TAX DISTORTIONS, FISCAL DUMPING AND TAX FRAUD

by

John Christensen
tax justice network

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A series of corporate scandals in recent years, involving such high-profile companies as Enron, Tyco, and most recently Russian oil major Yukos have drawn public attention to the growth of organised corporate tax abuse through transfer-pricing, re-invoicing, the use of special purpose vehicles, corporate inversions using tax havens, dubious charitable trusts and other tricks of financial engineering.

In the case of Enron, which until two years ago was being heralded by corporate gurus as the role model for the twenty-first century, a total of 881 offshore subsidiaries, of which 692 were incorporated in the Cayman Islands, were used as part of an elaborate strategy to avoid taxes[1]. Data for the period 1996 to 2000 shows that over a five-year trading period Enron generated pre-tax profits approaching US$1.8 billion (€1.5bn), but paid no federal income taxes and was in fact a net recipient of tax rebates[2].

Enron's aggressive strategy of minimising its asset base and avoiding taxes on a global basis made it the darling of international investors, and it was only after the house of cards collapsed that its accounting and legal advisers sought to distance themselves from what was delinquent corporate behaviour from the outset. Importantly, however, many of the practices adopted by Enron remain in use, particularly in the field of tax abuse. Studies conducted in the United States show that a large number of top companies, including famous brands such as Accenture, ExxonMobil, Hewlett-Packard, Intel, Halliburton, 3M, and Bank of America, have paid armies of accounting, banking and legal practitioners to concoct schemes devised solely to launder profits without paying their fair share of taxes.

Recent estimates suggest that the US federal authorities lose some US$170 billion (€143 bn) annually to corporate tax avoidance, and this is in addition to the US$85 billion (€71bn) lost to the Treasury as a result of tax shelter abuse by wealthy individuals.

I have not picked upon American companies because of a sense of anti-Americanism – I am not an anti-American – but because our American colleagues are way ahead of us in their research into the problem of organised corporate tax abuse. But capitalism's quest for increasing profits by lowering tax payments is not confined to the United States. It is global. Regrettably, little progress is being made in Europe in tackling tax abuse. Neither the European Commission nor Parliament have shown much interest in examining organised tax avoidance, and their initiative to counter tax evasion through the recently enacted Savings Directive is laughably inadequate.

The situation in the UK illustrates the problem that we have with corporate tax avoidance in Europe. Research in the UK, for example, conducted by the Association for Accountancy & Business Affairs (a think-tank), estimates the revenue loss to the UK government to be at least £25 billion (€36bn) annually, and it might be as high as £85 billion (€122bn) annually. Regrettably the UK has persistently declined to investigate the nature and scale of tax abuse in the UK, despite the fact that the collection of corporate taxes has declined to a mere 2.8 per cent of GDP, and companies in Britain contribute only about one quarter of total income tax yield.

Neither a minimal nor transitory phenomenon

Judging from what little research has been undertaken in recent years, organised corporate tax abuse, typically in the form of aggressive profits-laundering through tax havens, is systemic throughout the majority of globalised industries, including and especially, the extractive industries, banking and finance, aviation, shipping, communications, pharmaceuticals, media, traded commodities and the weapons industry.

The scale of this issue has become so enormous that it can fairly be described as a shadow economy operating on a global basis. Because of the secretive nature of this type of activity it is not possible to accurately quantify the scale of the offshore economy, but recent estimates give some idea of its broad orders of magnitude:

- Half of all world trade appears to pass through tax havens, even though these jurisdictions account for only about 3 per cent of global GDP[3]. This apparent anomaly is due to the fact that a large proportion of transnational companies book their intra-company transactions through tax havens solely to avoid tax. In reality, of course, there is little or no economic substance to these transactions, which are part of what is referred to as a profits-laundering process, involving the transfer of profits to jurisdictions that charge minimal or even zero rates of tax on profits;

- The value of assets held offshore, either tax-free or subject to minimal tax, is estimated at US$11 trillion (€9.2 trillion), which is over one-third of global GDP[4];

- In the mid-1970s there were about 25 tax haven jurisdictions. Today the IMF identifies more than 60 tax havens and offshore finance centres, hosting an army of accounting, banking and legal professionals[i]. Interestingly enough, about half of the recognised tax havens around the world are members of the British Commonwealth, and the City of London, itself a tax haven, has played a leading role in developing the offshore economy.

- The volume of funds that pass through tax havens annually is estimated at some US$7 trillion (€5.9 trillion)[5], approximately equivalent to the value of global trade in goods and services;

- Offshore companies are being formed at the rate of about 150,000 per year[6], and are now numbered in the millions. Many of these are being used by wealthy individuals, which partly explains why the EU Savings Directive, which is targeted at individuals but not companies, trusts, or "charitable" foundations, is a man of straw. And of course this figure does not include the huge number of trusts and foundations that have been established offshore over the past seventy or eighty years;

In summary, the offshore finance industry cannot be described as a minimal or transitory phenomenon, though strangely enough this is a phenomenon that appears to have passed virtually unnoticed by orthodox economists, the majority of whom have totally ignored the reality of the offshore economy in their analyses. Nonetheless, despite the virtual absence of references to tax havens or offshore finance centres in mainstream economic analysis[ii], the offshore economy is a significant and deeply embedded part of globalised capitalism.

Whilst the tax avoidance industry is clearly damaging to the interests of developed countries, it is almost certain that harmful tax practices are an even greater problem for economies in transition and developing countries[iii]. In the absence of powerful and sophisticated tax authorities like the US Inland Revenue Service, it is relatively easy for transnational companies and local political elites to erode the potential tax base, resulting either in the transfer of the tax burden onto labour and consumption, or a reduction in the rate of capital accumulation and investment by the state.

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[i] The Channel Island of Jersey, for example, employs about 12,500 people (23 per cent of its economically active workforce) in its offshore finance industry.

[ii] In fact, such is the lack of knowledge and understanding of the offshore world, that when the Organisation for Economic Co-operation and Development (OECD) published their 1998 report on harmful tax competition[ii], virtually the only critique of their analysis came from academics who accused OECD members of acting as a 'self-serving cartel'[ii]. Quite how democratically elected governments can be accused of acting like profit-maximising companies by seeking to safeguard their tax revenues from aggressive tax practices by transnational companies is beyond comprehension!

[iii] The weakness of the Bolivian fiscal system illustrates the problems faced by so many developing countries. Earlier this year the Bolivian National Congress sought to change the tax code in order to recover €355 million in revenue arrears and bring thousands of businesses into the formal tax sector for the first time ever. Facing a fiscal deficit of 8.8 per cent in the current budget[iii], Bolivia is struggling to stave off economic collapse, but endemic tax evasion by local business elites has made the state increasingly reliant on multilateral credits and grants from donor countries[iii].

According to Oxfam (a development NGO), the revenue losses to developing countries from the effects of tax competition and from non-payment of tax on flight capital amounts to at least US$50 billion (€42bn) annually. This is a conservative estimate that does not include losses due to tax evasion and transfer-pricing[7]. Coincidentally, €42 billion is roughly equivalent to annual global aid flows.

It is unarguable that the impact on developing countries and the transition economies of corporate tax abuse is immense, forcing many of these countries to borrow on the financial markets to fund revenue and capital expenditure that would otherwise be less expensively funded from tax revenues.

A threat to democracy

The rapid growth of the offshore economy since the 1960s can be traced to the recent technological change in telecommunications and to liberalisation of the global capital markets[8]. In combination these changes have generated forces in the economic globalisation process that undermine the ability of national governments to effectively enforce their tax regimes and threaten the effectiveness of national democracies[iv].

The increased mobility of capital enables transnational corporations to choose between different jurisdictions according to the preferential tax terms and other benefits that are on offer. Competition to attract foreign direct investment has led to many countries offering inducements in the form of tax holidays and export processing zones with minimal tax rates. The result of this process of tax competition is that countries, particularly developing countries, have eroded their potential tax base, resulting either in a transfer of the tax burden to labour and consumption, which in both cases is socially regressive, or in a net reduction in the revenues available to the state to invest in social and physical infrastructure.

At best the benefits to developing countries of tax competition are questionable. A study by international consultants McKinseys published in 2003 concluded that fiscal inducements offered by four major developing countries – China, Brazil, Mexico and India – had negative and unintended consequences. *"Without materially affecting the volume of investment in most cases,"* said McKinsey, *"popular incentives such as tax holidays, subsidised financing or free land, serve only to detract value from those investments that would likely be made in any case."* In Brazil's car industry, for example, government fiscal incentives led to over investment that resulted in low capacity use[9]. Which begs the question, why do governments persist with offering fiscal inducements when the evidence suggests that good social and physical infrastructure, an educated workforce, and stable social and economic conditions are a more important incentive for investors?

[iv] Interestingly enough, the harmful potential of liberalisation of capital flows had been foreseen by the famous economist Lord Keynes, who during the negotiations at Bretton Woods advocated the creation of an international trade authority that would, *inter alia*, be used to counter the potential emergence of harmful tax practises of the type that have emerged over the past half century.

In contrast to tax competition between industrial economies, which are at least engaged in productive economic activity, tax havens are used to accelerate the process of fiscal degradation by offering non-resident companies and individuals a low or zero tax alternative. Transnational companies create artificial structures to assign asset ownership or the apparent location of transactions to shell companies registered in low or zero tax havens. For example, the British Crown Dependencies, i.e. the Channel Islands and the Isle of Man, currently offer tax rates as low as half of one per cent on corporate profits booked into international business companies, and will shortly be lowering the overall tax rate on all types of corporate entities to zero[v]. This is the logical outcome of a fifty-year process of successful corporate lobbying to reduce tax rates on capital across the globe[vi].

Tax havens and the neo-liberal delusion

But concerns about harmful tax practices lie deeper than the loss of state tax revenues that legitimately belong to the people. The ability of transnational corporations to structure their affairs through paper subsidiaries in tax havens provides them with a significant tax advantage over their nationally or locally based competitors. Local businesses, no matter whether they are technically more efficient or more innovative than their transnational rivals, will be competing on an uneven field. In practise, of course, this differential tax treatment favours the large business over the small one, the international business over the national one, and the long-established business over the start-up.

As a result of the transnational companies' ability to exploit the uneven global fiscal topography, investment decisions are being taken on the basis of whatever tax and regulatory concessions can be extracted from competing governments, which effectively negates the Ricardian doctrine of comparative advantage that lies at the very heart of the liberal global trade model[10].

In addition to these profound market distortions, aggressive tax avoidance[vii] by transnational companies undermines the integrity and equity of existing tax structures; increases the administrative burden of revenue collection; and perhaps most importantly, increases income disparities within and between nation states[11].

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[v] Now people in Jersey are demonstrating because its agriculture and tourism sectors are virtually dead., and the government is raising £100 million in taxes through hikes in sales and indirect taxes, in order to finance the zero-rate corporation tax.

[vi] Taking a long-term time horizon reveals a dramatic shift in the distribution of the tax burden. In the United States, for example, in 1953 families and individuals paid 59 per cent of federal revenues and corporations 41 per cent. According to the latest Statistical Abstract of the United States, this ratio has now shifted to approximately 80:20 in favour of corporations[vi]. A similarly dramatic shift has occurred in the United Kingdom, where corporate tax revenues account for a mere 2.8 per cent of GDP, which is scarcely evidence of companies playing a significant role in financing education, health, transport infrastructure, defence spending, and all the other services that the business world expects in a modern economy.

[vii] The term aggressive tax avoidance is used by revenue officials in the US and UK. Within the tax advisory industry, however, the preferred terms are 'tax planning', 'tax management', and 'tax efficiency'.

Far from acting as a legitimate disciplinary agent on high-tax, high-spend governments, the type of harmful tax practices that have been identified are symptomatic of an almost wholesale withdrawal of wealthy elites and transnational corporations from their economic and social obligations. Furthermore, the aggressive fashion in which they exert their considerable political influence is in itself profoundly anti-democratic.

Conduit for capital or cancer at the heart of the globalised economy?

Proponents of tax havens and offshore finance centres justify their role in the global economy by claiming that they act as conduits for financial assets entering the global capital markets. This assertion does not really make much sense in the context of liberalised markets in which capital can be transferred almost anywhere in the world by a few taps on a computer keyboard.

In reality the only reason for routing investment flows through tax havens and offshore finance centres is to obtain a tax advantage or hide the true origin of the capital. Many of these centres came into being as a result of their usefulness for circumventing exchange control regulations, and much of the capital routed through the offshore circuits is being 'laddered' between different jurisdictions for money-laundering purposes, typically involving tax evasion, fraud, embezzlement, illicit capital-flight, and narcotics or terrorist funding.

Whilst it is important to recognise that many of the financial crimes perpetrated against the people of developing countries originate from their local business and political elites, we need also to recognise that many of these transactions would not be possible without a sophisticated 'pinstripe infrastructure' of financial services practitioners who act as an 'offshore interface' between the criminal activities and the mainstream global economy.

When Nigerian dictator Sani Abacha and his cronies were pillaging that country's treasury in the late 1990s to the tune of some US$50 billion, they were actively aided and abetted by banks, accounting firms and lawyers in a variety of jurisdictions, including Switzerland, the City of London, and Jersey, Channel Islands. Needless to say the latter profited greatly from their active connivance in what was straightforward criminal activity, and sadly none of these accessories to criminal activity are ever likely to serve time in the prisons where they belong.

Empowering nations to protect the integrity of their tax regimes

The only way to effectively counter harmful tax practices is through global initiatives. A multilateral framework is therefore required that will balance the need for sovereign states to protect their tax revenues from aggressive tax avoidance with a respect for the right of democratic governments to determine a tax rate appropriate to their circumstances. At the same time measures are required that will empower countries, especially developing countries, to stem their tax losses and to resist pressure from transnational corporations to degrade their tax regimes.

- An important first step towards addressing these concerns would be the introduction of automatic information exchange agreements. The secrecy space provided by offshore jurisdictions is conducive to tax avoidance and also facilitates money-laundering and corruption. Agreement is needed at a global level to define minimum standards of transparency and disclosure by companies and to enable the development of wider networks of cooperation extending beyond the OECD to all developing countries and transition economies.

- A multilateral approach is also required to define common standards for the tax base of transnational companies, in order to limit the scope for tax abuse. Common standards to define the tax base would not lead to a harmonisation of tax regimes nor would they jeopardise the rights of sovereign states to set tax rates on business and individuals.

- International agreement is needed to enable states to tax transnational companies on a global unitary basis, which would require these companies to compute the accounts of their local subsidiaries as a proportion of the unified accounts of the group as a whole. A unitary basis for taxation would eliminate the intra-group transactions between related subsidiaries, and would allow tax authorities to ensure that profits are taxed in the state where they are actually derived.

- Crucially, a functional unitary basis for taxation will also need international standards for information disclosure by companies.

- A global tax authority is required to address the problem of fiscal degradation and to monitor international tax policies to ensure that national tax systems do not have harmful global repercussions. Concerns about the offshore system are currently being addressed by a number of fora, including the OECD, the UN, the WTO, and the EU, but these initiatives are not being coordinated, and in some cases lack global authority or legitimacy.

UN secretary-general Kofi Annan has very recently proposed that the existing 25-member UN ad hoc group of experts on international cooperation on tax matters should be upgraded to an intergovernmental body that would report to the UN's Economic and Social Council. The group of experts will be meeting in Geneva in mid-December to discuss this upgrade and the Tax Justice Network plans to be there in an observer status to support the proposal.

Tax avoidance and Corporate Social Responsibility

What should company directors and their advisers think about tax avoidance in the context of their corporate social responsibility agendas? Transnational companies make use of aggressive tax planning strategies because they are able operate in the legal vacuum that exists between nation states, but business executives should recognise that paying taxes is the first and foremost duty of corporate citizenship.

Tax avoidance might improve company profits and raise executive bonuses, but it also lowers the rate of development of social capital and transfers the tax burden onto labour and consumption. The publicity surrounding the Enron case has ensured that company directors and audit committees can no longer turn a blind eye to the role of tax schemes in the wider context, even if there remains a legal vacuum in some areas of tax law. In this respect, directors will need to recognise that the tax issue is similar to where we were on human rights about ten years ago, and it is no longer acceptable to adopt the attitude of the three monkeys.

Aggressive tax planning by tax advisers should therefore be treated as socially unacceptable and the tax advisers and company directors who implement such schemes should be made personally liable for tax losses that arise from their actions[12].

Transnational companies, and the tax planning industry that advises them, should adopt clear standards for corporate social responsibility in the area of taxation which should include explicit requirements to publish all necessary accounting information and to refrain from the use of profits-laundering vehicles that are created without substantial economic purpose.

A starting point for reform in this area would be adoption of a general anti-avoidance principle that would provide a degree of balance to the currently unqualified profit maximisation principle, which provides a pretext for corporate tax avoidance. The current situation, based on the principle established by the *Duke of Westminster case,* (1936)[viii] has not kept pace with the debate on corporate governance[13].

A manifesto for tax justice

The global Tax Justice Network was launched in March 2003 to provide a vehicle for social movements around the world to act upon their concerns about the harmful effects of tax competition and tax avoidance[14]. The network's aims are as follows:

- to eliminate cross-border tax evasion and limit the scope for tax avoidance, so that large corporations and wealthy individuals pay tax in line with their ability to do so;
- increase citizens' influence in the democratic control of taxation, and restrict the power of capital to dictate tax policy solely in its own interest;
- restore similar tax treatment of different forms of income, and reverse the shifting of the tax burden onto ordinary citizens;
- remove the tax and secrecy incentives that encourage the outward flow of investment capital from countries most in need of economic development;
- prevent the further privatisation and degradation of public services.

[viii] The ruling, which has been widely copied throughout the world, stated that taxpayers may organise their affairs to pay the least tax possible under the law.

In conclusion, the scale of tax avoidance and fiscal degradation has reached a level at which it undermines the capacity of states to tax and spend as their citizens might choose. This threatens the very core of liberal democracy.

The industrial scale of profits-laundering through tax havens has distorted global markets in favour of transnational companies, nullifying the notion of comparative advantage and causing investment decisions to be taken on the basis of tax concessions rather than on substantive economic advantages.

Multilateral action is required to counter these harmful trends, and social movements need to activate on a global basis to counter over fifty-years of corporate lobbying of governments to secure one tax concession after another. The Tax Justice Network has been formed for this purpose. We hope to receive your support.

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