belgium	7.6	2.5	5.1
Cyprus	10	0	10
Germany	12.8	1.9	10.9

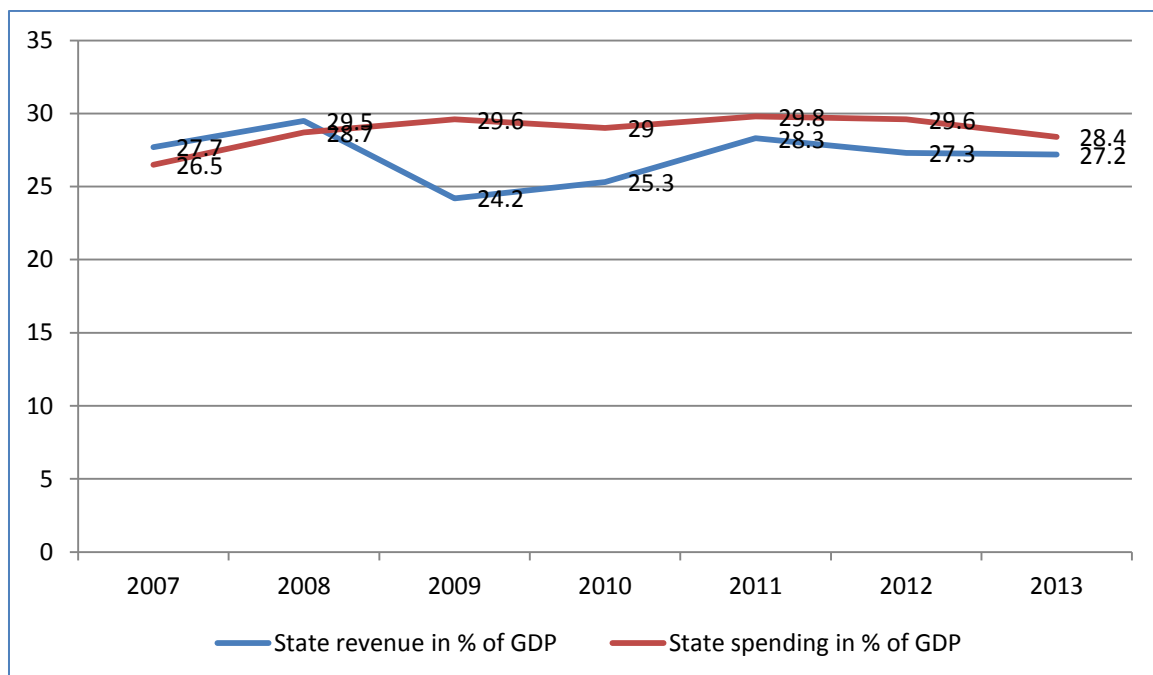
Greece	21.8	6.4	15.4
Ireland	40.4	5.7	15.4
Spain	7.6	3.1	4.5
United Kingdom	6.6	2.2	4.4
United States	4.6	4.6	0
Average	6.9	4.1	2.9
Total in US\$ billion	1,752	1,029	722

Source 5 (International Monetary Fund, 2013, p. 16)

So far, the burden and costs of the crisis were carried over proportionately by ordinary citizens: costs for labour went up, as did costs for everyday life because of increases in VAT. At the same time, no comparable changes were introduced regarding progressive taxation of income and wealth, e.g. a higher progression of taxes of income, higher taxes of corporations, capital, rents, real property, wealth or inheritances. Equally, known loopholes and weak spots assisting tax evasion and aggressive tax planning were not closed (Eurostat, 2013).

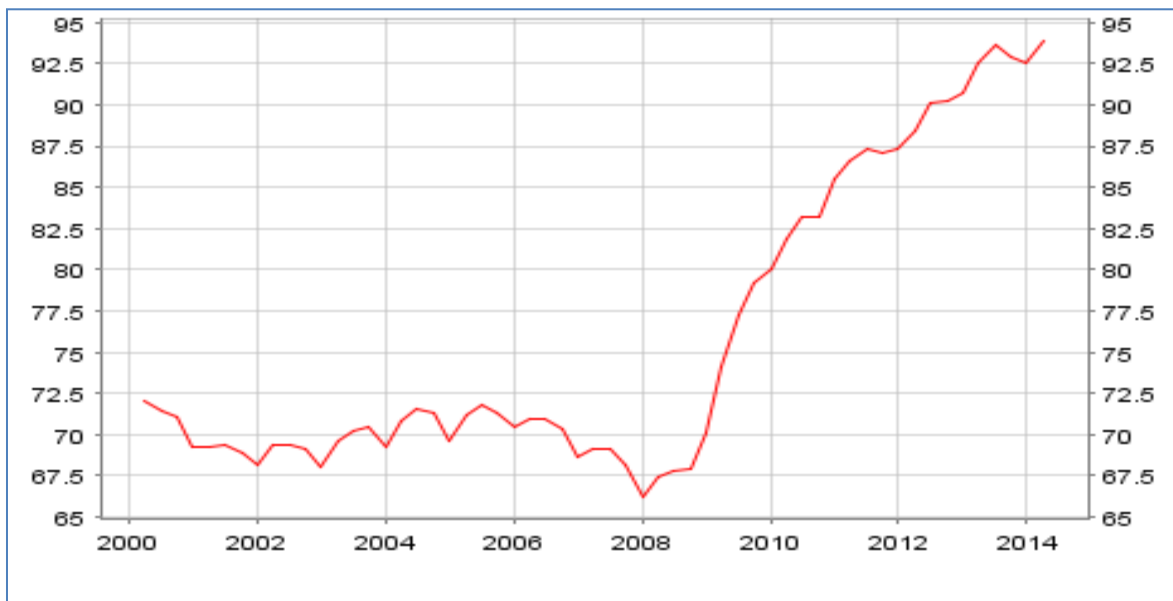
Therefore the price for public households was and is hefty. A continuing rise or persisting high levels in public debt can be stated both in sub-Saharan African and European states:

Graphic 4 Discrepancy between state revenue and state spending in sub-Saharan Africa (% of GDP)



Source 6 (Lanzet, 2013, p. 18)

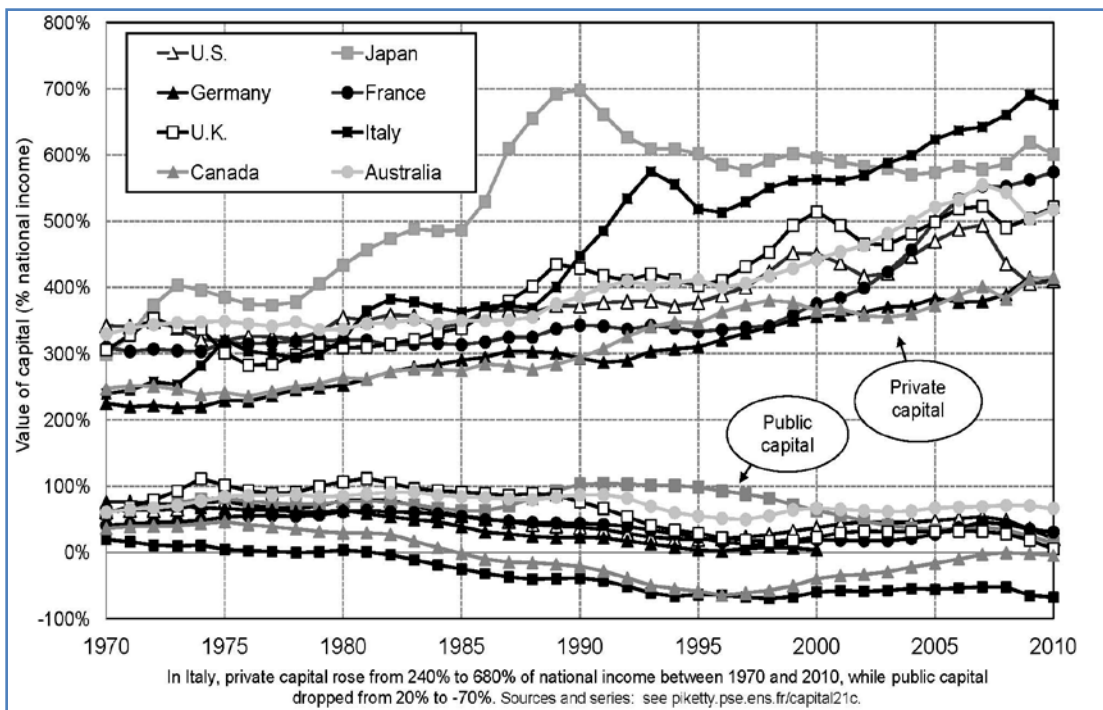
Graphic 5 Government debt of Euro Area states (as a % of GDP) ²



Obviously, when, in such a situation, it comes to the payment of interest or repayment of credits, there is, due to the lack of alternatives, a rising temptation to cut spending profiting the public and common good or programs supporting the poor.

Finally, there is an interesting parallel between the growth of private capital and the decline in public capital and, accordingly, growing public debt – which can be demonstrated at least for some OECD states:

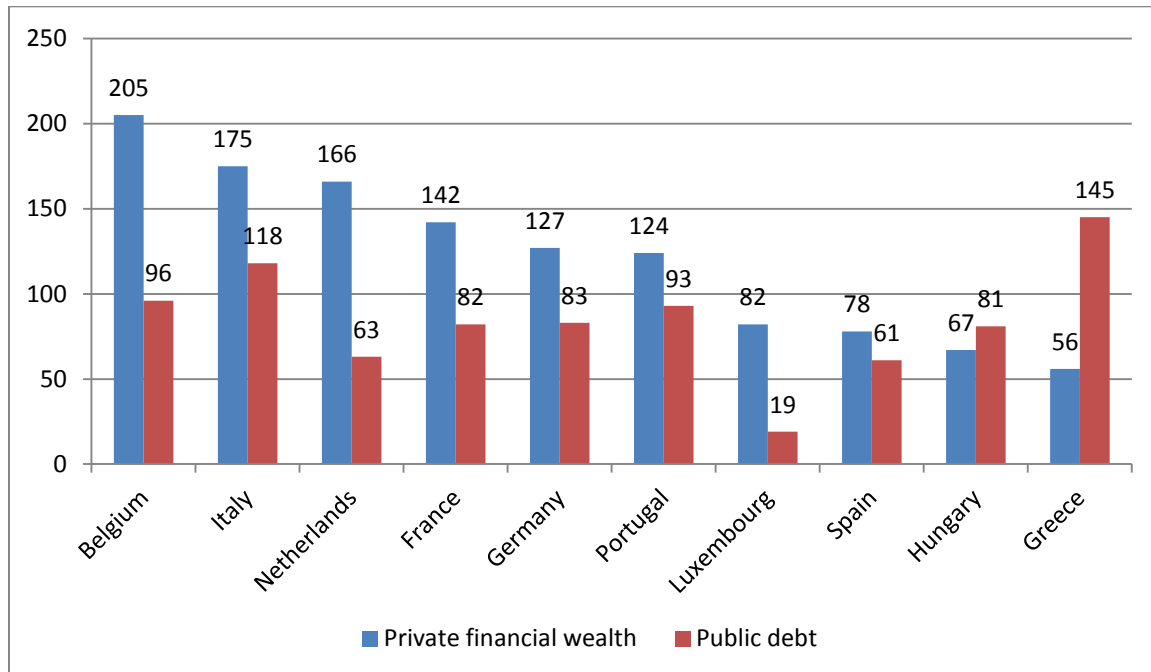
Graphic 6 Private and public capital in rich countries, 1970-2010



² Graphic found on the European Central Banks Statistical Data Warehouse. Retrieved February 23, 2015 from http://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=GST.Q.I7.N.B0X13.MAL.B1300.SA.Q&

It is because of all that that today in many states private wealth surpasses public debt several times – which is illustrated by the following graphic which compares the current state of private financial wealth and public debt in selected states:

Graphic 7 Private financial wealth and public debt in percent of GNP³



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. One obvious point is the comparative weakness of tax administrations in both Europe and in sub-Saharan Africa: all of them have problems in enforcing national tax laws internationally, especially those concerning private and corporate wealth. This results in ineffective combating of tax avoidance, tax evasion and illicit financial flows, decreasing or low levels of revenue and little money to spend on infrastructure and support of the poor.

Last not least: this research follows those who argue that, in order to understand the entire picture (i.e. the stability of the present global financial and economic system) one needs to keep private, corporate AND governmental debt in view: Due to the interconnected financial markets, default in the private sector OR corporate sector OR governmental sector can bust the entire system.

Poverty

Inequality may be high, and yet it may be possible for poverty to decrease because “due to the rising tide” income and opportunities also of the lowest tail of society might im-

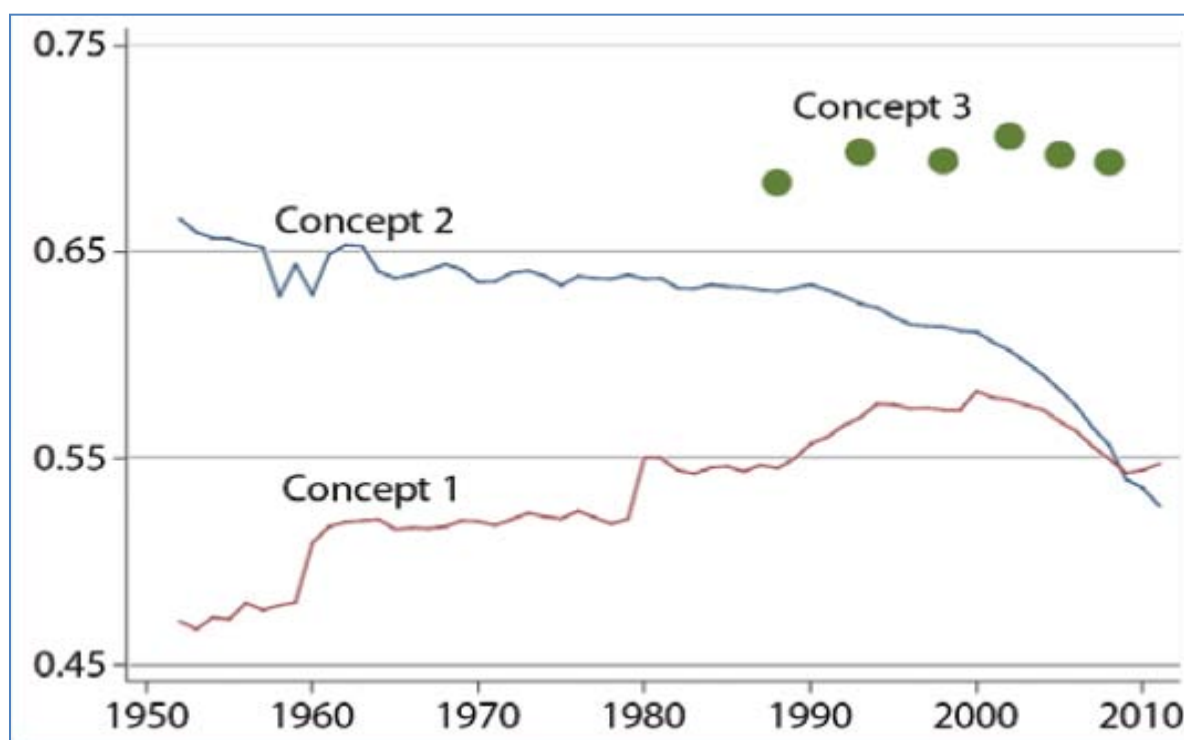
³ Based upon a graphics from Statista, which in turn is based upon data from Eurostat. Retrieved February 23, 2015 from <http://de.statista.com/statistik/daten/studie/215460/umfrage/privates-geldvermoegegen-und-staatsschulden-in-ausgewaehlten-laendern-europas/>

prove. But this is not what has happened over the past decades. The report “Humanity divided” argues that inequality does matter when it comes to understanding causes for poverty and that here is ‘a surprisingly strong empirical basis. ... This implies that, if the objective is to reduce poverty ... there is a need to track and intervene with policies to manage inequality in order to maximize rising average income and rising income of the poor.’ (UNDP, 2013, p. 55).

It is true that the course of globalization has, over the past years, increased the average GDP and average income in many countries. But: This research follows those who argue that, in order to get a realistic insight into society it is more important to see the development of actual household situations at the top and bottom deciles of national and global society. This angle of research by means of household surveys is gaining importance since the 1980s only, which is why its findings are not comparably reaching back in time as macroeconomic calculations do. But for the existing period it can be stated that worldwide poverty is remaining at high levels.

How important the method is with which inequality (and accordingly poverty) is measured can be demonstrated by presenting three different methods to establish developments of income inequality: Number 1 is based upon average income per capita, which, for example, puts progress made in India and the Maledives on one and the same level. Number two sticks with the average income per capita but takes into account population weight which gives progress made in India a greater weight than that in smaller states. Number three, however, focuses upon the development of actual income of households and leaves the development of national averages aside. Those three approaches offer very different results:

Graphic 8 Gini index of global income inequality



Source 8 (UNDP, 2013, p. 65)

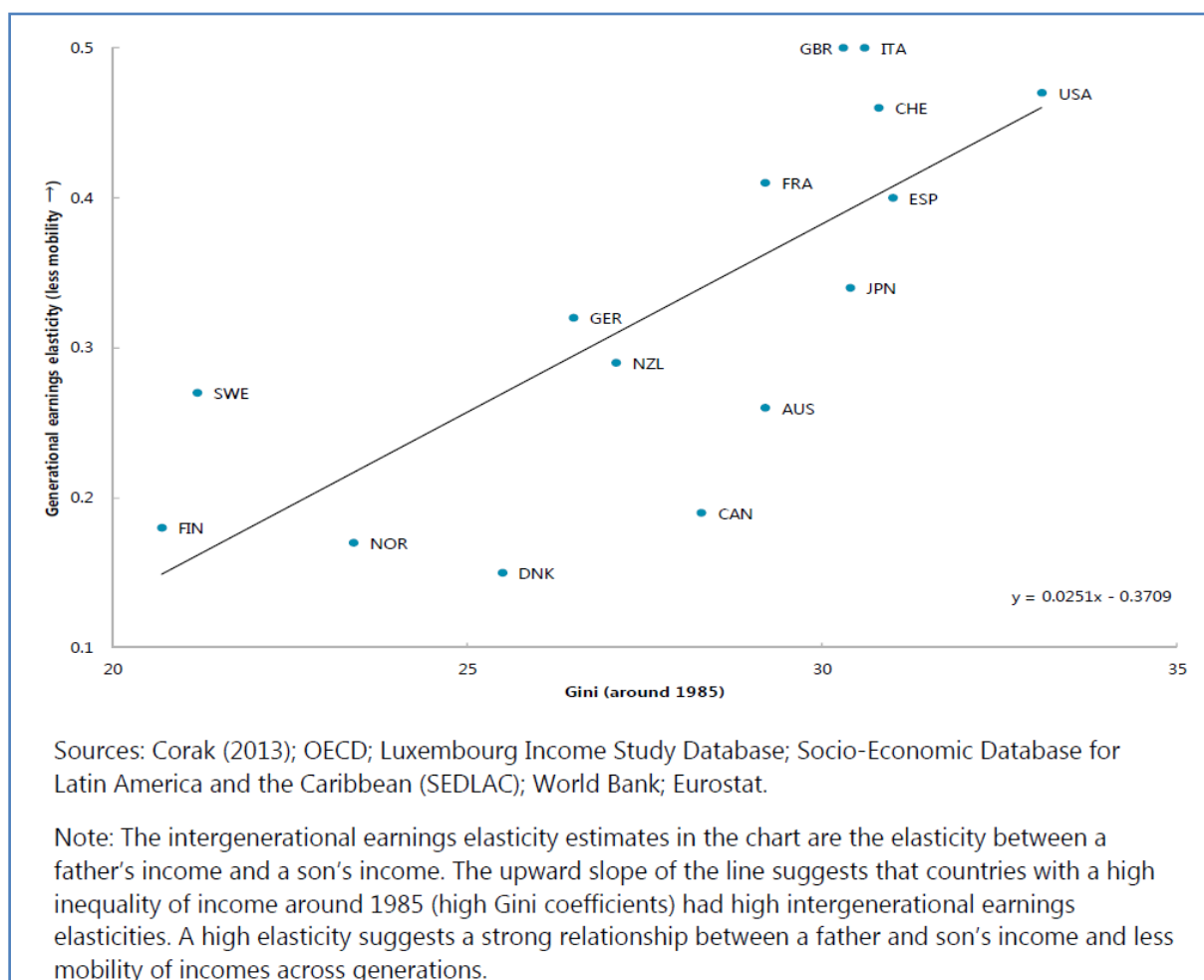
According to method 3, based upon actual household income, global inequality increased dramatically during the period of “Globalization” and is still at very high levels. This insight is shared by this research and in tune with findings of two of its three host organisations doing this research, who run own research programs on the situation of poor households by surveying developments of income and prices for so-called “basic need baskets”.

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 may belong already to the middle class this is about the wage a German worker would obtain within one hour. And 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 for OECD states and Africa that not only inequality rose, but that the situation of the poor did not improve.

Generally, this research project follows Christian Aid, Catholic Social Teaching, the UNDP and others who understand poverty along lines which have been popularized by A. Sen’s “capability approach”: ‘In this approach, development is characterised as a series of freedoms or capabilities; and poverty, by implication, is unfreedom – the deprivation of capabilities.’ It comprises personal, social, political and economic dimensions (Christian Aid, 2008, p. 3ff.).

This approach does not only look into a currently existing situation of material deprivation. It also assesses the likelihood with which a person can free itself from it. 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. The following graphic shows this interrelationship by using data from developed countries, but it is a good guess that the situation is similar in developing countries: The higher inequality, the lower social mobility.

Graphic 9 Income Inequality and Economic Mobility



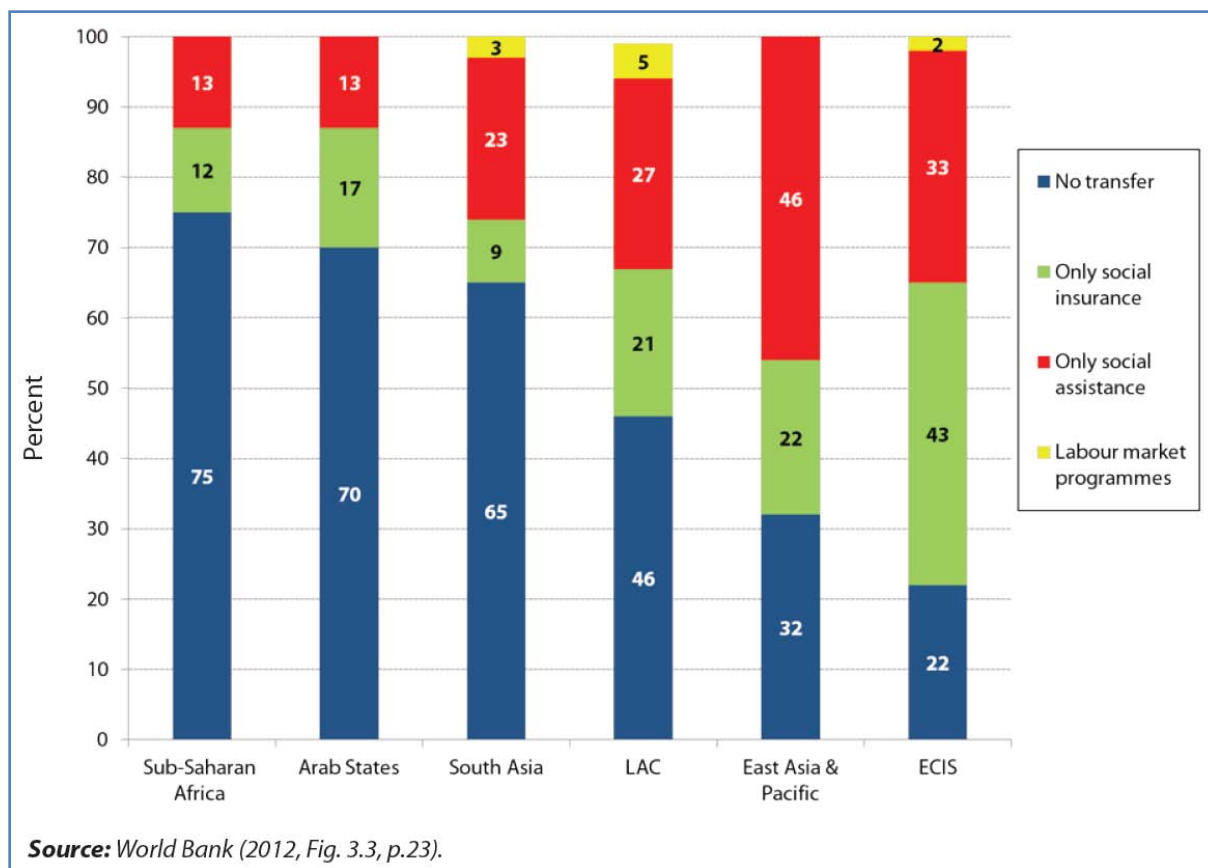
Source 9 (International Monetary Fund, 2014a, p. 14)

Important achievements of modern states are social welfare systems which, by providing assistance in cash, benefits and public services, ameliorate poverty. This redistributive effect of transfers and progressive taxation in OECD states could indeed lower inequality of around one fifth on OECD average. These systems have become less redistributive since the mid-1990s, because of a decrease in revenue, the need to re-direct revenue into areas not related to pro-poor policies and cuts in assistance to the poor, while, at the same time, numbers of those being entitled rose, which subsequently lead to changes in eligibility criteria. 'While growing market-income disparities were the main driver of inequality trends between the mid-1980s and mid-1990s, reduced redistribution was sometimes the main source of widening household-income gaps in the ten years that followed. In fact, income inequality after counting benefits and taxes increased at a faster rate after the mid-1990s than in the decade before.' (OECD, 2011a, p. 292)

Parallel to this, one can observe a general decline in quality of publicly financed infrastructure and services, e.g. in the areas of housing, medical care and education, which makes those, who can afford it, turn to privately financed alternatives, which in turn makes public facilities and services decline and the wealth-income divide grow further. To change this, more and active pro-poor policies would be called for – but money needed is not at hand.

The previously said applies only, of course, if a redistributive policy and working social welfare systems are in place at all. As the following graphics demonstrates, this is not adequately the case in many developing countries and particularly bad in Africa:

Graphic 10 Coverage of social protection and labour, by region



Source 10 (UNDP, 2013, p. 241)

Equally important for this research project and in accordance with the doctrine of Catholic Social Teaching is not only the situation of the present living generation, but 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 this world. This contradicts long held beliefs that globalization is reducing poverty and ameliorating the situation of the poor. Rather, it seems, the present situation benefits the few over the benefit of the many.

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 mixed blessing. They agree that the following four drivers are most influential for both global inequality and the situation of governmental 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 ‘increased financial openness is associated with higher inequality.’ (Jaumotte, Lall, & Papageorgiou, 2013, p. 273f.)

Globalization of trade takes place in the world’s real economy, generating products and services and therefore generating jobs, 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 capitals 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 investment. As particularly the OECD indicates in its study “Divided we stand” (OECD, 2011a), this means in consequence 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 (perhaps even in need of public subsidies) on the other. This illustrates at the same time a shift in power when regarding the four drivers of global inequality: even though it is true that national (domestic) policies initially and actively set dynamics of globalization off by means of deregulation and privatization, those policies are nowadays all too often reactive, meaning they have to adjust and respond to occurrences triggered off by “the markets”. In tune with this is yet another reason of why private and corporate wealth is rising as fast as it is: because of the mobility of capital, states are competing for residences of the wealthy, investment and 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 new and unprecedented effects of financial integration regarding the increasing wealth gap, governmental debt 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 enables traders to generate huge profits and is, at the same time, not subject to turnover tax or even explicitly used for tax-dodging.
- Institutions of the financial sector grew in size and power: Of the world’s largest and most influential 147 Transnational Corporations, 45 of their top-50 belong to the financial sector. Via interlocking ownerships with other corporations and businesses, however, those 147 exert enormous influence in the “real economy”.

- Along with the emergence of this industry is 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” which 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 e.g. for consumption. Here, 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 nevertheless 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.

The speedy worldwide economic recovery is misleading. It needs to be borne in mind that destroyed assets, businesses and jobs are not *restored* in old splendour. ILO research indicates that the picking up of the economy is in many areas, a “jobless recovery” and the job gap opened by the crisis is rather widening than closing (International Labour Organisation, 2013). Furthermore, analyses suggest that a large number of well-paid and well-insured jobs have been *replaced* by badly paid and badly insured jobs: The number of vulnerable and precarious employment is rising. Equally, the progress of diminishing the number of working poor worldwide (i.e. those earning US\$2 a day or less) is stalling and their number remains with 839 million worldwide alarmingly high. All this is good for employment statistics, because people are obviously having jobs, but it is bad for tax revenue since those worker pay less taxes and social security contributions than those employed before the crisis. At the same time, the decreasing costs of labour make any investment even more profitable which is why

the increase in private and corporate wealth at the top tail of society is so fast and high as it can be observed after the short dip in 2009/2010. This leads to two conclusions:

All this leads to a taxation relevant conclusion: against the over-heated financial markets, the Financial Transaction Tax is among the recommendable instruments. It puts a price on those products and practices which should make it less attractive, so that the volume of trading decreases. If it does not, at least it is generating revenue which might be useful when the next financial crisis is coming.

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 to both rehabilitate public finance, to spend again not on the interest of the few, but the common good of all, 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 (OECD, 2013c). To understand that phenomenon better, conceptual clarification and explanation here are important:

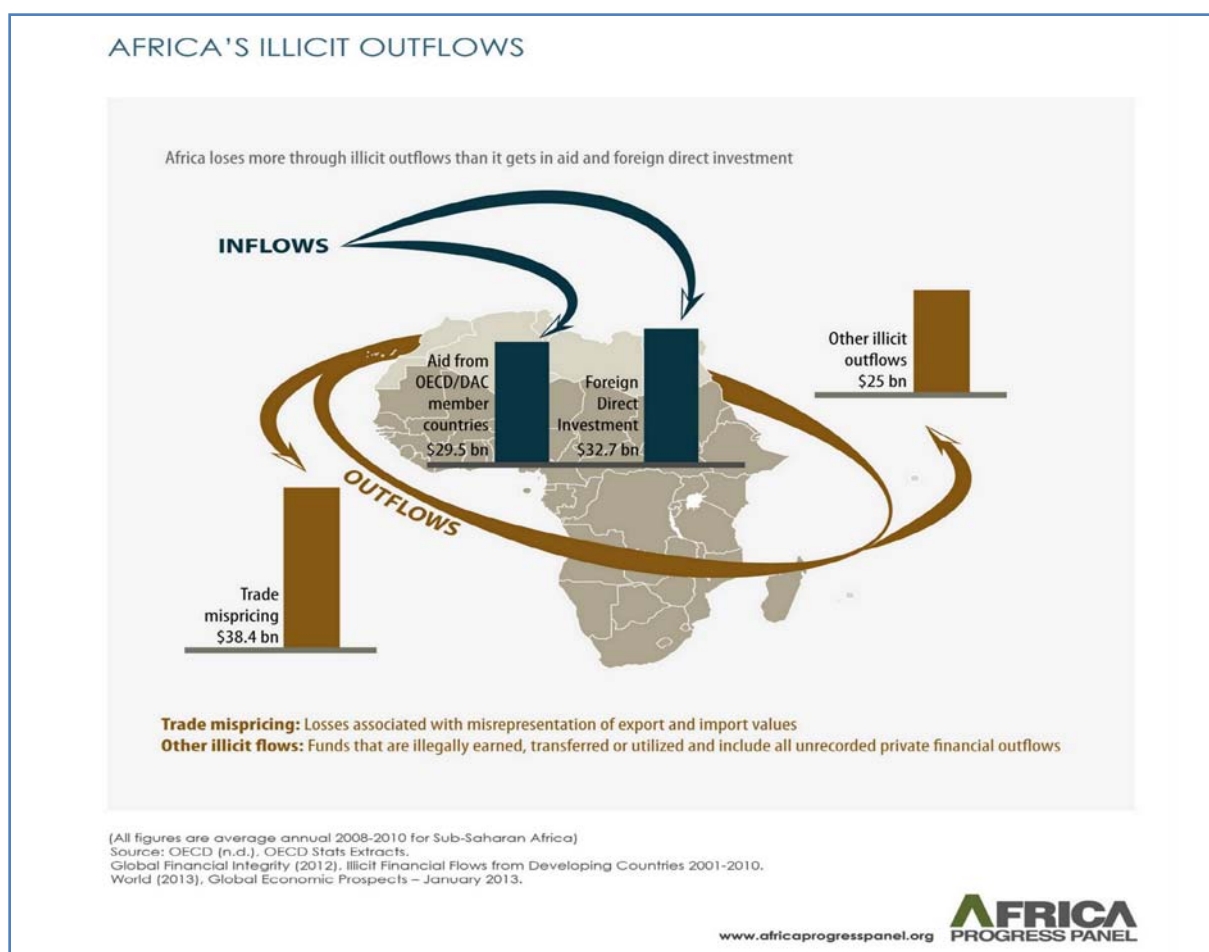
- The formal financial sector consists of those banks and financial institutions which are making headlines and are well known to many people. They are, at least to some degree, under the regulation of national and international law or, in the absence of laws, self-imposed regulations symbolized e.g. by stock exchanges.
- But 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 tax avoidance comes in,

where hordes of lawyers, e.g. of the so-called “Big Four” consultancy companies search relevant laws, their application and relevant jurisdiction for loopholes they can use for hiding money from tax authorities – an activity which is at times labelled “aggressive tax avoidance” or “aggressive tax planning”. This research adopts a wide view of illicit financial flows. We want to have “aggressive tax avoidance” practice included in illicit financial flows because (a) these actions benefit primarily those who have already plenty and are able to pay expensive experts for advice, and because (b) it withholds revenue from the community which would urgently be needed to address issues of *common* interest (i.e. also in the interest of the wealthy and businesses!), e.g. the maintenance of infrastructures, health care, education or public security.

Due to the fact that illicit financial flows occur in non-transparent contexts it is extremely difficult to estimate the size of those flows because there are many different methods to calculate. It is agreed by inter-governmental (OECD, 2013c) and non-governmental organisations (Global Financial Integrity, 2009), however, that illicit financial flows are a major problem for Africa, while the main profiteers of those transfers seem to be the USA, the UK and Germany (Klär, Lindner, & Sehovic, 2013).

Graphic 11 Capital inflow and outflow to Africa



Source 11 (Africa Progress Report 2013, Infographic 22)

For completeness sake, it is not just the IFFs which are a huge problem of developing countries' outflow of assets. Also the repatriation of assets by investors, debt payment and

lending of money to wealthy states contributes to a recent EUROADs assessment, that for every dollar flowing into developing countries, two dollars are leaving them (Griffiths, 2014).

The problem is not just the direct loss of money for poor countries, but also the wasted potential for investment into infrastructure and jobs (and therefore tax revenue!): ‘Simulations suggest that if all the flight capital over the period 2000-2008 had been invested in Africa – with the same productivity as actual investment – the average rate of poverty reduction would have been 4 to 6 percentage points higher per year.’ (Christian Aid, 2014a, p. 28).

A cornerstone of today’s system of illicit financial flows is the use of tax havens: 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 income and 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. Just two examples:

First, it is interesting to note that Offshore Centres are nowadays, behind the USA, the second largest point of origin and destination for Foreign Direct Investment in/from the European Union:

Table 2 FDI inflows and outflows to the EU 27 in billion EUR.⁴

⁴ European Commission/Directorate Trade (2014) European Union in the world. Trade-G-2 09/04/2014. Retrieved February 23, 2015 from http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_122532.pdf. The star in the table refers to the following explanation at the end of page ‘Offshore Financial Centres (OFC) is an aggregate which includes 38 countries. As examples, the aggregate contains European financial centres, such as Liechtenstein, Guernsey, Jersey, the Isle of Man, the Faroe Islands, Andorra and Gibraltar; Central American OFC such as Panama and Caribbean islands like Bermuda, the Bahamas, the Cayman Islands and the Virgin Islands; and Asian OFC such as Bahrain, Hong Kong, Singapore and Philippines.’

FDI inflows (billion EUR)

Partner	2004	2005	2006	2007	2008	2009	2010	2011	2012
Extra EU-27	58,3	129,7	231,2	432,1	182,1	274,4	222,6	424,0	291,8
United States	11,5	67,2	74,4	195,0	39,2	108,6	77,8	260,4	98,8
Offshore financial centres (*)	17,1	17,0	74,4	106,6	19,1	55,8	37,5	46,0	81,4
Canada	-4,1	8,0	11,4	7,0	19,0	13,3	19,6	1,2	19,7
Switzerland	16,6	19,1	24,9	29,1	12,3	34,3	31,4	42,4	19,7
Norway	-1,1	1,4	2,6	9,1	2,7	9,2	10,5	10,0	10,6
Liechtenstein	-0,1	0,4	0,7	0,2	0,3	-0,3	1,9	-0,3	9,5
Russia	0,3	2,8	1,5	10,5	2,8	12,5	7,6	3,1	8,4
China (except Hong Kong)	0,5	-0,1	2,2	0,7	-0,4	0,1	0,4	4,3	7,7
Singapore	0,5	-2,0	6,0	10,6	5,8	3,9	10,7	4,4	5,8
Mexico	1,2	1,2	0,3	0,4	0,9	3,0	1,9	0,4	4,9
South Korea	1,4	1,3	0,9	0,4	-0,6	1,6	4,0	1,7	4,3
Japan	8,2	-4,2	16,2	18,3	3,8	6,0	-0,7	10,0	3,9
Israel	-0,2	1,2	0,1	-0,2	3,7	0,9	4,4	0,9	3,1
Turkey	0,3	0,4	-0,3	0,6	-0,2	1,4	0,1	0,3	2,6

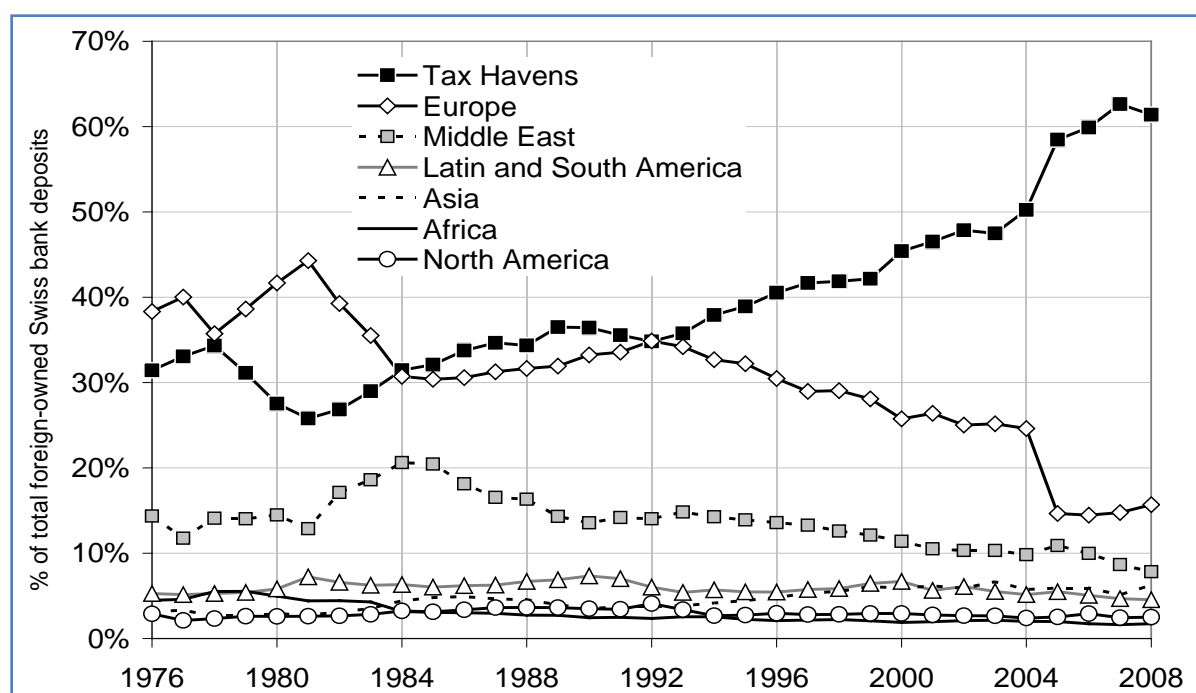
Source: Eurostat (bop_fdi_main)

FDI outflows (billion EUR)

Partner	2004	2005	2006	2007	2008	2009	2010	2011	2012
Extra EU-27	142,3	239,9	317,7	564,2	381,2	331,9	302,6	474,1	255,6
United States	15,5	36,5	105,7	178,3	127,2	95,2	60,5	163,4	62,9
Offshore financial centres (*)	65,0	23,1	59,0	158,6	47,3	85,2	13,7	71,9	39,1
Brazil	5,7	8,5	5,4	14,6	8,6	12,6	44,8	30,3	22,2
Norway	7,6	0,7	5,5	9,4	3,3	3,4	7,7	6,5	19,3
Canada	-2,3	11,9	31,2	30,5	6,3	4,4	-1,8	30,3	17,6
Russia	6,0	9,8	11,5	17,4	27,6	8,8	27,7	8,3	16,2
China (except Hong Kong)	3,9	6,1	6,7	7,1	5,9	8,1	10,5	20,1	15,5
Hong Kong	11,3	3,8	3,6	7,2	4,7	3,7	7,8	7,0	15,0
Australia	0,9	-1,7	6,7	9,4	18,5	-0,5	17,1	-4,0	11,6
India	1,6	2,5	2,5	4,5	3,3	3,5	7,5	13,8	5,5
South Africa	6,0	7,5	5,1	5,1	2,9	10,8	7,1	2,8	4,9
Egypt	1,2	0,7	2,8	1,5	10,8	-3,2	3,0	5,4	4,5
Switzerland	-11,9	74,6	22,1	37,7	31,2	49,0	41,6	48,7	4,5
Iceland	-0,1	-0,2	0,0	0,2	1,3	-1,7	0,5	0,8	4,4

Second: Gabriel Zucman analysed data provided by the Swiss National Bank and found an enormous and rising amount of wealth owned by residents of tax havens:

Graphic 12 Owner nationality of Swiss fiduciary bank deposits, as reported by the Swiss National Bank



Source 12 (Zucman, 2013a, p. 1333).

Obviously, in those cases the owner would be taxable subjects of those tax havens and not the state where the wealth was produced or earned. However, one needs to bear in mind that not only exotic islands such as St. Nevis and Kitts or British Virgin Islands are those of which we need to think about. This would be bad enough since many of the so-called Double Taxation Treaties amount in practice to Double-Non-Taxation Treaties since they might look nice on paper, but lack precise mechanisms of information exchange or cooperation of tax authorities. Beyond that there are plenty of indications that the tax haven system exists because developed countries profit from this financial haemorrhage e.g. from Africa and for that reason are not interested to make co-operation more efficient (Henry, 2012). This means in short: Africa's loss is (still) Europe's and other developed countries' profit.

For completeness and fairness sake we need to add 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 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.

Summarizing the discussion, the core criterion for this research, when assessing the overall damage for our societies, 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. Regarding figures available, they diverge vastly, depending on the area investigated. According to Henry, tax losses for developing and developed countries arising from private wealth hidden in tax havens amount to US\$ 189 billion annually (p.42). Murphy (2012) claims that damage done by shadow economy, private and commercial tax evasion and tax avoidance to the states of the EU alone amounts to EUR 1 trillion annually (p. 9). In the end: whatever it is, we talk about a lot of money which is there, but cannot be taxed by the states.

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.

All this begs the question, what the meaning of social justice and distributive justice means in practice in today's world – and whether (and what forms of) redistribution needs to be reconsidered in serious. Certainly, there are diverging views about these issues among neo-liberals or adherents of Catholic Social Teaching, but the situation to lead this debate seems to be right:

There is an increasing call among academic researchers, governmental, non-governmental and inter-governmental institutions to include taxation into the bundle of reform

measures needed after the 2007/2008 crisis; among those are some very unexpected allies such as like the EU, OECD or IMF. 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.

Take, for example, the IMF, who wielded over decades a lot of influence with structural adjustment packages, comprising not only deregulation and privatization, but also cuts in taxes and social assistance. Now, IMF recommends the following for advanced and developing states, which certainly are a good starting point for a policy discussion, to which this research also wants to contribute its share.

Table 3 Fiscal Reform Options for Efficient Redistribution

	Advanced	Developing
Social Spending		
Improve fiscal sustainability of existing pension systems through increasing statutory retirement ages	X	X
Tighten link between contributions and benefits		X
Expand noncontributory means-tested social pensions		X
Expand means-testing of family benefits with stronger link to work	X	
Intensify use of Active Labor Market Programs (ALMPs) and in-work benefits for social benefit recipients	X	
Develop unemployment savings accounts		X
Consolidate social assistance programs and improve targeting		X
Replace general prices subsidies with targeted transfers	X	X
Expand conditional cash transfer programs as administrative capacity improves		X
Improve design of public works programs as a safety net instrument		X
Improve access to education of low-income families	X	X
Increase private financing of tertiary education	X	X
Maintain access of low-income groups to essential health services	X	
Expand coverage of publicly financed basic health package		X
Taxation		
Implement progressive Personal Income Tax (PIT) rate structures	X	X
Relieve low-wage earners from tax or social contributions	X	
Expand coverage of the PIT		X
Reconsider income tax exemptions, based on a critical tax-expenditure review	X	X
Impose a reasonable PIT exemption threshold		X
Tax different types of capital income in a neutral manner	X	
Develop more effective taxation of multinationals	X	X
Automatically exchange information internationally	X	X
Utilize better the opportunities for recurrent property taxes	X	X
Examine scope for more effective taxes on inheritances and gifts	X	
Minimize VAT exemptions and special VAT rates	X	X
Set a sufficiently high VAT registration threshold	X	X
Use specific excises mainly for purposes other than redistribution	X	X

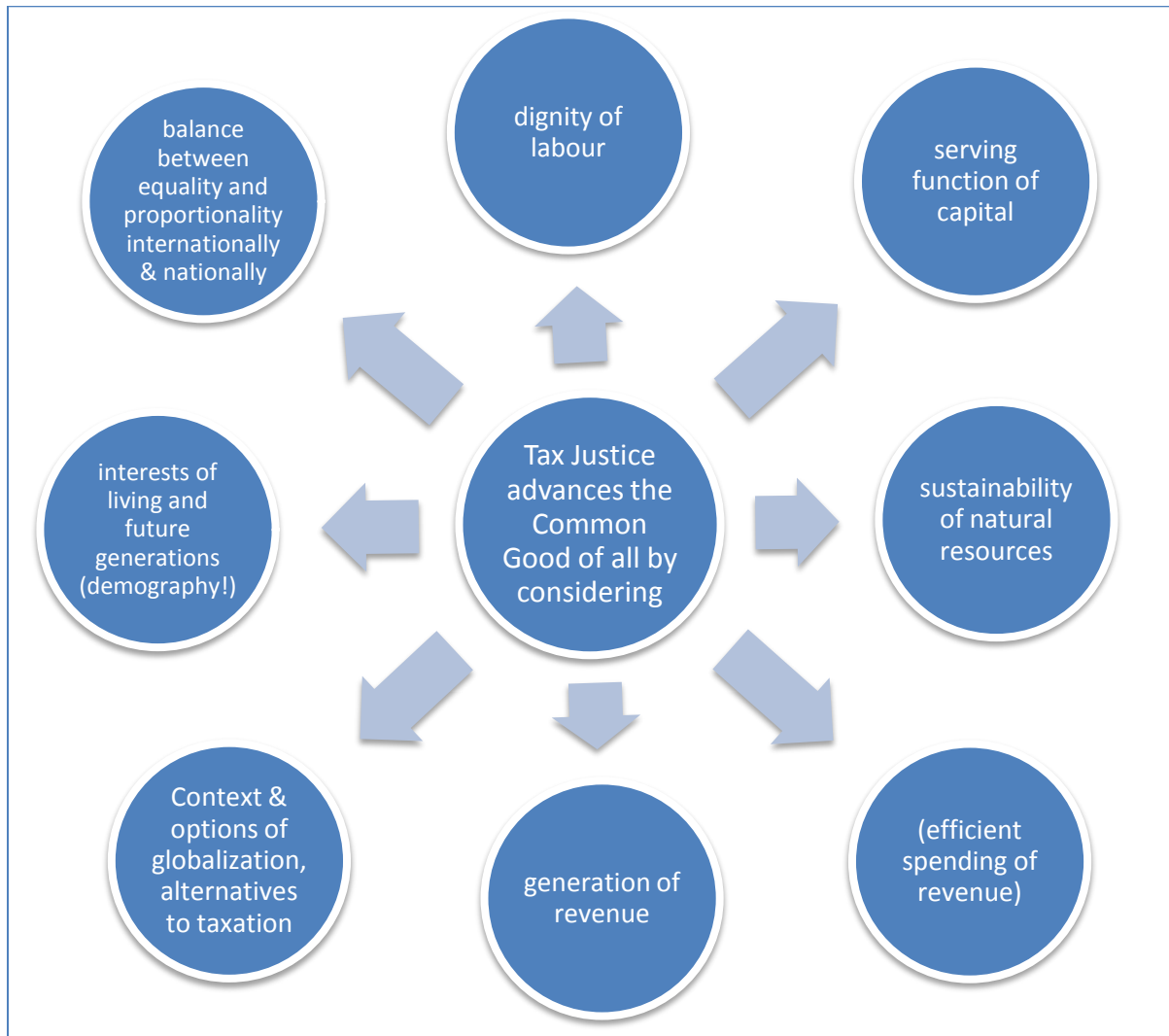
Source 13 (International Monetary Fund, 2014a, p. 43)

Which of these recommendations are implemented and how strong, for example, a progressive Income Tax will be depends on, among other factors, the principles, norms and values of the world view of those participating in relevant policy discussions. Here (still existing) adherents of neo liberal views will certainly argue different from those following Catho-

lic Social Teaching. But also Catholic Social Teaching has to be mindful to find a balance between the ideal and the real, i.e. taxation recommendations which could endanger jobs or which could tempt corporate and private wealth to go offshore would be counterproductive.

On the whole, recommendations based upon Catholic Social Teaching should be mindful of the following parameters:

Graphic 5 Tax Justice parameters also for Catholic Social Teaching



Outlook

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. Looking at the ways tax systems are working, the following avenues suggest themselves for improvements:

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. Equally transparency is lacking when it comes to the channels via which capital can be transferred out of countries, resulting in tax avoidance and tax evasion. Accordingly and second: if present taxation laws could be enforced nationally and internationally, higher tax revenue could be collected. In order to implement the two preceding points, however, it would be required that tax competition between states will 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 and 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 and proportionally 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. In the words of the IMF: 'The notion is that, at least in democracies, political power is more evenly distributed than economic power, so that a majority of voters will have the power and incentive to vote for redistribution. However, as pointed out by' numerous researchers 'this need not be the case if the rich have more political influence than the poor.' (Ostry, Berg, & Tsangarides, 2014, p. 8).

Here, however, the wide range of persons, governmental, non-governmental and inter-governmental organisations waking up to the problem and challenge is encouraging. It is hoped also that this research might contribute to a better, more efficient, fair and just taxation which could enable the strong in society to carry once more a tax burden for the common good, more in proportion with their ability. This alone will narrow the wealth gap and, in addition, will raise revenue which will provide governments with more funds to decrease their dependence on external financing and increase their ability to assist the poor.

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For more information:

Whoever wants to look up issues addressed here in 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>**

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