Tax avoidance and implications for industrial policy

Jonathan Di John
SOAS, University of London

- Edmund Burke: “*Revenue is the chief preoccupation of the state. Nay more it is the state”*

- Joseph Schumpeter : *‘the fiscal history of a people is above all an essential part of its general history’*

- Charles Tilly: *“States make war and war makes states”*

Why is Taxation important?

- Governments use tax to ensure sustainable funding for social programs, and for public investments to promote economic growth and development.

- Taxation is thus a key element of state building and state capacity.

- Taxation, particularly in the form of land and property taxes, customs and border collection can demarcate the territorial reach of the state and help secure property rights.

- State legitimacy depends to a large degree on fiscal capacity, not simply representative democracy.

Taxation and Production Strategies

- Examples of developmental taxation:

- Land taxes and agricultural development

- Mauritian export tax on sugar (19^{th} and 20^{th} centuries)

Taxation, state territorial reach and production strategies

- History provides several examples of the importance of *land and property taxes* in enhancing the territorial, social and economic reach of the stat**e** (Japan, South Korea, Taiwan, US in 19th century)

- important feature of the land tax was that it was introduced as part of a production strategy to help improve agricultural production. The link between tax collection strategies and production strategies is often lost in contemporary discussion of tax collection.

- the role of agricultural marketing boards have played in some countries an important role in expanding the territorial reach of the state and in linking rural interest groups to the state

Taxation, state territorial reach and production strategies

- **In the case of Mauritius**, export taxes on sugar, the main export commodity in the 19th and most of the 20th century had several positive effects on state-society relations and in increasing the productive capacity of the sugar sector (Bräutigam, 2008).

- First, the tax was an effective substitute for income taxes, and was generally progressive as it shifted the burden of taxation and redistributive spending on the wealthy and middle classes.

- Second, the tax was used by the state to finance research and development, infrastructure, and marketing which enhanced production and productivity growth in the sugar sector.

Export taxes in Mauritius (cont.)

- Third, the export tax helped the private sector organize, and it built their capacity to interact with the government over time. As well, it helped both the state and society to solve collective action problems they faced in building skills and in supporting research on sugar.

- Finally, the export tax helped develop the territorial reach of the state since the tax affected the main employer in the countryside and promoted mutually beneficial rights and obligations between the state and farmers, both large and small.

Tax avoidance and evasion can negatively affect development in several ways

- reduces private savings and investment as a result of capital flight
- reduces tax collection
- creates speculative asset bubbles as owners of illicit funds invest in specific assets perceived to be safe havens,
- creates unfair competition
- can make the enforcement of developmental policies more difficult because of the difficulty of disciplining illicit financial interests

Tax avoidance and evasion can negatively affect development in several ways (cont)

- Can make the use of tax incentives/tax holidays less effective
- In Hirschman's **exit-voice** framework, can reduce the incentives of cooperative dialogue between the state and business groups

On the other hand…

- Open capital markets and exit options **discipline** governments against appropriation of property, unsustainable macro policies, excessive taxation (Milton Friedman)

- The use of offshore can increase FDI by **reducing transaction costs** if investors trust the legal system of tax havens (Sharman, 2011) in case of commercial disputes.

e.g. In 2011 30% of India's inward direct investments came from Mauritius; 25% of Brazil's came from The Netherlands; 60% of China's came from Hong Kong and the British Virgin Islands (IMF, 2020)

- There are is **no strong link** between tax/GDP and either: economic growth or investment levels (eg .Brazil, South Africa vs China and India).

- **What is the causation**: is tax avoidance the result of ineffective industrial policy and investment climate or vice-versa.

3. **Tax and Elite Bargains**

)

Taxation and the Elite Bargain

- In the model of 'limited access orders', the creation and deployment of economic rents and privileges to relevant elites in a ruling coalition is the essence of elite bargains (North et al, 2007).

- In turn, exploring tax patterns can illuminate important insights into the shape and character of the elite bargain, which North et al argue is central to maintaining political order.

- At the same time, the nature of elite bargains provides a window into the political limits of expanding tax capacity.

What does this mean practically for LDC tax policy?

- High levels of tax evasion are tolerated; close connection between state officials and business elites.
- The negligible collection of urban and rural property taxes
- Relatively low rates of taxation on agriculture which (while part of investment incentives) benefit elite landowners and particularly large farmers and agro-processors.
- A significant decline in the corporate tax burden on big business which has benefitted both foreign firms (particularly in mining) and political and economic elites.
- Most mining contracts are secret in SSA