



**CHOWN DEWHURST LLP**

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**TRANSITIONAL AND EMERGING COUNTRIES -  
THE ROAD TO PROSPERITY – CAPITAL MARKETS AND TAX POLICY**

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**1. INTRODUCTION**

Countries emerging from poverty or making the transition from Communism need effective capital markets if they are to grow and prosper. John Chown has had many years of experience with public policy in the UK and elsewhere and now spends much of his time helping such countries both on specific assignments and as a regular participant in the inward and outward missions organised by International Financial Services London<sup>2</sup> where he is on the CEE, CIS and pensions committees. This work was originally on the specific tax aspects of capital market development but now in collaboration with Jackie Newbury and others extends into a general package of advice on the development of capital markets in the broadest sense.

My old professor and life-long friend Peter Bauer famously said that international aid only too often transfers money from the pockets of poor people in rich countries to those of rich people in poor countries. This is certainly not an argument against aid as such, but is a danger that its providers must guard against. Foreign aid is essential to deal with abject poverty but, at least in those countries which are striving towards modern democratic institutions and relatively free markets, small sums spent on providing the right kind of technical advice on how to grow their economies can achieve vastly more than much larger sums of direct aid.

It has to be the right kind of aid. As explained in section 6 dealing with aid agencies can be very frustrating for precisely the people who are most able and willing to help in that section make suggestions about how matters might be improved. This in its present version was stimulated by reading a book by a former World Bank economist, explaining the key difference between "searchers" who are effective and "planners" who are not.

We begin with general comments on capital markets: taxation is covered in Sections 7-9.

**2. THE ROLE OF CAPITAL MARKETS**

Capital investment stimulates growth and prosperity, but it has to be productive investment. There are plenty of examples of totally useless 'prestige' projects – and not only in former dictatorships! My own country can boast several, from the 'groundnuts scheme' to the 'Millennium

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<sup>2</sup> Other major projects during this period involved Cyprus and Thailand. These were mostly on the tax aspects but our wider interest follows our work on a 2003 World Bank-financed project on the development of capital markets in Russia. More recently, we had projects on capital markets in Mongolia and Thailand and were involved with several other countries including visits, during 2006-7, by the Lord Mayor to Hungary, Turkey, China, Kazakhstan and Qatar, Russia, Azerbaijan, Taiwan. Jackie Newbury with her extensive experience of international capital markets has been a valuable colleague in Mongolia, Thailand, Kazakhstan and elsewhere.



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Dome' to mention but two. Even investments chosen by investors risking their own money can produce negative returns, subtracting value from, rather than adding it to, the economy and there is no magic formula to ensure that all investment produces results. Specific government intervention in investment decisions generally produces worse results than a free market, but good policies on taxation and regulation can help enormously to improve the quality, as well as the quantity, of investment and enhance the prosperity of the country. Investments can come from:

- Foreign investment, which brings in technical and managerial know-how as well as money. Foreign investment is, by its nature, mobile and investors being free to take their money anywhere in the world will commit funds only after looking very carefully at the tax regime, the regulatory aspects and the protection given by the legal system to support their property and contractual rights.
- Domestic savers. Even the poorest country generates savings (India and China – only relatively poor – have far higher savings ratios than Western nations) but sound and trusted market mechanisms are needed to mobilise these savings into productive use. This is a main theme of this paper, but policy makers should recognise that small farmers and traders, putting aside some of their profits into productive physical assets, account for a significant part of total capital formation, even if this may not be properly recorded as such in the official statistics. Micro-finance can have an important role to play.
- Repatriated 'flight capital' including both substantial profits made (sometimes, but not always, honestly) during the early development of the country and smaller amounts sent abroad by otherwise honest employees, professionals or businessmen, who did not trust their then government. This is a particularly important factor in some former Communist countries,.

The question of attracting foreign or repatriatable capital is discussed in Section 5 below, but the main topic of our recent studies has been on the development of domestic capital markets for mobilising domestic savings. To achieve this we have to ensure a supply of savings and to channel this into a demand for investments. This is discussed in Section 3 but if we are to develop public capital markets we also have to ensure a supply of suitable securities that are discussed in section 4 which also stresses the importance of finance for early-stage businesses.

### **3. THE SUPPLY OF SAVINGS AND DEMAND FOR SECURITIES**

Initially at least the country will want to encourage and harness the savings of a comfortably off but financially unsophisticated population, and who may need incentives to encourage them to save generally, or to invest in certain specific ways. For them, financial intermediaries, pensions, life assurance and mutual funds have a major role to play. Our first two assignments in Russia were on the tax aspects of mutual funds and pension funds respectively.

Good laws relating to pensions and their tax treatment can substantially improve incentives and increase domestic savings and are the key to many other aspects of economic performance, intriguingly including infrastructure financing. This has been a key component of work we have done on capital market development in other countries. Most countries including my own have made the mistake of having separate departments (e.g. Finance Ministry, Social Security departments and Financial Development and Regulation), and a major part of any assignment has been to liaise between these departments (we typically have very different goals) and to make sure that because we need their efforts to devise a sensible system, all the aspects are looked at as a system.



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A good tax system can encourage savings, while a high level of savings is, to some extent, a substitute for taxation. The tax system should create a bias in favour of the honest citizen who is investing his money profitably and paying a reasonable amount of tax. British, American and other experience show that many specific tax concessions simply open up opportunities for tax avoidance for reasons discussed below. Those proposing them seldom make a rational and informed analysis of the trade-offs between revenue foregone and economic objective (such as higher saving) generated. In retrospect, these often prove to be substantially unfavourable.

We have studied the long history of measures to encourage savings and investment in many countries, and few, if any, have achieved a rational package. Typically, new incentives have been introduced hastily to deal with perceived politically sensitive or topical problems (often actually created by earlier tax measures introduced for a different purpose) and the end result has only too often been a complex collection of little understood and sometimes mutually contradictory tax provisions which do little to achieve their stated aims.

Although specific incentives to savings can produce dramatic results, the expected gains from the better use of resources have to be balanced with (at least) three types of offsetting cost.

- the rewards, often half or even more of the potential tax saving, which are pocketed as commissions by financial salesmen. If possible, incentives should be designed so that they do not require the services of intermediaries, or encourage “schemes” which are expensively sold as “financial products”. This may be acceptable given that it is often said (most commonly by salesmen) that “financial products are not bought. They are sold” but may adversely affect the “cost benefit” trade-off referred to above.
- the “dead weight cost” of giving the incentives to those who would have made the investment in any case. Suggestions promoted by lobbyists often have this effect.
- the distortions caused by increases in other taxes which need to be raised to balance the budget.

#### **4. THE SUPPLY OF SECURITIES**

A capital market needs a supply of, as well as a demand for, securities. Some countries such as France (and Thailand where we worked on the subject) feel the need for incentives designed to encourage companies to list. Other countries have the opposite problem. In countries with long-established capital markets, the great majority of companies seeking listings are those which have been built up in the lifetime of the founding individual or group. These countries need and most have incentives to tempt money away from the stock market and into early stage new companies which will contribute to economic growth in their own right and form the nucleus of the listed companies in the future. This requires a combination of banks, individual “business angels” and (sometimes) specific venture capital funds.

In some countries, privatization has been used to develop capital markets. Chile is a classic example of a country which used privatization to kick-start both pension and capital market reform. The United Kingdom’s impressive privatisation programme also sought to take the opportunity of widening share ownership but the procedures used gave, for reasons we can explain, an unnecessary benefit to institutional investors and market insiders. In the early post-communist days in Russia and Eastern Europe we saw at first hand the experiments in “voucher privatisation” but these were predictably not a success.



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Some countries have used the concept of Public Private Partnerships to bring private capital into public sector infrastructure projects. This has frequently been abused and we have had occasion to criticise it, but at its best can be a very powerful technique. Such arrangements can produce a flow of precisely the type of bond instruments appropriate for a private pension system.

The bond market is an important part of capital markets in many countries but is sometimes ignored in the countries where advising

### 5. ATTRACTING FOREIGN INVESTMENT

From our experience as advisers to foreign investors, we know that non-tax factors, and a sensible general tax system are more important than specific tax incentives. They need:

- a clear and stable legislative income tax framework and a well-trained administration to administer the tax law fairly and consistently. If companies are advised that the law is unclear, they will make their decision whether or not to invest on the least favourable outcome but if they do invest will use their best efforts to reduce their tax bill. The country thus gets the worst of both worlds: the disincentive effect of a high tax rate with the yield from a low tax rate.
- the clear right to deduct all proper business expenses in computing taxable profits
- proper treatment of losses and generous provisions for carry-forward.
- Low inflation, or at least laws recognising that inflation can distort tax systems particularly on capital gains but also including depreciation: ad hoc adjustments to compensate for this are normally unhelpful.
- Tax holidays, though, generally prove to have little value, being of the greatest benefit to short term quick-profit businesses. Specific business negotiated tax concessions often turn out to have been give to what the OECD politely calls “politically vocal groups” and are not usually the best answer for the country.

The base on which tax is collected can be even more important than the nominal rates and this should be the true economic profit, as perceived by the investor, after depreciation, taking account of inflation and after conversion into dollars, euro, yen or other home country currency.

Exchange controls have in the past been a major obstacle to international investment. History suggests that they are generally ineffective, but the sudden abolition or relaxation of exchange control can bring into focus previously irrelevant distortions in the tax system and cause adverse tax induced capital flows.

The impact of withholding taxes depends on where investment is expected to come from, and this is particularly important for debt securities. There is an enormous pool of money in the world, owned by those who, whether legally or illegally, do not pay tax on the returns. If such an investor can (for a given level of risk) earn 5% tax-free from one source, then he wants this return net of any withholding tax which is imposed in another. In such cases, withholding taxes clearly fall on the borrower, not the foreign investor. However, direct investors from countries such as the UK, US, Japan and Germany will usually be able to credit the tax against otherwise taxable profits, and a withholding tax will then collect revenue without affecting their investment decisions. There are some very interesting opportunities for designing tax systems which “play” to the needs of such investors.



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## **6. WHY AND HOW THE WEST SHOULD HELP**

"Give a man fish and you feed him for a day:  
teach a man to fish and you feed him for life"

Massive and generous assistance international aid is often needed, but, the best long-term solution must be to help countries to help themselves. Modest amounts spent on technical assistance to help them develop a soundly based and appropriate economic structure can do far more than billions of direct aid, even when this aid is properly and honestly applied for its purpose. Good professional advice on the topics covered in this paper costs relatively little and can confer an enormous benefit on the country - but only if the study is properly conceived and the government can be persuaded to implement it. There is no point in writing a brilliant report which then gathers dust on the shelf.

On one major project, I commented to the (very helpful) local office of my paymaster that I knew exactly what needed to be done but it would need at least two more visits to "engineer consent." They were rather surprised at the expression, but I explained that I would need to talk to many people about possible objections. Where these are valid, the advice may need to be changed; and where there has been a misunderstanding, the adviser must explain the point better in the context of the country's economic and political situation. That will still leave objectors who pursue a private agenda to protect an interest and their views, however mistaken, will inevitably influence the political process. Tax changes are never made by simply adopting a foreign consultant's report. Implementation involves many levels of several departments of governments both at the civil service and at the political level, and any proposals have to be manoeuvred through the appropriate legislature.

I never expected to live to see the day when Communism collapsed but when it did I was keen to give these countries any help that they wanted, particularly in developing their tax systems and capital markets. My early efforts were frustrating, and I might have given up but for the old UK Know How Fund which changed its name and lost its effectiveness after the change of government. Having completed one project with them, I was treated as a trusted resource. They employed people (in my, probably typical, case a retired civil servant) who discussed with us what needed doing, put together a team and then helped us handle the inevitable paperwork.

During ten years' experience of public policy work in Russia and elsewhere, I have met many other late career professionals or academics delighted to share their experience with countries needing technical assistance. In Moscow, our informal network which excelled in avoiding unnecessary duplications often arising from the lack of communication between different departments of the same aid agency. One common complaint was the rigidity, bureaucracy and general inefficiency of these agencies, and the amount of work needed, not on helping beneficiaries, but in filling in tedious forms and attempting to operate within an unrealistic and arbitrary structure.

Even today, when these countries are becoming prosperous, they have been spoilt into the belief that technical assistance is paid for by somebody else. Plenty of good work is being done by people funded by aid agencies, but when governments themselves on a project now far more likely to recruit and work directly with small high-level teams, and to act promptly on, what they have themselves paid for.

We have had some good experiences with aid agencies but they can sometimes be very frustrating. I found the European Commission particularly rigid in its practices (this is some time ago and I have not had or sought any recent experience) but I once had occasion to tell the then British Commissioner in Brussels that there were countries out there needing help, people very willing to



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provide help, funds voted by the European Parliament to finance it - and a whole bureaucracy in Brussels dedicated to keeping these three factors apart!. The nature of the problem is brilliantly explained by William Easterly<sup>3</sup> a former World Bank chief economist. His concept of the difference between "planners" and "searchers" really explains the problem we have all been facing. The author is as keen as any of us about the need to alleviate world poverty, but is critical about how it is done. There have been, he says, too many grand plans when the most viable solution to development is to have no plan, hence "the tragedy of the West spending \$2.3 trillion in 50 years and not solving the simplest problems."

He divides people into "planners" and "searchers" with the aid agencies being dominated by the former: "the attention to grand plans takes the pressure of the rich to help the poor even if the plans being laid are fundamentally flawed". The planners have no real accountability, while "searchers get a direct feedback from the clients they are trying to reach.

This explains why so many useful people, very willing to help at a fraction of their normal fee rates, are so discouraged by the approach of the aid agencies, whose proposals so often begin by setting out what they think needs to be done and then divide up the task to fit in with their concept of the type of experts needed and precisely how many days each expert would need. They then set up a competition between teams put together by such experts, with no scope for the obvious "mix and match" approach, such as was used by the pre Clare Short UK "Know How Fund", with which it was a pleasure to work.

We "searchers" know we cannot tell in advance which lines of enquiry will prove rewarding and which have to be abandoned, nor do we know what particular skills will eventually be needed. We feel our way through problems, one step either leading to another – or showing that we are on a false trail and have to back-track. We really like to begin with a small team who can undertake a scoping project, and having had the go-ahead on that can build a team as we go along. The extra people we find we need can be identified very quickly with a few telephone calls once we know precisely what we want. High quality people are happy to help once there is specific and agreed project, but not to complete the interminable forms required by the agencies on the off chance of a project coming off!

## 7. GENERAL PRINCIPLES OF TAXATION

This brings us to my original special subject. Saving and investment and business activity generally can be very sensitive to apparently minor features of the tax system. During my early Know-How Fund assignments my terms of reference typically included "how to encourage the development of [capital markets] while ensuring that participants pay an appropriate share of tax." After the change of government it was suggested to me half in jest that we should amend this to "how to collect tax from capital markets without driving them away".

The natural honesty of taxpayers, and the ability of tax collectors to pursue evaders, varies widely from country to country. But tax evasion involves costs for the taxpayer, even apart from the guilty conscience (sometimes, although perhaps not often, a deterrent) and the perceived risk of prosecution. The evader may have to rely on possibly dishonest and certainly expensive intermediaries to get his money abroad or, because he has to conceal his wealth, may miss out on investment opportunities at home. Money "under the mattress" gives no yield. The would-be honest citizen should

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<sup>3</sup> William Easterly: "The White Man's Burden: Why The West's Efforts To Aid The Rest Have Done So Much Ill And So Little Good." Oxford University Press, September 2006. Reviewed in World Economics, October-December 2006 by Carol Graham.



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be encouraged to declare and pay tax on his earnings and then invest any savings openly and productively. This can actually increase the tax take, while helping to produce goods and generate employment.

Two key principles are that "high rates don't work (but really low rates are not necessary)" and "tax law must be clear and simple". Investment will be stimulated if the overall burden at investor level is reasonable: what is 'reasonable' will depend on circumstances: a yardstick around 20-30% of true economic profits should be acceptable. Taxes should be imposed in ways which do the least damage to the productive economy.

### 8. TAXING FINANCIAL MARKET PARTICIPANTS

The taxation of financial market participants themselves is an enormously complex subject. Legislation in countries such as the United Kingdom and the United States on derivatives alone run to hundreds of pages mainly because the aim of ensuring neutrality between different legal ways of carrying out the same economic transaction conflicts with the need to prevent tax avoidance.

Specifically, the tax treatment of derivatives<sup>4</sup> has typically lagged far behind the development of the markets themselves. Derivatives create, or at least highlight, the problems of 'tax fragmentation', the different tax treatment of transactions which differ in form but which have the same economic effect

Although as a general principle the tax treatment of derivatives should follow the treatment of the underlying instrument, if different combinations of derivative and underlying transactions have the same economic effects, the tax treatment should be the same. Treatment should be symmetrical in two ways. First, there should be no risk that the tax authorities can treat the fact of a profit, perhaps applying anti-avoidance legislation, by imposing a tax while denying relief against an exactly similar loss. Second, where an income item is taxed to one party, the corresponding cost should (normally) be allowed as a deduction to the other.

It is never quite as simple as that, and the tax treatment of the underlying financial transactions, and differences between the treatment of dividends, income and capital gains has, in all countries, developed in a rather haphazard way. The growth of derivative markets also often brings existing defects in the tax system into sharper focus.

Value added tax (in some countries called 'Goods and Services Tax') intended a comprehensive tax on goods and services notoriously works badly when applied to financial services, as these do not fit into a normal VAT structure. This was a major issue in assignments in Russia and Thailand. A large gross cash flow (loan interest or insurance premiums) can include a much smaller net element of 'service'. No country has found a really accurate way of taxing this 'service' element but the general EU compromise is to 'exempt' financial services (i.e. without the right to reclaim input tax) but this under-taxes services provided directly to the final consumer while imposing an extra burden of 'trapped VAT' on services provided to business. Generally transaction taxes on gross turnover, even at modest rates, can inhibit and often prevent the development of financial markets, and should be abolished wherever possible.

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<sup>4</sup> This has been a special subject of ours. John Chown, having written extensively about the problems, was a member of the "Group of Nine Representative Bodies" which negotiated the reform of the taxation of foreign exchange and derivatives with the UK Inland Revenue, and in 2000, He undertook a four-visit World Bank project specifically to advise on the taxation of derivatives in Thailand.



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## 12. APPENDIX - THE QUESTION OF TAX RATES

All countries need both to raise tax revenue, and to encourage a healthy, free economy. Can they have both? Joseph Schumpeter, a great economist who in youth served briefly as Minister of Finance in Austria after the 1914-18 war, may have been the first to point out what is now a well-known phenomenon. Impose a tax rate of zero, and you will obviously collect no revenue. A tax rate of 100% will simply destroy the tax base, and again produce zero revenue.

The high tax rates endemic in the post-1945 world revived practical, political and academic interest in this topic. Colin Clark introduced the concept of "the limit of taxable capacity" which he put at 25% of GDP, a figure long since exceeded. Lionel Robbins, with his "incentive index", resolved the paradox that, although high taxes discourage work and enterprise, they can also force people to work harder just to pay them. The concept of the 'Laffer Curve' is sometimes invoked to 'prove' that low rates bring in more revenue. This is true, but only up to a point. James Mirrlees, who with William Vickrey, won the Nobel Prize in 1996 gives another interesting view in "Information and Incentives: the economics of carrots and sticks"<sup>5</sup>.

Our own analysis is simple in concept: reducing the rate from 90% to 80% will increase revenue but reducing it from 20% to 10% will not, revenue collected being a multiple of the tax rate (T%) and the tax base, while the disincentive effect (which reduces the tax base) varies with net income, i.e. what is left after tax (100-T%). I used to say that there was an optimum top tax rate at somewhere between 25%-30% but tax competition has (thanks partly to the influence of the new EU members) fallen a little below that on corporate and business income. Earnings, though, continue to be taxed at a higher rate thanks to social security contributions. This reflects the fact that capital is more mobile than labour and indeed some countries, such as Sweden, have been experimenting with a 'dual income tax' with low rates for investment income. Some transitional countries in particular have been adopting flat taxes which can work for them although, again because of social security contributions, they are not quite as generous as they seem.

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<sup>5</sup> Economic Journal, 1997, pp. 1311-1329.