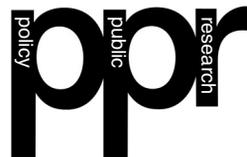


# A good century for tax?

## Globalisation, redistribution and tax avoidance



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*It does not surprise anyone when I tell them that the most important tax haven in the world is an island. They are surprised, however, when I tell them that the name of the island is Manhattan. Moreover, the second most important tax haven in the world is located on an island. It is a city called London in the United Kingdom.*

**Marshall J. Langer**

### **Tax havens and international arbitrage**

Tax avoidance is now a problem of globalisation. The problem is driven by increasingly aggressive competition among advice professionals – tax lawyers, accountants, investment bankers, financial planners – in the world's financial capitals, pre-eminently New York. Once upon a time, national ethical settlements prevented these professions from competing with one another, and confined professional conduct within norms that respected a certain spirit of the law. Competition policy and globalisation are changing that. English tax lawyers discovered in the '90s that they had to compete for the first time with New York accounting firms for international tax advice to British companies. Contingency fees may have been anathema to a British tax lawyer, but now they might confront an American accounting firm proposing to clients a series of shelters that allow a wipe-out of the company's liability in return for a fee of thirty per cent of the tax saved (see Novack and Saunders, 1998). A great deal of European tax advice is now provided in New York.

Structural discontinuities, like those created by different tax treatments for the same transaction in different nations, open up opportunities for international arbitrage. Corporations can double dip, taking one position on the meaning of a transaction for US tax purposes, another in a second country that creates tax benefits under both sets of rules. Cross-border derivatives that may be characterised in different ways in different jurisdictions were cited during my recent research in the US and Australia as the emerging growth area of tax avoidance by arbitrage (Braithwaite, 2005). New York is the centre of innovation in such arbitrage, with London also having its share of 'rocket scientists' of financial engineering. This is part of what Langer refers to in the quote opening this essay. In more marginal places, like Australia, we can look across to New York and London and see the future of tax avoidance by large corporations and very wealthy individuals.

Profit shifting in and out of tax havens is another important avoidance *modus operandi*. The extent to which income can avoid tax will depend on the extent to which income can be shifted to havens, where income and company tax are mostly not levied. Gregory Rawlings (2004) has shown the connection between British colonial policy and tax haven constitution. Almost all of the tax havens that have been identified by the OECD as major in the present or recent past are either current

colonies or crown dependencies (the British Virgin Islands, Anguilla, Turks and Caicos Islands, Montserrat, Gibraltar, Jersey, Alderney, Guernsey, Sark and the Isle of Man) or former British colonies (the Bahamas, Belize, Barbados, St Lucia, Grenada, St Christopher and Nevis, Barbuda, Antigua, Dominica, St Vincent and the Grenadines, Tonga, Vanuatu, Nauru, Seychelles and Bahrain). Other countries or territories not explicitly identified by the OECD, but which are also major tax havens or global finance centres, are also current British colonies (the Cayman Islands and Bermuda) or former colonies (Hong Kong, Singapore, Malta and Cyprus).

There are two reasons for this. One is that Britain found it convenient to nudge resource-poor island colonies toward becoming off-shore financial centres as an alternative to propping them up with foreign aid. Second, this created financial services business in the city of London that gave it a competitive advantage over New York. Paris, in contrast, was no competitor for New York, and France never nudged its colonies into being tax havens (Rawlings, 2004: 334). Rawlings (2004) has sensitively explored this difference in decolonisation policy through the intriguing case study of the Vanuatu (formerly New Hebrides) tax haven: Britain and France jointly colonised Vanuatu under a unique condominium arrangement. Britain promoted Vanuatu becoming a tax haven in a way the French did not and the regional financial power, Australia, vigorously resisted.

### **‘A great century for tax’**

In 2000, Christopher Hood said that the twentieth century had been ‘a great century for tax collection by Western governments’. In previous centuries both the US and Australia had seen bloody tax revolts. In the US this led

to revolution. In Australia, to the Eureka Stockade in 1852, the closest thing it ever had to a revolution, with gold miners taking up arms to resist the collection of taxes which fell as heavily on those who found little gold as it did on those who made a million. The twentieth century has seen no similar revolts in these and most other Western democracies.

At the beginning of that century, few Western economies were organised well enough to be able to collect income or company tax: it was more practical to focus on the customs barrier. Meanwhile, land taxes – paid on transfer of land and on estates at the time of death – progressively became more important. When income tax was introduced in Australia in 1915, workers with annual incomes up to the considerable level of £156 paid no tax. In most of the West, it was only highly paid workers who paid income tax during the first half of the century. Between the two world wars there was growth in collections from new sales taxes and other indirect taxes.

Surprisingly, Steinmo’s (1993) data show that for much of the twentieth century, the US tax system was more redistributive than the Swedish and British systems and possibly even the Australian system. This was particularly so during Franklin Roosevelt’s long presidency and in the mid-30s, income tax still only affected the very wealthy with under five per cent of the US population paying anything (Steinmo 1993:24). During the ‘30s top marginal income tax rates in the US reached eighty one per cent and were generally higher than in Sweden, the UK and Australia. During the second world war, they rose to ninety four per cent and were still at ninety per cent under the Eisenhower administration. Later, in the ‘50s, a top Australian rate of eighty five per cent finally exceeded that in the US.

Income tax, company tax and sales tax steadily increased the government share of

gross domestic product during the twentieth century and this was the general trend throughout the West. This is what Hood meant by the century being a good one for tax. Collectability was assisted by the corporatisation of the West (see Braithwaite and Drahos, 2000: Chapter 9). The final stage of this was financial institutions becoming more concentrated and computerised, making withholding on interest and dividends feasible. As retail organisations became larger companies, as opposed to family-owned corner stores, the collection of indirect tax became more cost-effective. When most of the Australian – and to a lesser extent, American – working class was a rural working class, itinerantly shearing sheep for graziers, cutting cane or picking cotton, collecting taxes was difficult and costly. As the working class became progressively more urban – in the employ of large city-based corporations – income tax collections from workers became a goldmine, especially after the innovation of pay-as-you-earn (withholding of tax from pay packets by employers) in the mid-century.

Taxation became less redistributive as a result with workers paying a higher proportion of their income in sales taxes and other indirect taxes than the wealthy. Just as the income tax was progressive, sales taxes were regressive. So as indirect taxes grew, the tax system became less redistributive and income tax also became less progressive. As workers became wealthier and less itinerant, eventually almost all of them were caught in the income tax net. The paradox of 'bracket creep' in a progressive tax system saw inflation bring more and more of the workforce under higher tax brackets originally targeted at the wealthy.

Most income tax in the US is still paid by the rich. In 2001, forty one per cent of income tax was paid by the wealthiest five per cent of the

US population (McIntyre, 2002: 2). They earned thirty three per cent of the nation's income. But with the proportion of income tax being paid by the very wealthy falling, as the proportion of the national income they earn rises fast, there is now only limited progression left in the income tax to counter the extreme regression of other taxes such as those on sales, excise and payrolls (Johnston, 2003: 11).

### Corporate tax competition

Microsoft, the company that builds the wealth of the wealthiest man in the world, paid \$3 billion in US tax between 1996 and 2000. It also received \$12 billion in tax breaks. Enron paid no income taxes at all in four of the last five years of its existence. IBM had an effective rate of 3.4 per cent for the last five years of the '90s when the tax shelter boom peaked. General Electric, the most profitable corporation in the US over this period, had an effective tax rate of only 11.5 per cent. This was in part thanks to creative lease-backs in the electric power plant market that it dominates globally (build it, sell it, then lease it back to create deductions in high tax jurisdictions and record profits where taxes are low). CSX Corporation paid no federal income tax at all in three of the four years before its CEO, John W. Snow, became Bush's Treasury Secretary.

International corporate tax competition started when the Thatcher government in the UK cut the corporate rate from fifty two per cent to thirty five per cent in 1984. The US followed in 1986 with a cut from forty six per cent to thirty four per cent. Another round of corporate tax competition raged between 1996 and 2003 when the average rate of the thirty richest countries fell from 37.5 per cent to 30.8 per cent (*Financial Times*, 2 May 2003, p.1). Capital gains is the tax that is used to capture some of the corporate wealth that is passed on

to build individual wealth. US capital gains tax rates were almost halved between 1987 and 2003 (Johnston, 2003: 40). In May 2003 PricewaterhouseCoopers tax partner John Whitney warned 'I believe that corporate tax is in near terminal decline. Over the next ten years governments may have to deal with a lot less corporate revenue...'

A final stage in the erosion of a redistributive tax system in the US has been a shift away from the historically much higher odds of tax audits for the wealthy compared to the poor. In 2001, for the first time, low income taxpayers (earning less than US\$25,000) were targeted with a higher audit risk than high income taxpayers (earning more than US\$100,000). Audits of people earning over \$100,000 dropped from 74,566 in 1992 to 29,086 in 2001 even though there was a huge increase in the number earning this amount. This shift is defended by organisations like the Heritage Foundation as an accomplishment for the Bush administration, on the grounds that there are high rates of fraud on the part of the poor (Johnston, 2003: 135).

Global tax planning by large corporations was the biggest reason why most OECD countries in the latter part of the twentieth century saw the proportion of total revenue collected from company tax fall sharply (Steinmo, 1993: 20). Australia was actually an exception to this trend from the '90s to the present. But the US was part of the international trend to lower company tax collections fuelled by international tax competition, though the US fall in the percentage of tax collected from corporations has not been as steep as for some other countries such as Sweden (Steinmo, 1993: 175). Nations competed to retain the capital of their corporations and wealthiest individuals by bidding down both top marginal income tax rates and company tax rates very sharply in the

'80s (Steinmo, 1993: 30). By 1995 Germany was collecting only 2.8 per cent of its total tax collections from corporate income tax. Even after it recovered to 4.4 per cent for the rest of the decade (Genser, 2001: 5) by 2001 corporate income tax had fallen again to 1.7 per cent of tax collected. This is so low as to raise the question whether the substantial transaction costs in collecting corporate taxes justify such miserly returns. In 2005, Germany still had the highest corporate tax rate in Europe, but is about to join a renewed round of competition with low taxing new Eastern members of the EU on its borders by cutting its rate dramatically.

The late twentieth century has also seen 'loophole madness' growing with more and more private interests being granted tax breaks. The value of tax expenditures or tax breaks in the US increased particularly sharply during the Reagan years. This phenomenon in Australia and the US created the loophole-ridden tax laws that were a major part of what enabled their late-century explosions of aggressive tax planning. Thankfully, the UK is not as deeply afflicted with this problem. Opinion polls in both the US and Australia consistently show that at the end of the twentieth century ordinary citizens felt large corporations and wealthy individuals should pay more tax and that middle- and low-income families should pay less. The imperatives of the global competition for capital and for political campaign contributions – where the corporate tax system has become a way to raise campaign funds by offering concessions – outweighed the democratic imperative to respond to the wishes of the people.

### **Twenty-first century regression**

A century that started with workers having itinerant wealth that was hard to track down ended with the wealthy having the mobile wealth. Wealthy corporations started to

reincorporate their US operations as 'runaway headquarters' in tax havens like Bermuda to avoid paying US tax, just as they moved intellectual property such as patents, copyright and the title to the company's logo to such havens. Yes, the twentieth century was a good century for tax: a growing proportion of GDP was collected (OECD, 2001: 35-39: 86-87). It is simply not true that the Reagan and Thatcher revolutions ushered in an era of smaller government: the current Bush administration in the US is the biggest spender that nation has experienced. But it was a century where taxation was inverted from being a pre-eminent tool for the redistribution of wealth from rich to poor, to hitting – at the turn of a new century – a turning point and becoming a tool for redistribution from the poor and the middle class to the very rich.

In the large middle of the US tax system, a great amount of redistribution still goes on from the upper middle class and moderately wealthy people, down to those less well off. It is the very richest individuals and wealthy corporations that pay the lowest effective tax rates. Effective income tax rates on individuals still continue to rise slowly in the US until adjusted gross income hits \$2 million, beyond which it falls (Sullivan, 2003). This situation has got worse and will deteriorate further as Bush tax changes impact. The situation is much more regressive than the official figures indicate. We know that very wealthy people receive a lot of income in the form of gifts and inheritance that are grossly undervalued for gift and inheritance tax purposes (Johnston, 2003: 86-90, 165-66), a lot of income covertly off-shore and vast income in deferred, often non-taxable benefits.

Former General Electric CEO Jack Welch's recent divorce litigation revealed the multitude of untaxed or minimally taxed deferred

benefits he was receiving from GE. Just one example was a company jet arguably worth \$3.5 million a year. If Welch flies in it to Paris, the cost to GE would be more than \$100,000 each way if GE had to charter it, but Welch would be out of pocket just \$486 each way in federal tax liabilities given the way Congress has required the IRS to value the personal use of company planes (Johnston, 2003:62). Johnston (2003:57) reports that in 2003 two hedge fund managers had more than \$2 billion each in an untaxed deferral account offshore, another two more than \$1 billion each. One of these was thirty five years old and looking forward to decades of untaxed compound interest on these funds until he retires or spends it. 'Deferral, the tax lawyers say, is ninety per cent of tax planning. Delay a tax for thirty years and its cost in today's money is almost nothing. Inflation and investing the unpaid tax should cover the whole bill.' (Johnston, 2003:117).

### **From fiscal termites to moral termites?**

Former IMF tax policy chief Vito Tanzi (2000) has argued that the twenty-first century may not be a good century for tax. He identified eight *fiscal termites*: electronic commerce and transactions (using cyberspace to buy where there is no tax); electronic money (cutting out the financial reporting of intermediaries that allowed the efficient twentieth century growth of VAT and sales tax); intra company trade (multinationals avoiding tax by internal sales at high prices into high tax countries, low prices into low tax countries); off-shore financial centres and tax havens (with deposits which Tanzi estimates to exceed US\$5 trillion); derivatives and hedge funds (about a trillion dollars flow through hedge funds each year); inability to tax financial capital (the increasing impossibility of imposing high taxes on mobile

financial capital that moves in response to tax rates); growing foreign activities that lead for example to tax-free non-resident accounts and, finally, foreign shopping (a spin-off from increased travel by wealthy individuals).

Subsidiaries in the top eleven tax havens accounted for twenty three per cent of foreign profits of US companies in 1988, thirty eight per cent in 1999 and forty six per cent in 2001 (Sullivan, 2004). For Australia, in contrast, funds flowing in from OECD identified tax havens fell between the peak of the aggressive tax planning boom in 1997-8 to half that level in 1999-00, and stayed around that reduced level for the next three years. Funds flowing out from Australia to tax havens fell by more than a quarter between 1997-8 and 2002-3 (Australian Taxation Office, 2004: 4). As I have examined elsewhere (Braithwaite, 2005), Australia in this period put in place some quite effective measures against corporate profit shifting, which included shifting profits into tax havens.

Fiscal termites in turn introduce *moral termites* into the tax system (Braithwaite, 2005). There is growing evidence that when ordinary people perceive the rich to be getting away with paying no tax, their commitment to voluntary compliance with tax laws erodes (Wenzel, 2002). In addition, because every one of Tanzi's eight fiscal termites are much more exploitable by the rich than the poor, they will continue the transformation of the tax system from an institution that redistributed wealth from rich to poor into the reverse. Avi-Yonah (2000a:1) sums up well how developed nations responded to capital becoming more mobile and subject to greater tax competition: 'first..shifting the tax burden from (mobile) capital to (less mobile) labor [structurally increasing inequality of wealth], and second, when further increased taxation of labor became politically and economically difficult,

by cutting the social safety net [increasing inequality again]'. Avi-Yonah (2000b: 1577) points to evidence showing that as economies become more open, taxes on capital go down while taxes on labour go up.

Facing these realities of globalisation, each nation might be seen as having to choose between attracting capital and securing growth on a small-government, low-taxation-of-capital, weak-safety-net trajectory, versus a bigger-government, lower-growth trajectory where the gulf between rich and poor is not allowed to widen. The choice is not this simple: when we allow the gulf between the rich and the poor to widen, this also substantially reduces subsequent growth, especially in the long run (Agion *et al*, 1999; Alesina and Rodick, 1992; Persson and Tabellini, 1994; Repetti, 2001: 832-840).

Increasingly the economic evidence suggests that the reason inequality dampens subsequent growth is that it causes an underinvestment in education by the poor. When a large fraction of the population under invests in education compared to the investment being made by the economies with which one competes, productivity growth falters (Agion *et al*, 1999; Perotti, 1993; Galor and Zeira, 1993). This is the most plausible account of why 'the relatively egalitarian states of East Asia have grown three times faster than the highly unequal economies of Latin America' (Mack, 2002). The poorest people of East Asia see more point in investing in the educational development of their children than Latin America's poor. Andrew Mack also points to World Bank research that high income inequality increases risks of criminal violence and armed violence between warlords. Of course civil war and unsafe streets disastrously reduce economic growth.

Finally, he points out that ‘increasing inequality and social exclusion increase the risks of a backlash against the very market reforms that represent the best long-term hope of escaping the scourge of poverty’ (Mack 2002: C2). Empirically, it is politically easier to do the constant economic restructuring needed to succeed in the contemporary world in nations where safety nets mean the poor do not fall into a deep hole when they lose their jobs (Leibfried and Rieger, 1995). Hence, joining a ‘race to the bottom’ to low tax rates is no guarantee of attracting capital and prodding growth. There is no inevitability about globalisation causing a race to the bottom.

### The state can fight back

There are alternative policy paths to making a crude choice for or against opting into low taxation of wealth and a weak safety net for the poor. This includes a variety of ways that all national tax authorities can learn together how to combat the aggressive tax planning that exploits the derivatives and tax havens that have been opening the tax gap ever wider.

For example, the Australian Tax Office enforcement programs against international profit shifting have raised about a billion extra dollars in tax for each million dollars spent on the programs. This strategy involves a responsive regulatory pyramid of more intensive audits and other enforcement tools. The idea is to drive voluntary compliance down to a culture of learning and innovation into new compliance strategies that work at the base of the pyramid. If that does not happen, enforcement against profit shifting escalates to progressively more intensive levels. Strategic, evidence-based tax administration can be advanced internationally in a way that sustains the

capability to fund a credible safety net for the poor and that shifts some of the tax burden from the backs of labour to the taxation of capital and high wealth individuals. The US and Australian tax administration have some valuable lessons for the rest of the world on how we might begin to do this.

Strategic enforcement can advance both economic growth and economic equality for the nations that are in the vanguard of introducing such administrative measures. Moreover, all nations can share in greater growth, greater equality and therefore better prospects of peace when international cooperation works to secure them globally. Very wealthy individuals and corporations of course have formidable political capabilities for resisting enforcement. However, the contrast between US tax policy that has allowed the proportion of tax collected from them to decline, and the Australian tax administration which has seen the tax share of very wealthy individuals and corporations increase sharply over the past decade, shows that there are better and worse paths for the state in managing this resistance.

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