Greeks bearing no gifts this time

By KEN MARK

Concerns over sovereign debt in advanced countries such as Greece continue to cast a dark shadow over a global economy struggling to recover.

"It is not just Greece that is facing deficits and public debts of significant size, but all large market economies," says William White, retired Bank of International Settlements (BIS) chief economist in Basel, Switzerland. "By 2020, there is an expectation that these countries, including the U.S., will have national debt-to-annual-GDP ratios of 100 per cent or more.

"Countries like U.S., UK, Spain, Italy and others will find it more difficult to make an economic recovery because they will be weighed down by public debt."

Is there a risk of a double-dip recession? "Not from this event," says Waterloo Ont.-based Wilfrid Laurier University economist Pierre Siklos.

"The risk was already there because of doubts that central banks can successfully exit from their unconventional monetary policy measures.

"There is also a large global build-up of debt. If interest rates rise, this will mean a simultaneous tightening of both fiscal and monetary policies. That possibility is enough to risk a return to recession."

At present, Greece is the global whipping boy for sovereign debt since it must roll over two bond issues totalling 12 billion euro by the end of May and 20 billion euro by the end of the year. Global investors have been seeking annual yields of just over seven per cent, twice the going rate for similar 10-year German bonds. Greece's current deficit is about 13 per cent of GDP — more than four times the allowable limit under European Union rules. Its overall debt-to-GDP ratio is 113 per cent.

In late April, the Greek government requested 45 billion euro in aid from a European Union-International Monetary Fund package.

Such rescue efforts seek to forestall a Greek default on its financial obligations. While the jury is still out on that possibility, Siklos says "if Greece or any of the other so-called PIIGS (Portugal, Ireland, Italy, Greece and Spain) do default then look for other countries that might face debt problems to feel much less reluctant to default."

Of special interest to accountants is the recent revelation of Greece's presumed use of aggressive accounting techniques. In question are its 2001 hedging moves involving credit default swaps (CDS) that apparently concealed 2.4 billion in foreign debts. In 2008 Eurostat, the European Union's statistical office, banned such practices.

"We look for reliability in government reports," says Ian Beauchamp, London-based head of global rates strategy, RBC Capital Markets.

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Pierre Siklos, Wilfrid Laurier University economist

"Those from emerging markets are not always dependable. Ones from the core of Eurozone countries are solid. But Greece may be considered on the cusp of being an emerged economy. It was first rejected for membership (in 1999) but was accepted two years later.

"The key issue is credibility. Greece has not done itself any real favours. Its recent actions have planted doubts in our minds."

DI MATTEO

"Canada's problem was the result of rising government program spending financed by debt."

Livio Di Matteo, Lakehead University

According to Tim Beauchamp, (no relation) Toronto-based director, public sector accounting board of the Canadian Institute of Chartered Accountants, standards setting groups such as the International Accounting Standards Board and the International Public Sector Accounting Standards Board (IPSACB) have recently introduced new standards on how to account for financial instruments such as derivatives.

"However, national governments have sovereign power so they have the authority to set up and follow their own standards," he says, adding that it's "completely voluntary" to decide whether or not they want follow other standards.

"Auditors preparing the financial statements may decide to issue a qualified audit opinion if they believe that the statements do not fairly represent the financial position and annual results if the non-compliance is material to the results."

For practitioners assessing government statements before deciding to invest in their bonds, Beauchamp suggests they look beyond the income statement to the balance sheet to get a better idea of what is going on regarding changes in financial position.

When White heard a Greek government official claiming that the hedging strategy was no big deal because it represented only 1.5 per cent of his country's debt, his response was, "It was a big deal since it was the government's intent to use these contracts to mislead."

No matter how the Greek credit crisis turns out, White argues that countries encountering such problems can still face further economic problems. He cites the research of Kenneth Rogoff and Carmen Reinhart, authors of the recent book, *This Time is Different*. In an earlier study, they concluded that, "The real value of government debt tends to explode, rising an average of 86 per cent in the major post-World War II episodes (of financial crises).

"The main cause of debt explosions is usually not the widely cited costs of bailing out and recapitalizing the banking system. The collapse in tax revenues in the wake of deep and prolonged economic contractions is a critical factor in explaining the large budget deficits and increases in debt that follow the crisis."

As for possible danger signs, White points to a spiralling debt-to-GDP ratio made worse by interest rates climbing faster than GDP growth rates. "As a result, the debt is 'grossed up' by rising debt service charges," he says. "To reassure banks, governments must reduce debt levels.

"If they do nothing, the amount of debt becomes uncontrollable and unsustainable. To reduce the deficit, countries have two choices — cut expenses and increase taxes."

In fact, Canada is an old hand at implementing such drastic measures. In the early 1990s, that's how it tamed its runaway deficit. According to a recent article by Livio Di Matteo, a Lakehead University economist in Thunder Bay, Ont., Canada's modest $1 billion annual deficit in the 1970s climbed to $29 billion in 1982 before topping out at almost $40 billion in the early '90s.

Di Matteo further states that the deficit kept climbing because of very high interest rates in the '80s as well as a widening fiscal gap involving real annual spending increases of two per cent versus annual revenue increases of just one per cent.

As a result, total outstanding government debt ballooned to $596 billion in 1996 from $108 billion in 1982.

"Governments have a fascination with debt," says Di Matteo. "In the short run, it is something for nothing because it pays for government programs and projects with no immediate cost. But in the long run, debt becomes nothing for something because the money has been spent but the debt still has to be repaid.

"Canada's problem was the result of rising government program spending financed by debt. The debt level kept rising because expenditures kept growing but the cost of borrowing grew even faster."

In the mid-1990s, popular support supplied the government with the political will to introduce austerity measures. "It happened after the collapse of the Mexican peso which caused long-term international bond and then domestic mortgage rates to rise sharply," recalls White, who was working in Ottawa at the Bank of Canada at the time.

"The man-in-street response to the government was 'do something about controlling interest rates.'"

Although the measures inflicted severe financial pain, the absolute level of Canada's public debt and the debt-to-GDP ratio both fell. Between 1992 and 1997, federal spending fell by almost 20 per cent. As a result, the federal government enjoyed 10 straight budget surpluses.

Could Ottawa introduce similar programs now to handle its current $54 billion deficit? "Economic conditions today are relatively worse," says Di Matteo.

"The whole world is now in recession — some advanced economies saw their GDP drop by six per cent to10 per cent along with major job losses. The U.S. economy alone lost close to eight million jobs.

"Canada also got lucky in the 1990s because it caught the boom in the U.S. economy and our exports benefited from a 60-cent

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Shifting wealth brings treaty pressure

TAX VIEWS

By Vern Krishna

Canada is negotiating tax information exchange agreements at a furious pace to counter international tax avoidance. World economies are rebalancing and the tax authorities are running fast to protect their treasuries.

Canada, a commodity producing country, must expand its horizons beyond its traditional trading partner — the United States — to take advantage of new economic opportunities.

Emerging markets promise future growth for developing and developed countries alike. Economic power shifts also bring a new focus to international tax treaties, which are economic bargains between countries.

Early treaties focused primarily on preventing double taxation. In 1923, the Report of the Experts, commissioned by the League of Nations, recognized that double taxation could deter foreign investment and act as a barrier to international trade. So international bodies developed model tax treaties to reduce such barriers and encourage foreign investment.

There are many different types of tax treaties. For example, there are treaties on income and capital, estates and gifts, inheritance, and on administrative assistance in tax matters. There are also limited scope treaties that deal with specific industries — for example, shipping and aircraft.

The title of tax treaties articulate their traditional purpose: the 'avoidance of double taxation' and the 'prevention of fiscal evasion.' More specifically, tax treaties address four basic questions:

• Jurisdiction: Which of the treaty partners has the primary and secondary jurisdiction to tax revenues?

• Nature of income: What is the character of income that a taxpayer derives?

• Source: What is the source of the taxpayer's income?

• Enforcement: How do we enforce tax collection, avoid double taxation and prevent tax evasion?

Tax treaties do not impose taxes; they merely limit the state's taxing powers. Although tax treaties may reduce a taxpayer's domestic tax, they do not generally increase taxes. A tax treaty is a shield, not a sword. The U.S. model explicitly states this principle: "The convention shall not restrict in any manner . . .any benefit accorded by the laws of either contracting states."

For example, a tax treaty between two countries might limit the maximum withholding tax by the source country on interest payments to 10 per cent. That does not mean, however, that the source state must impose any tax on interest payments to non-residents.

A taxpayer can choose between the benefits of the domestic law or the treaty. However, one cannot 'cherry pick,' choosing the domestic law for one part of the result and the treaty for another.

The enforcement of treaties depends upon the constitutional structure of the particular country. Under Canadian constitutional law, for example, Parliament and provincial legislatures have the sole authority to levy taxes. Thus, Canada specifically legislates its tax treaties into its domestic law.

The United Kingdom also limits taxing powers to Parliament. The *English Bill of Rights* of 1689 provides: "That levying money for or to the use of the Crown by pretence of prerogative without grant of Parliament for longer time or in other manner than the same is or shall be granted is illegal."

Tax treaties have two broad purposes. The first is to eliminate double taxation of income that residents of one country earn from sources within the other country. Eliminating double taxation promotes closer economic co-operation between treaty countries and reduces barriers to trade caused by overlapping taxing jurisdictions. Typically, tax treaties seek to prevent double taxation either by exempting particular types of income from tax or by stipulating a maximum rate at which the income is taxed.

The Organisation for Economic Co-operation and Development Model Tax Convention — which developed countries use to negotiate their treaties — prevents avoidance of double taxation through two fundamental mechanisms. It provides that:

• The country of residence will eliminate double taxation of income by providing a foreign tax credit for foreign income or by exempting the income from tax; and

• The source country will reduce the scope of its jurisdiction to tax income at source by reducing its withholding tax on income that the non-resident earns in the country.

The United Nations Model Convention — which developing countries use — serves an additional purpose. In addition to eliminating double taxation and reducing inappropriate tax avoidance and evasion, the UN Model also promotes politically acceptable investment in developing countries. So, there is some tension in treaties between developed and developing countries.

Developing countries accept the first principle — reduction of taxes by the country of residence through a tax credit or exemption for foreign income, which results in the residence country yielding its jurisdiction to tax foreign source income.

However, developing countries are much more reluctant to reduce their own yield on source taxation. The issue is as much political as it is economic. Indeed, some developing countries say that the source country should have the exclusive jurisdiction to tax income arising in the country.

The second purpose of treaties is to reduce tax avoidance and evasion of income taxes in international trade and commerce. To do so effectively, countries must exchange tax information with each other. Canada has a number of treaties that provide for the exchange of information for the prevention of fiscal evasion and the avoidance of double taxation.

The authority to exchange information with other tax administrations is in Canada's tax treaties under the *Exchange of Information* article. The Canada Revenue Agency has the authority for exchanging information with treaty partners.

As developing economies grow and become more powerful, developed countries will press for treaties to reflect the new realities of economic power. We are already seeing the emergence of information exchange treaties to counter tax avoidance.

We fully expect that China and India — neither of which are in the OECD — will dominate economic growth in the next two decades and surpass most European Union countries. As they do so, there will be a shift in balance between world economic powers and renewed interest in tax anti-avoidance measures.

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Spectre of debt lessens wiggle room

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dollar. Today, U.S. consumers are not buying as much and the Canadian dollar is close to parity."

He also points out that unlike in the 1990s, current interest rates are expected to rise and there is a very high level of private sector debt in addition to public sector debt. As well, currency volatility and rising protectionism will make global trade more difficult.

According to White, capital losses from the financial meltdown will further hobble global recovery efforts. Another concern is long-term unemployment. "As a result, matching past economic performance figures may no longer be reasonable," he says.

Di Matteo agrees. "Realistic forecasts for real annual growth (after eliminating CPI) should be around two per cent," he says. "That's been the average for the past 100 to 150 years. These will not approach the average 1945-73 annual figures of three per cent to four per cent — they were boom years."

Ian Beauchamp

As the world economy gradually recovers, its shape and form may start to change.

"Despite the increased risks related to the huge U.S. deficit, global investors are not reducing their existing holdings of U.S. treasuries," says Ian Beauchamp. "Nor is it likely that the U.S. dollar will lose its position as the global reserve currency. There is no real alternative right now. The Chinese renminbi, if allowed to float and circulate freely, might be ready in 10 years."

"Currently central banks and other investors are starting to look more at bonds in other currencies including the Australian, New Zealand and Canadian dollar. They are also diversifying their portfolios into other assets including property and equities.

"Such a change is long overdue."