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Globalization, Fiscal Federalism and Taxation

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1 – Introduction:

One important issue in federal regimes is the assignment of tax powers. The more decentralized is the ability to tax, the greater will be the autonomy of state and local governments to carry out their own policies. On the other hand, a more centralized fiscal regime may be recommended for macroeconomic reasons related to the coordination of fiscal policies. To keep an adequate balance between autonomy and coordination is a matter of great concern.

Of the three broad bases for taxation – property, consumption and income -, the first, that is the real state property, is more commonly assigned to local authorities, given its adherence to the local boundaries. By the same token, incomes, which are of a national character, should be taxed at the federal level; consumption, being neither local nor truly national, should fall within. This simple rule, however, is not applicable in practice. Each federation has its own history and culture that over time modeled the particular situation it faces nowadays.

Regional disparities with respect to population size, per capita income, administrative capacity and social needs, do not allow for simple solutions. When production and income are highly concentrated in a small area, the fiscal balance can be achieved only by means of an efficient regime of compensatory transfers. Thus, some centralization is required to meet the financial needs of the less developed states through a redistribution of federal tax receipts. Centralization may be enhanced when the tax administration at the state and local levels is not prepared to deal with modern taxes, so as to avoid a loss in the quality of the fiscal system.

Recourse to multiple forms of collecting taxes from the production and consumption of goods and services has been widely made to achieve a better balance in the distribution of fiscal revenues. Turnover taxes, more easily collected, grow in line with modern value added taxes, provoking economic inefficiencies and reducing the competitiveness of domestic production in the external and internal markets.

Globalization of financial and commercial activities, together with the advance of free trade areas and economic unions, poses new challenges for achieving fiscal balance in federal regimes. With the removal of barriers to trade, disadvantages due to higher tax burdens should be removed to avoid economic and social losses. Pressures for tax harmonization will, thus, produce a positive effect on the quality of the fiscal regime contributing for a successful regional and international integration.

This paper deals with the tax consequences of regional integration for federal countries. It is organized as follows: a brief commentary on the process of tax harmonization in economic unions precedes the analysis of the consequences of globalization for fiscal autonomy and regional equilibrium; this provides the argument for the proposition of a federal fiscal regime that can reconcile tax harmonization with economic efficiency and intergovernmental cooperation. Some reflections on the future follow as a way to conclude.

2 – Economic Unions and Fiscal Harmonization.

There is no dispute as to the importance of tax harmonization for the consolidation of economic unions. Since its first moments, the European Economic Union put out a well conceived project for harmonizing the tax systems of its members and worked together to have it implemented. Whereas the EEC could use some time to advance in the direction of full harmonization, the new candidates for economic integration will have to proceed at greater speed. As pressures from the global economy mount, tax harmonization within a given bloc will have to be achieved fast to avoid the risk of disintegration.

Financial markets are, as has been demonstrated recently, the most sensitive to global pressures. For that matter, taxation of both capital and income are in the priority list for adjustment. Higher taxes on profits and capital gains are conducive to capital flight, unless extraordinary gains, due to abnormal high interest rates or low labor costs, can compensate for higher taxes in the short run. Despite the possibility of provisional gains, external pressures might lead to a fast outcome. In the end, taxation of financial flows should be abolished and taxation applied on investment income (profits, dividends and interest) must converge according to international standards. As to the taxation of personal income, Tanzi (1995) mentions the possibility of going back to the old income tax regime so as to apply more uniform rules to capital income and reduce the advantages of tax heavens.

Long distances, consumer habits and non tariff barriers to trade allow for some additional time in adjusting taxes applied to goods and services. International pressures can be less evident but the demands of an economic union are overwhelming. When the traditional barriers to trade are abolished within the bloc, the elimination of tax differentials becomes a matter of top priority.

As mentioned, the trail followed by the EEC has to be retraced at greater speed. This may be now facilitated due to the fact that most western economies have already substituted a broad base value added tax for different taxes on goods and services, making it easier to proceed towards a full harmonization of tax regimes in new projects for economic unions.

Taxes on labor are less sensitive to international pressures, due to the low mobility of the labor force. Growing barriers to immigration, along with high levels of unemployment, make the problem of high differentials in payroll taxes less relevant for the time being, Culture and language also help to alleviate pressures for harmonization in labor market taxes. What counts here is the need to reduce labor costs in order to face fierce competition in external markets.

There is no general solution for promoting tax harmonization at a regional scale when federal regimes are involved. Each federation is unique, with regard to history, culture, social and economic relations, all of which must be taken into consideration. The key aspect to be considered is the degree of federal autonomy. The more a group of countries advances towards full economic integration, the greater is the need for tax harmonization, thus reducing the alternatives for giving tax powers to lower tiers of government in federal regimes. Fiscal autonomy is also constrained by the adherence to strict rules of budgetary equilibrium.

3 *– Globalization, Economic Unions and Fiscal Autonomy.*

Economic integration under global markets imposes severe limits to the autonomy of the Nation-State, as the experience of the EEC demonstrates. The consolidation of an economic union requires successive advances in the achievement of common agreed targets. Applying a common tariff at the border for the commerce extra bloc is just the beginning. Next steps lead to a full harmonization of macroeconomic policies and the adoption of a single currency. Autonomy to impose taxes, to issue money and to implement development policies have to be sacrificed to reap the benefits of the economic union. Yet, the process is not exempt from criticisms. After all, the transfer of powers over matters that affect the lives of the people to supranational institutions is not easy to accept.

Federal regimes are twice affected in the process of moving towards full integration. Tax harmonization implies the loss of autonomy to tax at the state level, whereas the acceptance of macroeconomic constraints implies a tighter control over the budget and the access to credit. Thus, the notion of federal autonomy has to be revised. Greater autonomy to spend, provided that the fiscal balance is observed, could compensate for narrow limits to raise resources at the state level. Besides, greater reliance on user charges at the local level may improve autonomy of municipal governments to the benefit of big cities, mainly.

An important aspect to be considered is the regional consequences of the global economy. Not without reason, the EEC designed from the very beginning a comprehensive regional policy based on funds to be used for enhancing the economic prospects of the less developed members of the bloc. Money supplied by the richer members is diverted to the poorer ones (and to poor zones of the not so poor) to improve their economic infrastructure, human resources and technological standards, in order to give them better conditions to participate in the European market as well as in the global economy.

Regional disparities are a matter of great concern in Brazil as well as in other large less developed economies. A recent study carried out by the Economic Commission for Latin America shows that four out of the six sectors that invested more in expanding productive capacity in Brazil in the 1995-97 period - automobiles, electronics, pharmaceutical and food processors - are dominated by multinational companies. Greater external control over decisions to invest, based on strategic considerations of access to global markets, raises doubts about its impact on internal regional disparities. The likelihood of establishing closer ties among southern Brazilian states and Mercosur countries contributes to renewed worries in the less developed Brazilian regions about the prospects for the regional distribution of production and income. It is worth noting that the newer automotive plants located in Brazil in the nineties opted for being closer to the southern border.

In the global economy, the ability of governments to deal with the problem of regional inequalities depends even more on cooperation. Traditional location factors – ill paid labor force, availability of raw material, proximity of consumer markets and low degree of labor organization – lose gravitational force at a time when the ability to move goods and services at long distances, the growth of e-commerce and the abandonment of the antagonism between labor and capital render those factors obsolete. The obsolescence of traditional location factors also renders the use of fiscal incentives ineffective. Besides, the degree of freedom to concede fiscal benefits for regional policy purposes is curbed in the process of tax harmonization, as the drive for competitiveness does not permit the maintenance of artificial solutions.

There are solid reasons to argue that integrating in the global economy and in regional economic blocs could lead to greater internal disparities in Brazil, and at the same time weaken the degree of national cohesion, due to more intense external economic relations and closer ties with its neighbors.

The Amazon region is a case in point. Already, the economy of the Brazilian Amazon is well connected to the exterior. Economic relations of the Amazon with the Northern hemisphere tends to proceed at a faster pace, given the potential for increasing the access of products derived from its natural resources – minerals, forestry and grains, not to mention the well known biological diversity – to the northern markets, ever more eager to consume natural products. Prospects for the output of the Free Zone of Manaus to reach Caribbean and Andean countries' markets improve as investments in infrastructure facilitate the commerce within the Amazon basin and the Caribbean.

The poor Northeastern region also faces new possibilities for reducing its dependence from inputs and capital goods originated in the South. A sizable portion of traditional manufacturing industries is already moving to the Northeast to benefit from low production costs and more proximity from external markets. In the global economy, industrialization of the Brazilian Northeast is no longer dependent on the South, since it gains access to machinery and other inputs from abroad often better, in terms of quality and prices, than those domestically produced.

In the South, the Mercosur is object of rising positive expectations, whereas other regions see the progress of economic integration in the south cone as posing concrete threat to the national goal of a more balanced regional development in Brazil.

What is at stake, thus, is the possibility of national disintegration in the process of international integration. To avoid this undesirable outcome, it is necessary to harmonize the domestic tax system and proceed towards tax harmonization within the continent, replacing old antagonisms by well established rules of cooperation.

Tax Harmonization and Fiscal Federalism.

Broadening the basis of taxation and applying uniform rules all over the country is the way to achieve tax harmonization with a given economic bloc. This poses new challenges for assuring fiscal balance in federal regimes in the context of high regional inequalities. The traditional combination of assigning tax powers to state and municipalities and designing compensatory transfers to meet the needs of the economically backward areas cannot be sustained. The need to share a broad basis consumption tax must now be considered.

To share the tax is not the same as sharing its proceeds. In the latter, the fiscal system is wholly centralized and revenues from the central government tax are divided according to a specific formula. When the tax is shared, both central and state governments are entitled to explore the same tax basis, under a common legislation. Autonomy to set the rules of taxation is jointly put in the hands of the Parliament, but both partners keep the ability to collect and dispose of its revenue.

A common tax basis and a national legislation form a powerful incentive to intergovernmental cooperation in the field of tax administration, bringing benefits to taxpayers and administrators. On the taxpayer's side, harmonized laws on appraising fiscal obligations mean lower compliance costs and dispense the need to go to distinct jurisdictions to solve conflicts. On the side of the tax administrators, unification of tax registers and joint verification, improves efficiency, reduces tax evasion and lowers administrative costs.

With a uniform tax, there is no room for attracting economic activities through fiscal benefits, that often lead to fiscal wars. Economic development has to be promoted by means of improvements in basic infrastructure, urban services and social programs, with emphasis in basic education and health. Intergovernmental cooperation in public spending, to implement these policies, is the counterpart of sharing the tax. By sharing a broad base consumption tax, revenue distribution keeps a close association with income and consumption level in each member of the federation. Compensatory transfers may thus be reduced to the level required to maintain a minimum standard of services everywhere in the country, allowing for a greater role of local governments in the provision of urban and social services.

Stability in the tax system is another important advantage of sharing a tax. When a broad base tax is shared in a federation, frequent changes in legislation are less likely to occur, as proposals to change require enough support to overcome reactions of those who may not agree with the intended modification. It is worth noting that stability of fiscal rules becomes even more important in the context of global markets and regional integration, given its importance for attracting investments and for decisions to increase productive capacity.

Even though tax harmonization implies a loss in federal autonomy , by submitting tax powers to common rules, it produces gains from the viewpoint of well established principles of taxation . Neutrality of the tax system is reinforced by the overall considerations of competitiveness brought about by the global economy and regional integration. Besides being neutral, tax systems in the modern world have to fulfill other important precondition: to protect the taxpayer against fiscal abuse and instability.

The benefit principle of taxation also find new opportunities at the local level. Big cities play an important role in the global economy at the same time that face increasing difficulties to match revenue and expenditure needs. Local taxes on property and on final consumption do not create economic distortions and may thus be better explored . Charges imposed on the beneficiaries of services publicly provided at the municipal level could also play an important role in the local public finances.

On the other hand, emphasis on microeconomic competitiveness puts aside considerations of equity in taxation. Progressive income taxation is affected by the increasing mobility of capital and high paid jobs. Applying selective taxes on consumption is also constrained by competition in domestic and international markets. Equity may thus be better achieved by means of conceding priority to public programs designed to equalize opportunities for social mobility in public spending.

Overall tax burden is also submitted to international constraints and to macroeconomic standards of a sound fiscal policy. Efficiency in public spending is the only way to maintain an adequate level of public services without surpassing the limits to impose taxes.

Final Comments

The focal point in the analysis of problems faced by federal regimes which seeks to promote tax harmonization is autonomy. What kind of autonomy can be sustained within a federation in order to preserve its ability to deal better with regional diversities without losing the national unity?

As mentioned before, autonomy to tax could be replaced by greater autonomy to dispose of the fiscal resources at the state and local levels, so as to allow for a better adjustment of public spending to regional demands, provided that the rules of fiscal responsibility are obeyed. Besides, the submission of fiscal autonomy to a joint harmonization project reinforces the need for intergovernmental cooperation. A cooperative federalism is the way to reconcile federal autonomy with fiscal harmonization. The question is how to enhance cooperation in the face of renewed manifestations of antagonism and in the absence of adequate incentives.

In Brazil, and probably in other federations, antagonisms among the states have gained new impetus, as the so-called fiscal war demonstrates. Antagonisms are also manifested through increasing resentments on the part of taxpayers in richer states over high tax burdens required to sustain generous fiscal incentives and transfers, that often benefit those who are better off living in the poorer regions of the country. Once in a while, calls for separation appear to voice the discontentment with the present situation.

Thus the environment is not yet favorable to the development of a cooperative federalism. On the contrary, the search for individual gains making use of newer opportunities for improving external economic relations may be seen, at first sight, more profitable from the viewpoint of each particular state in the federation. The likelihood of a national disintegration, along with the deepening of the international integration, must not thus be overlooked.

<u>Reference</u>

Tanzi, Vito (1995) Taxation in an Integrating World. Washington, The Brookings Institution.