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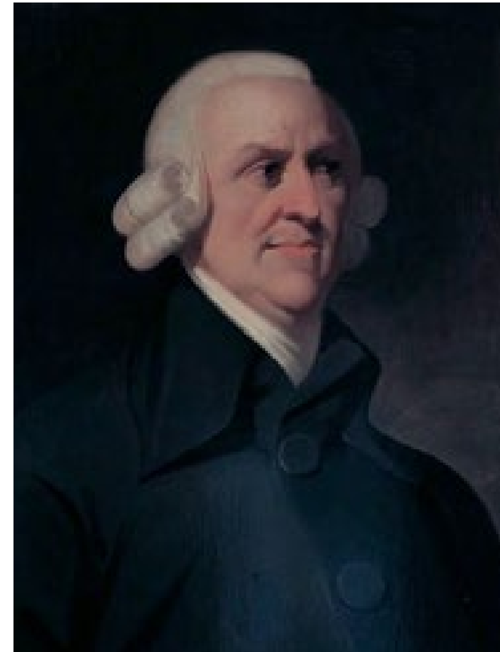
THE MYTHICAL ADAM SMITH

Few thinkers loom larger in the imagination of policy-makers and economists than Adam Smith. But the figure they venerate is a mythical creature, half man, half useful quotations.

Myths can be used to sustain and encourage governing projects. The shift to deregulation and limited government – 'neoliberalism' - in the English-speaking world after the election of Margaret Thatcher in 1979 and Ronald Reagan a year later depended partly on the creation of, and belief in, myths. One example of highly effective myth-making can be found in the notion that neoliberals like Thatcher and Reagan were the champions of the 'free market' first celebrated by Adam Smith.

Adam Smith and the Free Market

Chicago neoliberals like Milton Friedman and George Stigler interpreted classical political economy in general and Adam Smith in particular in a very specific way. They used his idea of an 'Invisible Hand' to argue that individuals merely had to pursue their individual self-interest and exclude other concerns for the market economy to function optimally. Like Keynes's ideas in the 1930s, this argument gave politicians a simple and



"The disposition to admire, and almost to worship, the rich and the powerful, and to despise, or, at least, to neglect persons of poor and mean condition is the great and most universal cause of the corruption of our moral sentiments."

Adam Smith, still Tax Justice Network's most popular pinup.

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plausible justification for the policies they wanted to pursue. During the Depression Keynes had argued for countercyclical investment to revive the economy. FDR used these arguments to provide intellectual ballast for the New Deal programmes, although Roosevelt himself was no economist and had little time for Keynes. Similarly, in the 1980s, Thatcher and Reagan cut taxes, fought unions and attacked the public sector on the back of neoliberal policy proposals. Neoliberal myths about the benefits of unfettered self-interest in market economies provided cover for another political project: the elevation of the profit motive as a cardinal virtue.

Adam Smith's account of commercial society in the *Wealth of Nations* (1776) does not provide a blueprint for a free market economy based on the selfish pursuit of profit. In his argument, the 'invisible hand', by which a market economy was sustained according to Smith, is shown to work by the actions of the educated and morally cultivated individuals to whom Smith refers in his *Theory of Moral Sentiments* (1759). Smith's conception of such individuals and their moral sympathy was a world apart from the sort of selfish greed encouraged by 1980s Conservative and Republican policymakers. Smith worried that "people's disposition to admire the rich and the great, and to despise or neglect persons of poor and mean condition", led to the "corruption of our moral sentiments". The main solution he proposed was publicly funded education. Government was also to provide the means for building and sustaining the necessary infrastructure for the successful functioning of the economy, something acknowledged by neoliberals like Hayek and Friedman themselves.

Despite the nuance and complexity of Adam Smith's actual positions, it suited both neoliberal thinkers and politicians to see themselves as part of a venerable lineage whether or not their ideas actually matched up with his. In their view, the "free market" was supposed to be the result of stripping away layers of government ownership and public expenditure. At the core of the myth was the idea that government was bad and business was good, a central narrative that helped to determine policy under both Thatcher and Reagan. When a myth is successful, as this one proved to be, then it can help to drive an agenda through by simplifying a government's message.

American Neoliberalism

In the case of the neoliberals, the Chicago theorists, along with their close associates in the Virginia School of Political Economy, led by James Buchanan and Gordon Tullock, were engaged in a radical new set of economic theories. The "free market" was rethought and repackaged as an idea. The Americans differed, not just from Adam Smith, but also from earlier European neoliberals based in Austria, Germany and Britain, who first emerged in the interwar years in response to war, depression and totalitarianism.

The earlier European neoliberals had as their main focus the conditions necessary for effective competition in the marketplace and they saw no incompatibility, even Friedrich Hayek in his famous *The Road to Serfdom* (1944), between free markets and the welfare state. The political project most closely associated with these early neoliberals, the Social Market economy of

Smith worried that "people's disposition to admire the rich and the great, and to despise or neglect persons of poor and mean condition", led to the "corruption of our moral sentiments". The main solution he proposed was publicly funded education.

the German Economic Miracle in the 1950s, attempted successfully to institute just such an economy with vastly different results for the German economy than those achieved for Britain after the 1980s.

The American model of neoliberal thought, in contrast, partly fostered by the very different conditions of rising prosperity and the Cold War, advocated a new role for the market from that proposed by either Adam Smith or the European neoliberals. They wanted to take a market-based approach to all kinds of hitherto untouched policy areas. What became known as "economics imperialism" saw methodological individualism, the focus on the rational actor pursuing his self-interest in the marketplace, being applied by scholars like Friedman, Stigler, Buchanan and Gary Becker in the realms of education, public administration, crime and even the family.

The Radicalisation of Neoliberalism

This expansion of free market radicalism born in Chicago and Virginia sharpened and clarified the neoliberal political message. But the idea that it rested on classical liberal foundations was a myth. What the Chicagoans and their political followers were engaged in was an entirely new kind of state-sponsored reform of the economy.

This reform drew on several further myths. The first of these was the idea that tax cuts would increase wealth that would trickle down into more jobs and rising incomes for all. In fact in both Britain and the United States we saw rising inequality, income stagnation as well as large numbers of unemployed among much of the population. The second was the myth that deregulation would free up important sectors and foster a more dynamic economy. Governing parties of all political stripes followed the deregulatory policies advocated by Stigler and others. The "dynamism" of self-interest led directly to the catastrophic financial crisis of 2008.

Finally the denouement arrived and Fed Chairman Alan Greenspan was forced to admit the "flaw" in neoliberal thought. The "free market" and its ability to adjust and correct itself was a myth (and not one created by Adam Smith, but rather by neoliberal economic theorists). It is not at all clear yet, however, that the political class has lost its appetite for myth. In both Europe and the United States, politicians are currently in thrall to another convenient myth: the idea that austerity can lead to economic growth. Until this myth is decisively rejected, the future of the world economy looks bleak indeed.

Daniel Stedman Jones is a barrister and author. Masters of the Universe: Hayek, Friedman and the Birth of Neoliberal Politics is published by Princeton University Press.

editorial

MYTHS AND THEIR BUSTING

Dan Hind

A good deal has happened in 2013 to quicken the pulse of those pushing for tax justice. In April alone we saw publication of a major investigation into offshore by the International Consortium of Investigative Journalists and signs of movement on automatic information exchange in the EU and in the G20. There is no sign that the pace will let up over the summer. In June the OECD publish a new report on BEPS (Base Erosion and Profit Sharing). It presents us with an opportunity to dispense the now discredited arm's length method for tackling transfer mispricing by shifting to a combined reporting with profits' apportionment approach.

Meanwhile, the Tax Justice Network has been busy on the writing and publishing front. Richard Murphy has put out an ebook with Random House UK called *Over Taxed and Over Here*. John Christensen and Nick Shaxson are putting the finishing touches to their book *The Finance Curse*, which is due for release in May. And the Tax Justice Network have teamed up with the New Economics Foundation in the UK to produce a series of essays – *Mythbusters* - that explore, and explode, the most persistent and powerful myths in contemporary economics. Introductions to the articles are being published weekly in the *Guardian* and the full-length versions can be found on the New Economics Foundation website.

To tie in with the *Mythbusters* series, this edition of *Tax Justice Focus* is looking at some of the ways in which mythical ideas survive and spread. Daniel Stedman Jones is the author of a recent book on the rise of neoliberalism, *Masters of the Universe*. In his contribution he introduces us to the eccentric reading of Adam Smith beloved of neoliberal thinkers. The champion of the 'hidden hand' so beloved of lobbyists for deregulation and the small state was himself convinced of the need for a wide range of state action to secure public goods. He also had a lively fear of the corrupting effects of opulence, and thought universal moral education vital in order to avoid moral corruption.

The perimeter of the City of London is guarded by dragons that the authorities insist on calling griffins. What goes on inside is also the stuff of fairy tales, as Aeron Davis, the Professor of Political Communication at Goldsmiths College, explains. Structural weaknesses in financial journalism, the rise of public relations and the narrowing of debate about economics have contributed to the current situation, where the City can promote a largely mythical account of its vital importance to the UK

A well-known Syrian regulator, in discussions with a representative from the financial sector.

Ceres, the Roman goddess of plenty – a myth we can all believe in.

economy. Five years after the spell of debt-driven growth was broken, the City remains a realm of mystery and magic.

But why do so many politicians remain entranced by the stories that the financial sector tells? Robin Ramsay, the renowned editor of *Lobster*, has been a mordant and clear-eyed observer of the British political scene for more than three decades. In his article for the *Focus* he looks at the distant and fraught relationship between politicians and the study of economics. An exchange with Bryan Gould, a former MP and Shadow Cabinet Minister, reveals a truth that the political class and their admirers in the press would rather keep from us. Starting a generation ago, most politicians in Britain either bought the City line wholesale or stayed away from economics altogether. It is a tribute to Thatcher that the old scepticism about finance had entirely vanished from the Labour party leadership by the time disaster struck in 2007. But the continuing weakness for myths from the City is much harder to explain.

Finally, William Davies, Assistant Professor at the Centre for Interdisciplinary Studies at the University of Warwick, takes a look at that luminous word, 'enterprise' and shows how politicians are using it to spin a new myth about the causes and consequences of the crisis. Recovery will only happen, we are told, if we stop blaming the risk takers and the entrepreneurs and remove the burdens that are holding them back. It is a bold gambit, given our recent history. As Davies points out, there is a world of difference between genuine enterprise and rent-seeking through asset price inflation, financial engineering and tax evasion. It is a difference that many politicians still don't' want to see.

As we prepared this edition of the *Tax Justice Focus* for publication it was revealed that one of the most influential recent articles in economics had serious flaws. When Carmen Reinhart and Ken Rogoff's paper, 'Growth in a Time of Debt', was published in January 2010 it provided a ready-made intellectual justification for cuts in public sector spending. Their data seemed to show that countries with debt in excess of 90% of GDP grew far more slowly than those with lower debt burdens.

Politicians and commentators around the world seized on their work. Only a month after Rogoff and Reinhart announced their findings, George Osborne, the British Chancellor, told an audience that 'the latest research suggests that once debt reaches more than about 90% of GDP, the risks of a large negative impact on long-term growth become highly significant'.

But once Thomas Herndon, a graduate student, went through the original calculations, he found that a number of countries were missing. With all the data fed in the effect described by Rogoff and Reinhart became much less pronounced. Austerity, it turns out, was justified by little more than a missing line of date on an Excel spreadsheet and some questionable assumptions. Even now, years after a crisis brought about by tall stories and wishful thinking, we are still living in a world far too hospitable to myths.

Still, these myths are finally being challenged.

Dan Hind,
May, 2013

feature

THE CITY IN MYTH AND REALITY

Aeron Davis

The media in Britain still fall for fairy tales about the importance of finance to the UK economy. The explanation lies in the structure of business journalism.

The official and oft-repeated narrative around the City and UK financial sector is that it is a vital industry for the UK economy. It brings substantial employment, taxes and overseas income. By the early years of this century, the City had recorded an average growth rate of 7% per year for 25 years, and showed a consistent annual overseas trade surplus in the tens of billions (Golding, 2004). According to UKTI (Dec 2012), in 2010, the UK financial services industry was responsible for 10% of UK GDP and 11% of tax income. It employed a million people with up to another million employed in associated professions.

Most importantly, it generated a trade surplus of £40 billion, higher than any other sector of UK industry. These figures vary depending on the year and accounting bases used. But, they always look impressive, whether appearing in government or industry reports (Wigley, 2008, Bischoff and Darling 2009, Maer and Broughton, Aug 2012, IMAS, 2013). The story has been consistently repeated by City representatives and successive Chancellors of the Exchequer since the early 1980s.

The story is frequently repeated unquestioningly in mainstream news coverage. It has justified successive waves of financial deregulation. It is why, after the 2007-08 collapse of the banking industry, and a series of high profile scandals, from PPI mis-selling to Libor, the City continues to do business as usual. It is why attempts to re-regulate the banks (Tobin taxes, retail-investment bank separation, greater capital reserves) or limit City bonuses are so simply deflected. Hence, the *Daily Telegraph* is happy to feature (27.03.13) the reports stating 'banks should be allowed to decide themselves how much capital they need to hold instead of being told by regulators', or lending and economic recovery will suffer. The *Financial Times* (4.03.13) argues that it is 'Time to rehabilitate bankers' bonuses' and that bank bonus caps will 'hurt competitiveness'. The *London Evening Standard* (26.02.13) declares that economic 'growth is being strangled by regulation ... rather than the antics of investment bankers', and that (28.02.13) new EU regulation will be a 'boost for Zurich, Singapore and New York at London's expense'. Typically, as the *Economist* declared (29.10.11), at the height of City unpopularity, 'Wholesale finance is one of the few industries in which Britain has large net export earnings', 'is a source of comparative advantage', and is one of the 'world's leading centers'. It concluded that 'London's long-term prospects depend on its ability to sustain these attractions'. No matter how badly our financial sector behaves, it must be defended, quite simply because the UK economy cannot afford to restrict its activities. Coverage may admit to City faults and unpopularity but then restates the case that of financial industry indispensability to the UK.

There are some journalists who regularly question the activities and value of the City at a more fundamental level. However, the vast majority of day-to-day coverage

You want myths? The City of London's got them!

is broadly supportive of the UK financial centre and usually willing to support the City-is-indispensable line. There are several reasons for this (see Davis, 2002, 2007). Financial news, like most news sections,

"The national financial press are written for the City by the City."

has suffered from a long-term decline of reporting resources as its business model has become increasingly untenable. Unlike other areas of news reporting, such as politics or celebrity, financial journalists have little leverage. City leaders do not have to talk to them if they do not want to and can make access very hard. Added to this, the world of finance is a highly technical and information dense subject area. It is very hard for financiers to digest and comprehend even part of the material in circulation; harder still for journalists having to cover larger territories and with tight deadlines. Lastly, financial news is very low down on the list of things that ordinary citizens consume news for. That it has expanded and maintained a place in news is down to high levels of advertising and public relations support coming directly from City sources. All of which makes financial journalists extremely dependent on the City itself, both for information and interpretation of that information, as well as for advertising and general access. Thus, as one financial executive confidently explained to me 'The national financial press are written for the City by the City.'

This dependence on financial sources for coverage of the City itself has grown all the stronger since the early 1980s. City influence at Westminster, financial deregulation, the closing down of pluralist debate around finance and the economy, and the rise of financial public relations, have all gone hand in hand. So, media reports will often cover scandals and ire over banker bonuses but will rarely question the basic narrative around City indispensability. However, the foundations of this narrative are themselves very questionable.

The first issue is that estimates of the size of the sector treat the entire financial services industry as one entity. Those figures on taxation and jobs combine the insurance industry, ordinary high street banking, and the activities of investment bankers and others in the City. Those working in high finance, a world of high risks, bonuses and scandals, are a minority in the industry and number in the tens of thousands.

Second, the overall accounting picture is extremely distorted. By 2009, the cost of the bank bailout was £289 billion and rising (CRESC, 2009). Further government loans and guarantees to banks are worth hundreds of billions more. Such figures more than wipe out the tax receipts of the industry accumulated since the turn of the century. From 2007 to 2009 the UK's external debt leapt from 22.5% to 66.5% of GDP and had continued to climb since (Turner, 2008). In sum total, whatever the City has contributed to Treasury balance sheets over recent decades, it's clear that it has taken more than it has put in over the last decade.

Third, quite apart from the financial figures there are wider questions about whether the UK's financial sector has contributed positively to the larger UK economy. Financial engineering and speculative activity have since caused huge bubbles and price volatility in internet stocks, property, commodities and derivatives markets, putting great pressure on personal and national finances (see Krugman, 2008, Cable, 2009). Many studies (Hutton, 1996, Myners, 2001, Chang, 2010, Engelen et al, 2011) argue that the City itself has been damaging to British industry as it is driven more by short-term returns than long-term investment. In the 1980s investment in manufacturing rose 2% per annum, but profits by 6% and dividends by 12% per year (Hutton, 1996). 'Productive investment', in business itself, declined from 1996-2008, from 30% to 12% (CRESC, 2009). From 1979 to 2011, employment in manufacturing dropped from 6 to 2.5 million (Engelen et al, 2011). As these and other studies argue, the UK's financial sector is more about extracting capital away from wider industry and external investors than it is about putting it into the economy.

Ultimately, the financial sector has contributed much to the UK in various ways. But it has also racked up large debts, been a cause of instability, and undermined other parts of the British economy. A real balance sheet is virtually impossible to construct as the sector remains opaque and amazingly well-spun to financial media, politicians and the public. Either way it is time more journalists stood back and asked what exactly the real value of Britain's oversized financial sector is.

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ENTERPRISE AND RENT-SEEKING: A MYTHICAL CONFLATION

feature

William Davies

In the years since the crisis, much has been made of the need to encourage enterprise. But its champions are using entrepreneurial endeavour a cover for policies that favour the extraction of risk-free rents.

There was a 19-year period, between the fall of the Berlin Wall and the fall of Lehman Brothers, when 'neoliberalism' became virtually invisible to everybody, save for its critics in what was called the 'anti-globalisation movement'. There was no longer a distinct political movement or philosophy that could be referred to as 'neoliberal', and nor were there any obvious ideologues selling the virtues of free markets or enterprise. Rather, the backdrop of unregulated, finance-led, global capitalism was just the reality against which politics and policy seemingly had to happen.

The global financial crisis has changed that. The intellectual and policy roots of our present economic malaises are now thrown into question, and the practices of elites (especially in the finance sector) are being raked over publicly. The term 'capitalism' is common currency in mainstream political debate, in a way that was not true a decade ago. How can we throw off the strictures of neoliberalism? Why are we still so stuck with it? And is there a different capitalism, or even an alternative to it? One small consolation of a protracted economic crisis is that such questions are put on the table, with often enlightening public results.

Inevitably, this hubbub has drawn some of the original 'neoliberals' out from their caves. British think tanks such as the Institute of Economic Affairs (IEA) and The Adam Smith Institute are returning to some of their favourite 1970s tunes, blaming government for everything, arguing that only entrepreneurs can save us. In one of the more outlandish examples of this, a former Conservative Defence Secretary in the British Government, Liam Fox, argued in March of this year that a 'great socialist coup' was responsible for the depression of the UK economy, and that only smaller government could rescue us.

The early neoliberal thinkers of the 1930s and 40s were notoriously paranoid about the threat and reach of socialism. But the tenacity of those such as Fox, in *still* seeing reds under the beds in this age of spiralling inequality and the near disappearance of private sector unionism, is quite remarkable. Either due to chronic failure of imagination, or sheer nostalgia, the assumption of this revitalised New Right seems to be that Britain is currently experiencing the 1970s all over again, and de-regulation will ride to the rescue.

One curiosity of this baroque policy revival is that, in its inevitable anti-tax rhetoric, its target has shifted slightly. Perhaps in view of the political disaster which was George Osborne's cutting of the highest rate of income tax in last year's budget, the main target of the anti-tax movement has shifted from income tax to capital gains tax (CGT).

Osborne himself had raised CGT from 18% to 28% in his emergency 2010 budget. But it was only as low as 18% because Alasdair Darling had abandoned the tapering system in 2007, which saw CGT vary between 10% and 40%, depending on how long the asset was held for. Income tax is such a politically charged area of fiscal policy, that politicians are fearful to make very significant changes. Large amounts of political capital can be expended, in exchange for relatively small increases in tax revenue. CGT, on the other hand, is a far more fluid area of policy, which allows the Right to become more ideologically exercised and vocal.

A horse, as designed by a neoliberal think tank.

The Adam Smith Institute put out a report attacking the level of CGT in February.

"Neoliberals were always curiously blind to the potential for private economic power to constrain liberty."

Philip Booth of the IEA wrote a piece for *Prospect* in the same month attacking CGT, inheritance tax and stamp duty, as impediments to growth. Then, in a speech to the IEA, Fox demanded that CGT be abolished altogether, in order to get the economy moving again. While Conservatives of a neoliberal persuasion like to talk up the benefits of hard work, they are looking to treat the proceeds of speculation, rent-seeking and asset price inflation more favourably.

While it seems highly implausible that even a Conservative Chancellor will adopt any of these proposals, what is being showcased here is a fundamental oversight in neoliberal thinking, that was present throughout the genesis of the New Right on both sides of the Atlantic. What Fox et al strategically – or blindly – elide, in their attacks on CGT, is the distinction between constructive entrepreneurship and a form of *rentier* capitalism dominated by asset speculation. The rhetorical trick of neoliberalism, both in its long period of exile as a critique of Keynesianism and socialism, and in its applied phase of the 1980s and 90s, is to use the language of 'enterprise' to defend the freedoms of speculators and asset-strippers.

The argument levelled by the Right is that a tax such as CGT is holding back an army of potential new businesses, all of whom are afraid to invest for fear that their assets will increase in value and they'll be robbed by the taxman when they come to sell them. The reality, of course, is that Britain has already suffered from a vast asset price bubble, fuelled by cheap credit, in which ownership of properties and firms became governed by a logic that owed everything to their market value, and nothing to the creation of new value. The mentality of the financier infects not only business, but also a generation of buy-to-let investors, for whom the promise of home ownership is to be able to live off rent and equity withdrawal, rather than anything productive. A society which valorises capital gain to this extent may be even more socially dysfunctional than one which valorises income inequality.

The Austrian economists who gave birth to neoliberal thought during the 1920s believed that the West faced a straightforward choice, between socialist bureaucracy on the one hand, and dynamic entrepreneurialism on the other. Either there must be the state, or there must be free enterprise. What this simplistic worldview ignored (but which their compatriot, Joseph Schumpeter, was cognisant of) was that *capitalism* can stifle economic freedom, just as much as socialism. The power of corporations, incumbents, financiers and other entrenched interests can seize control of the capitalist system, sapping its energy for their own private gain. But neoliberals were always curiously blind to the potential for private economic power to constrain liberty.

The challenge is to distinguish between what Labour leader, Ed Miliband, referred to as the 'producers' and the 'predators', in his 2011 conference speech. There is venture capital, that employs qualitative insight into technology and science, to support highly uncertain start-ups; then there is private equity, which employs financial economics to take ownership of a company so as to extract value before returning it to the market. The tax system will never be able to make a clean distinction between the two. But it is a characteristic sleight of hand on the part of the Right to claim that CGT punishes 'enterprise', when this term has more often been a veiled reference to financial asset players.

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MYTHICAL THINKING IN THE POLITICAL CLASS

feature

Robin Ramsay

Why do myths about the economy survive so long? In part it is because the politicians lack the knowledge and confidence to challenge them.

As we contemplate Britain's recent history with its succession of economic crises and scandals, a question suggests itself: do the country's politicians understand how its economy works? Of course, on the Conservative side there have always been MPs who come into politics after working in the City and so are familiar with the City's version of the story. But the City's perspective provides, to put it mildly, a partial view.

In the UK economic policies which benefit the international money men may not – generally don't – benefit that rest of the economy. Long before the current crisis this was demonstrated by the 1980 Conservative budget which began the great 'liberalisation' of the economy: it abolished exchange controls, raised interest rates (officially to reduce inflation but in reality to make holding sterling assets attractive) and thus pushed up the sterling exchange rate with other currencies, making a large slice of British exporting manufacturing uncompetitive. (From Mrs Thatcher's point of view, this had the added appeal of punishing the non-metropolitan working class for having the temerity to vote Labour in the previous twenty years.)

Until 1987 the Labour Party as an institution understood that industry and manufacturing had different interests from finance and Labour governments sought to limit the power of the City to shape economic policy. After the election defeat of 1987 the Party's leadership abandoned this approach and Labour began the long, excruciating process of wooing the City. This reached its climax when Chancellor of the Exchequer Gordon Brown delivered a speech to a City audience in 2006 in which he boasted about the benefits Labour policies had brought to the financial sector.[1]

1 http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/ speech_chex_210606.htm

British politician, Vince Cable, the only man in the current government who understands the City-industry clash?

Even before Labour adopted the City perspective outright, its misunderstanding of key aspects of economics were leading it to adopt policies that favoured finance over industry. The former Shadow Cabinet member Bryan Gould wrote in 1994 this about the debate over exchange rate policy in the mid 1980s:

> *I remember [Gordon] Brown addressing the Parliamentary Labour Party on the great advantages of joining the ERM [Exchange Rate Mechanism], using arguments I knew to be erroneous. He suggested that by fixing the parity within the ERM, we would be applying socialist planning to the economy, rather than leaving an important issue to market forces. The party responded warmly to the notion that speculators would be disarmed. They all seemed unaware that the only thing which gave speculators their chance was a government foolish enough to defend a parity seen to be out of line with a currency's real value … John Smith and Gordon Brown truly believed that the ERM was a new, magical device which would insulate their decisions about the currency against reality.'*[2]

I e-mailed Mr Gould: was he suggesting that his colleagues didn't understand economics? He replied thus:

> *I found that most of my colleagues had no knowledge of economics and either steered well clear of economic policy – preferring to concentrate on more general topics such as foreign or social policy – or else they swallowed whole the current orthodoxy since they had no capacity to take an inde-*

2 *The Guardian*, 19 August 1995

"I found that most of my colleagues had no knowledge of economics and either steered well clear of economic policy – preferring to concentrate on more general topics such as foreign or social policy – or else they swallowed whole the current orthodoxy since they had no capacity to take an independent view."

Bryan Gould, former Labour MP and Shadow Cabinet Minister

pendent view. Gordon Brown fell into this latter category – Tony Blair the former. John Smith had only a rudimentary knowledge of economics, but was a little more confident on the nuts and bolts of tax and accounting. I don't think these failings are unique to the Labour Party. I think one of the reasons for all of this is that economists have made economics such an arcane science that most people are frightened off it.

This is very striking. If you've been a literate, intelligent human and you have been interested in politics for years (if not decades) how do you *avoid* acquiring some economic understanding? And if you want to be a member of a government – the ambition of most MPs – how can you consider doing so without understanding the British economy? Even if you aspire no higher than representing the interests of a constituency (to put an MP's role at its simplest) if you don't understand the economy, how can you do this?

In the present coalition government the City-versus-industry clash is apparently understood only by Vince Cable, Secretary of State for Business, Innovation and Skills. But he has no power and his resistance to the City's agenda represented by the Conservative members of the Cabinet is confined to the occasional comment and article.[3] In the current Labour Shadow Cabinet no one seems to understand Britain's political economy – though it may be that there are individuals who do but feel unable to speak or feel paralysed by the errors of the Party's years in office.

The leaders of both the Coalition and Labour have spoken since the crash of 2008/9 of the need to 'rebalance' the economy away from the City towards manufacturing; but no one has suggested policies that could do this.[4] And no wonder: economic history suggests that at a minimum such a 'rebalancing' will require significant intervention by the state in the economy, including in the direction of investment – both of which are deeply unfashionable ideas that the City will oppose. For even though the financial sector now contributes only around 6% of UK GDP[5] (of which the international sector is about half) as yet none of the major political parties are willing to contemplate policies opposed by the City.

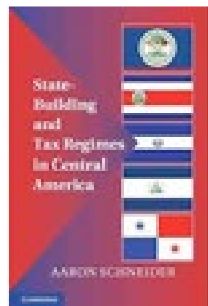
Robin Ramsay is the editor of Lobster, *described by Paul Foot as 'one of the most important magazines to be launched in the post Second World War period in Britain'. His books include* The Rise of New Labour, Smear: Harold Wilson and the Secret State *and, most recently,* Well, How Did We Get Here? A Brief History of the British Economy, Minus the Wishful Thinking.

3 See for example www.newstatesman.com/politics/politics/2013/03/when-facts-change-should-i-change-my-mind

4 For example Chuka Umunna MP, Labour's Shadow Secretary of State for Business, had a piece in the Telegraph, 'If we want the UK to grow, we should take lessons from Germany' (23 February 2012). The German lessons for Umunna are: more medium-sized firms, better education and a state bank – and an 'active government approach for business and industry', though quite what this last would look like was not spelled out.

5 That 6% figure is from the Bank of England. See the first table in www.bankofengland.co.uk/publications/Documents/quarterlybulletin/ qb110304.pdf

reviews



State Building and Tax Regimes in Central America

Aaron Schneider

Cambridge University Press, 2012

In a well-researched and insightful book, Aaron Schneider explains how the tax regime of a country offers a window into the process of state building and the politics of economic development. In analyzing tax reform in each of the Central American countries he shows how the states in the region have mobilized few tax resources, and have been unable to tap with success the most wealthy and privileged sectors. As a result, inequality remains widespread and the challenge of state building even more elusive.

Aaron takes us on a tax journey of El Salvador, Honduras, Guatemala, Nicaragua, and Costa Rica, and explains how the elite engaged in the tax policy-making process while carefully protecting their own interests. While the process differed in each country, there was a clear trend of the elite intervening successfully in the policy making process. They thereby hindered each country's ability to fund various public policy initiatives. And by allowing the wealthy sectors to successfully evade and avoid taxes, the state had little choice but to draw on the middle sectors, using consumption taxes and levies on wages. As a result, tax justice was largely subverted.

Taxes collected are a useful indicator of the legitimate capacity of the state. Finding a way to engage dynamic sectors to pay their fair share is especially important for governments in highly unequal societies. There is also a close connection between the failure to tax the wealth of powerful elites and the fragility of democracy in the country concerned. Aaron explains how El Salvador endured authoritarian regimes for decades, in which the military had free rein to govern the country in exchange for its willingness to use violence against the enemies of the country's small but powerful economic elite. The situation in Guatemala and Nicaragua was similar in many respects

In Guatemala, tax revenues as a percentage of GDP were 7.6% in 1990, and are now at 11.9%. In El Salvador, they were 9.1% of GDP in 1990 and now at 13.2%. Costa Rica is currently at 14%. All these countries are well below the average of Latin America at 19.4% and that of the OECD countries of 33.8%. Further complicating the issue is the willingness of some of the Central American governments to offer tax incentives, tax holidays, and free-trade zones, which often benefit the elite as they expand into a globalized economy. In Guatemala for example, the revenue that the State failed to collect as a result of the special concessions was between 14.6% and 16.3% of GDP between 2000 and 2005. That is more than the entire tax revenue collected.

Aaron rightly argues that the evidence that incentives alter investment decisions or expand economic activity is weak. "Mostly, these policies erode revenue, create special regimes already operating in privileged sectors and increase inequality in public finances". He believes that incentives weaken tax administration by making the fiscal system more complicated, and they create opportunities for tax avoidance and evasion as producers shift their activity into exempted sectors.

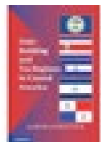
In Central America, dynamic economic actors have not only inserted themselves into leading roles in their own countries but also used them to leverage into the global markets. If we assume that such engagement is not in the public interest, what options do we have for addressing the issue?

A few answers emerge from Aaron's analysis, and a few are apparent from recent developments around the world. These are as follows:

- By staying on the territorial basis of taxation, as is the case in Central America, there is considerable income shifting to offshore activities. This results in a significant loss of tax revenue in each of the countries concerned.
- Other than El Salvador, there has been a complete absence of transfer pricing laws. Guatemala has just adopted such laws as of January, 2013. Costa Rica has no specific legislation on transfer pricing, and the concept of related companies is not even part of the legislation in either Nicaragua or Honduras. This also needs to be addressed.
- Perhaps the countries could benefit from adopting a best practice similar to Dictaman Fiscal in Mexico, that require the company executive and the company's auditors to certify that there are no transfer mispricing activities that have taken place.

Continued on p12 ...

reviews (contd)



State Building and Tax Regimes in Central America

Aaron Schneider

Maybe the time is right for the Central American countries to look at some of the success stories elsewhere. Could they harness the power of the region rather than be held back by the historic legacy of each country and the military economic elite that have dominated them. Instead of offering concessions and competing with each other, maybe they could look at the model of the European Union and adopt rules similar to the Common Consolidated Corporate Tax Base (CCCTB) being considered now. This will eventually lead to a unitary taxation model with profit apportionment to each country. With such adoption, the tax revenue base of all the countries could rise.

Under a region-based tax system that transcends boundaries, it may also be easier to consider other reforms such as the Financial Transaction Tax that was recently adopted in certain countries in Europe. While the elite could prevent its adoption in individual countries, in light of their strength in the policy making process, it may be possible to implement it as part of a broader regional initiative that could benefit all countries, and not unduly penalize any one in particular. There may also be merit to considering rules similar to the European Union's Savings Tax Directive, so as to access (untaxed) income residing outside the borders of each country. These are some possibilities to address the current dilemma that the countries face.

In summary, as Aaron argues eloquently in the book, taxes formalize our obligation to each other. They define the inequalities we accept and those that we collectively seek to redress. In the modern world, taxation is the social contract that defines what governments can and cannot do. In that sense, Aaron has rendered an important service to all countries in presenting the study of the Central American region as a microcosm of the fiscal challenges that exist, and the opportunities available to address them.

Review by Krishen Mehta

news in brief...

Automatic Information Exchange: the dam finally breaks

In 2005 the Tax Justice Network proposed that 'all banks and other financial institutions should be required to disclose as a matter of legal duty all interest, dividends, royalties, licence fees and other income (including that from employment) that they pay to citizens of another country each year, with sufficient information being provided to ensure that the recipient can be identified ... This information should be *automatically* exchanged between countries so that each country has access to data on the income paid to its citizens in other countries to ensure that it is properly taxed.'

We were laughed at. Until recently, the OECD, which has been the global standard-setter for information exchange, had been insisting that its almost-useless 'on request' system of information exchange was the internationally accepted standard. A few months ago, it made a volte-face – accepting the gold standard of automatic information exchange to be the goal - and now automatic information exchange, which we've long been pushing hard for, is making rapid, unprecedented progress, globally. In April 2013 the G20 Finance Ministers' Communiqué said that it expected 'automatic exchange of information' between jurisdictions to be 'the standard'. Most notably, pressure from the United States on countries to adopt its model of automatic information exchange via its Foreign Account Tax Compliance Act (FATCA), which forces financial institutions to provide worldwide account details for their clients, has been the crowbar for breaking the dam.

Meanwhile, a separate and different European scheme to promote financial transparency is at last seeing a logjam broken with Luxembourg, which had served as a the most implacable block on progress inside Europe, accepting that it will have to get rid of banking secrecy. The last internal holdout, Austria, is expected to fold soon, ushering in rapid progress on strengthening the project.

We are now in the early stages of the emergence of a new

Hermes, god of thieves and bankers, seen here contemplating his response to automatic information exchange.

international architecture of transparency for financial accounts. On April 9 the governments of the UK, France, Germany, Italy and Spain said they had reached agreement on a project to develop and pilot multilateral tax information exchange,' via somewhat FATCA-like processes. Exchequer Secretary to the UK Treasury, David Gauke, called this 'an important further step in the fight against tax evasion and represents the next stage in promoting a new standard in the automatic exchange of tax

news in brief (contd)

information'. He's probably right, up to a point, and these are welcome developments.

But there is no cause for celebration yet: the risk is that rich countries will move to protect themselves from offshore erosion, leaving the world's poorer and most vulnerable countries wide open to abuse. Professor Itai Grinberg of Georgetown University Law School explores these complex and fast-changing issues in a comprehensive May 2013 paper.

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2256587

Offshore leaks: More Revelations on Offshore

The International Consortium of Investigative Journalists (ICIJ) has shown how the wealthy have been making extensive use of the offshore sector to 'gain tax advantage and anonymity not available to ordinary people'.

The ICIJ has gone through more than two million files from the British Virgin Islands and other jurisdictions. Its reports set out in detail how, along with mercenaries, spies and criminals, some of the world's biggest banks are heavily involved in the offshore sector.

Gerard Ryle, one of the lead investigators at the ICIJ, said in an interview that 'the biggest surprise' is that 'it's not just the super-wealthy… it's the moderately wealthy and it pervades right down through society to doctors, dentists, small time developers, they've all discovered this world and they are all using it'.

http://www.icij.org/offshore

TJN makes waves with unitary tax; Country-By-Country Reporting gains momentum.

In December 2012 TJN published a seminal paper by Professor Sol Picciotto entitled 'Towards Unitary Taxation', which examines the current transfer pricing rules that are effectively falling apart and allowing giant multinational corporations to escape tax, and proposes a radical alternative: unitary tax, where corporations are not taxed according to the complex legal forms into which their accountants contort them, but according to the genuine economic substance of what they do and where they do it. This has gained significant attention, with coverage in the *Financial Times* and many other publications. As a result of this, Transfer Pricing Week has nominated TJN as one of the leading forces in global transfer pricing. (http://taxjustice.blogspot.ch/2013/04/vote-tjn.html)

Separately, a long-running TJN campaign for country by country (CBC) reporting has continued to advance. An April 2013 paper from the Bank for International Settlements, 'The Great Financial Crisis: Setting Priorities for New Statistics' has called for 'above all, comprehensive financial information from banks on a consolidated and global basis, covering their balance sheets but also their income statements'.

If the public interest requires country-by-country reporting, in order to head off financial instability, it also requires it to prevent rampant tax avoidance by large companies. http://www.bis.org/publ/work408.htm

TJN now sees opportunities to create a powerful synergy between its unitary tax and its CBC campaign. One key component of unitary tax is to create a holistic combined report outlining the total global operations of a multinational in overview.

If a multinational's combined report can be broken down on a country-by-country basis, then tax authorities around the world will have a massively powerful transparency tool to assess the economic substance of what those multinationals are doing and where they do it, and to tackle that either by unitary tax or by various other means. This will be a big, lengthy fight. But we are in this for the long hall, and we mean to win it.

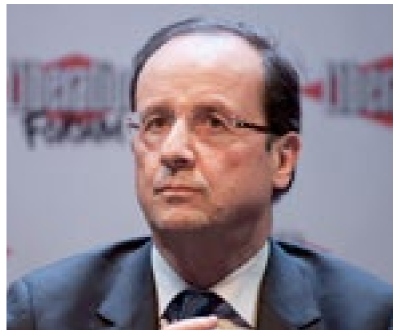
The Economist and Offshore

The Economist magazine, the leading cheerleader for globalisation, has made a dramatic volte-face on tax havens. Six years ago it ran a special report and cover story, whose leader was subtitled 'Tax Havens are an unavoidable part of globalisation and, ultimately, a healthy one.' It quoted TJN's John Christensen once, then dismissed his words with a wave of the hand. Fast forward six years, and the picture has changed completely, exploring TJN's position on tax havens in great detail, and producing a survey with which we would substantially (though not entirely) agree.

As they say, tax havens 'remain beleaguered as an increasingly confident band of "tax justice" campaigners pushes for more concerted action on tax evasion and avoidance, money-laundering and the proceeds of corruption.' In a moment of characteristic self-deprecation, the magazine floated the idea that 'perhaps the surprise is that action has taken so long'.

The Economist shouldn't be so modest. The long wait for action on offshore is in no small part down to its skilful rearguard action. We're delighted to see it finally embracing the new agenda that we've helped set.

news in brief (contd)


François Hollande has called for the eradication of tax havens.

François Hollande And The 'Eradication' of Offshore

The President of France, François Hollande, told reporters on April 10 that he intended to 'eradicate tax havens in Europe and the world'. Hollande admitted that a scandal involving a government minister, Jérôme Cahuzac, had left him 'wounded, shocked and bruised'.

Cahuzac, a budget minister in Hollande's government, admitted on April 2 that he had €600,000 in a Swiss bank account. He has now resigned from the government and is under investigation for tax fraud.

Russia, Offshore and the International Investment Bank

Strange signals emerged from Russia, one of the great victims of the global offshore system. In April, President Vladimir Putin decreed that officials have until July 1 to divest themselves of offshore financial assets, in a bid to stem corruption and capital flight and to "de-offshore" the Russian economy.

But on April 19th Russia's vice-Prime Minster, Igor Shulalov reportedly proposed creating an 'internal offshore zone' based in the International Investment Bank (IIB), a Soviet-era institution. The bank, which is independent of its member countries, enjoys diplomatic status and is 'protected from court and administrative interference', according to an Interfax report.

http://english.pravda.ru/business/finance/19-04-2013/124343-russia_offshore-0