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A large, jagged iceberg of white and light blue ice floats in a calm, blue ocean. The sky is a clear, pale blue. The iceberg's reflection is clearly visible in the still water below. The image is split horizontally, with the top half showing the sky and the bottom half showing the water and the submerged part of the iceberg.

GLOBAL CORPORATE TAXATION AND RESOURCES FOR QUALITY PUBLIC SERVICES

Edited by
Laura Figazzolo and Bob Harris

December 2011



GLOBAL CORPORATE TAXATION AND RESOURCES FOR QUALITY PUBLIC SERVICES

EDUCATION INTERNATIONAL RESEARCH INSTITUTE
on behalf of
THE COUNCIL OF GLOBAL UNIONS

Edited by Laura Figazzolo and Bob Harris

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The aims of the Institute are to contribute to the right to quality education for all, to enhance the status of teachers and other employees in education, and to promote education in favour of democracy, social justice and peace. In widening and deepening teacher unions' capacity to conduct quality research, the Institute affirms the critical role that research can and should play in any democratic society.

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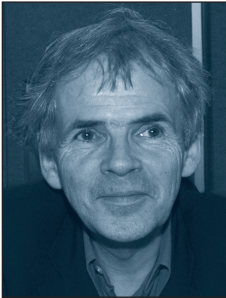
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Ron Henderson,



Chair of the Board
EI Research Institute

* *The Council of Global Unions brings together The Global Union Federations with the International Trade Union Confederation and the Trade Union Advisory Committee to the OECD.*



Fred van Leeuwen

General Secretary of Education International

"Over the last two decades, as globalization accelerated, corporate profits skyrocketed, while corporate tax revenues in OECD countries dropped significantly. The official corporate tax rates was reduced in many countries, but just as importantly, countries and communities suffered losses in revenues as global corporations used their global reach to manipulate the system so as to 'minimize' or avoid their tax responsibilities.

As a result, we are now left with a huge and ever growing 'shadow economy' of so-called offshore tax havens and the like – bigger than the budgets of most national governments in the world today.

There is enough money to provide quality public services, including quality education for all, in all countries. That money is simply being denied to public budgets because the tax avoidance industry, with its legions of accountants, lawyers, and bankers, is very successful. Education International supports the FTT and a new approach to taxation in a just transition to a green economy. Meanwhile, even without changing the tax laws, if Global Corporations paid fair and reasonable taxation we could overcome the debt crises in the OECD countries and close the MDG funding gap in the developing countries. The current obsession with debt is being allowed to obscure this reality. Rather than cutting public spending, we should be putting public finances on a sound basis by requiring global corporations to pay their fair share."



Peter Waldorff

Chair of the Council of Global Unions,

General Secretary of Public Services International.

"At a time when the global financial crisis has moved incomprehensible amounts from private debt to public debt we still see many governments hesitating to put taxation on their political agenda. But as this study says in its conclusion: global corporations should pay fair and reasonable taxes.

This study is a helping hand for the many political leaders who already now are in a catch 22 situation. Raising taxes might not be the sexiest thing in the world, but cutting deeply in education, health care and other public services will also put re-election into jeopardy. I wish to see heroic deeds from those with the political power, such that they will act to bring a seriously unhealthy system back into balance. This study will help them to make the right choices."



Sharan Burrow
General Secretary of the
International Trade Union Confederation

"This report documents a long-term failure of governments all over the world to properly tax corporate profits. Countries have for decades been engaging in a race to the bottom, cutting company tax rates to ever-lower levels. Governments have also been allowing, even encouraging, multinationals to launder profits through tax havens and to create elaborate schemes to hide their money. The economic consequences of this are extremely damaging, denying hundreds of billions of dollars to vital public services and holding back the potential for generating decent jobs and tackling global poverty and climate change.

As public finances in many countries come under enormous pressure, ordinary people are being forced to carry the burden of ineffective financial regulation and corporate tax evasion. The time has come for governments to act, to put an end to loopholes and destructive low-tax competition, and thus end the free ride for the richest. This report sets out the steps which governments need to take to fix one of the great injustices of our time. The trade union movement will continue to press the case until governments act on corporate tax."



John Evans
General Secretary of the
Trade Union Advisory Committee to the OECD.

"As the crisis enters a new and ever more dangerous phase – characterised by sovereign debt traps, capital flight and governments entrenching austerity policies as they try in vain to restore financial market "confidence" – the global trade union movement is calling for a radically different economic strategy that prioritises employment and social justice.

The bedrock for such a strategy is a sound tax system: one that finances the public goods and quality public services needed to stimulate inclusive growth and contributes to reversing the rise in income inequality that has been the feature of the failed economic growth model of the past twenty years.

The tax reforms undertaken by many countries have shifted the focus of taxation away from corporations, capital and rich individuals who are internationally mobile, and



on to the incomes and consumption of working families who are not. They fuelled the destructive private equity boom of the 2000s as the "super rich" took their income gains in the form of "capital gains" rather than higher taxed income.

The explosion in the growth of off-shore tax havens has further weakened the ability of tax systems to collect tax revenue and further shifted the tax burden on to working families. It has also produced gross economic distortions. Thanks to their tax haven status, Mauritius is the largest investor in India and the British Virgin Islands one of the largest investors in China. This shows where global corporations keep their money – not where they earn their money. Failure to clamp down on domestic tax evasion has also been revealed as a major governance failure – as today's Greek tragedy shows only too clearly.

G20 Summits have made successive proclamations on ending bank secrecy and clamping down on tax havens. And OECD- based work on tax havens and money laundering is regularly heralded as a "breakthrough". But the actions continue to fall short of the words.

This Global Unions' report identifies the loopholes which global corporations use to avoid their taxation responsibilities. Closing these loopholes must be a front line issue in the fight-back to attain an effective and just tax system, together with: - outlawing tax havens, ensuring tax justice nationally, using green taxation to fight climate change and the introduction of a financial transactions tax (FTT). Concrete proposals are mapped out in its pages. Working together with our civil society allies, the global trade union movement will continue to be at the forefront of public debate and action to restore justice and efficiency to public policy on tax."

FOREWORD

The current debate on sovereign debt is conducted as if there were no other option than austerity. This report changes the focus.

Here the focus is on the revenue side.

The problem with the 'no option but austerity' line is that it thrusts national economies into downward spirals. Austerity dampens then freezes economic activity. Public revenues drop. The objective of reducing sovereign debt is defeated because of the downturn in economic activity, while uncertainty drives up the cost of servicing the debt – the classic 'debt trap.'

There is another way. Public revenues can be boosted, if there is political will do so. Resources injected into communities are resources invested in people, in their health, safety and education. These investments get the engines of growth moving again, they enhance equity, they provide the support structures that private enterprises need to flourish, and they help build the future. A focus on the revenue side is the way to get out of the downward spiral and to avoid the 'debt trap.'

This report explains how the resources for investment in people can be found. Billions of dollars and Euros are lost to communities because tax laws are national while the economy is global, and that simple fact has created unprecedented opportunities for tax minimization and avoidance. Global corporations have opportunities for tax avoidance that national enterprises do not have, let alone small business owners and wage and salary earners. Even without changing the tax laws, closing just some of these loopholes would make a huge difference in public resources.

Closing loopholes will require changing mentalities – and political will. It means changing the widespread acceptance of tax avoidance as a legitimate goal of large corporations. To close these loopholes is to take a step towards a change of paradigms, change that would take us off the path where ultimately everybody loses and put us onto a path where most have an opportunity to win. And isn't that what democracies and market economies are all about?

Bob Harris



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LIST OF ACRONYMS

| | |
|--------|------------------------------------------------------------------|
| BEA | Bureau of Economic Analysis (U.S.) |
| CCCTB | Common Consolidated Corporate Tax Base |
| CGU | Council of Global Unions |
| CIT | Corporate Income Tax |
| CPM | Comparable Profits Method |
| CSR | Corporate Social Responsibility |
| DRC | Dual Resident Company |
| ECJ | European Court of Justice |
| EFA | Education For All |
| EI | Education International |
| ETUI | European Trade Union Institute |
| EU | European Union |
| FDI | Foreign Direct Investment |
| FTT | Financial Transaction Tax |
| GDP | Gross Domestic Product |
| HNWI | High Net Worth Individual |
| IFI | International Financial Institution |
| IMF | International Monetary Fund |
| ITUC | International Trade Union Confederation |
| LLC | Limited Liability Company |
| LLP | Limited Liability Partnership |
| MDG | Millennium Development Goals |
| MNC | Multinational Corporation |
| NCP | National Contact Point |
| NGO | Non-Governmental Organisation |
| ODA | Overseas Development Assistance |
| OECD | Organisation for Economic Cooperation and Development |
| OFC | Offshore Financial Centre |
| PSI | Public Services International |
| QPS | Quality Public Services |
| SME | Small and Medium Enterprise |
| TNC | Transnational Corporation |
| TUAC | Trade Union Advisory Committee (to the OECD) |
| UK | United Kingdom |
| UN | United Nations |
| UNESCO | United Nations Educational, Scientific and Cultural Organisation |
| UNCTAD | United Nations Conference on Trade and Development |
| US | United States |
| VAT | Value Added Tax |
| WB | World Bank |
| WHO | World Health Organisation |

OUTLINE

Rationale

The purpose of this project is to highlight, on the basis of existing research, the issue of the **payment of fair and reasonable taxation by global corporations**. The study aims to expose the way in which existing tax regimes are manipulated by corporations with global reach. Through this report, citizens and political decision-makers will understand that resources for quality public services, such as public education, health and essential community services can be found, even without increasing taxation on citizens or small or medium enterprises (SMEs), but by applying the existing rules. This requires in essence that principles be put in place requiring respect by global corporations of their fiscal responsibilities.

This study is complementary to the well-researched public campaign for a tax on international financial transactions (the FTT), while putting the spotlight on an area which has received less attention – the loss of tax revenues under existing rules, due to the use of loopholes opened up by globalization. The study is set in the broader context of the role of taxation in society, as a source of revenue for quality public services, and as an instrument of distributive justice and equity.

Thirty years ago, Margaret Thatcher and Ronald Reagan succeeded politically in establishing the concept of small government linked with reduced taxation and deregulation. After three decades, it is time to reaffirm the vital role of public services in the community – and by that we mean quality, effective, ethical and adequately resourced public services. One of the major issues for industrialized and developing countries alike is the question of resources for social needs – including education, health, safety nets for the poor, and services for migrants. Yet resource constraints derived from the dominance of the small government low tax movement have militated against the provision of quality public services. The financial crisis and the attention given to tax havens by the G20 and the OECD have put the public spotlight on the extent of tax avoidance in a global economy, and debate has developed anew over the case for taxation in international transactions has been reinvigorated. .

Preliminary work by the ICFTU in 2006¹ showed that **Multinational Companies use their global reach to avoid their responsibility to contribute through fair and responsible taxation to national and community social needs**. Techniques for “minimization” of corporate tax include the use of offshore tax havens, setting up competition between localities and countries for tax advantages (“arbitrage”), and the little-known technique of “transfer pricing”. The latter technique exploits on the fact that an estimated 40% of global commerce occurs within global corporations, enabling them to avoid national taxes by manipulating the prices charged for the transfer of goods and services. This phenomenon has developed dramatically since the mid

¹ *Weise, K. (2006) Having their Cake and Eating it too: the big corporate tax break, ICFTU*



1990s. It is estimated that several trillion U.S. dollars of tax revenues are lost to national budgets annually through the use of such techniques – enough to provide the resources needed to fund UN Millennium Development Goals (MDGs) and the budget requirements for social services in industrialized countries, including the growing costs associated with migration and global mobility.

Attempts to regulate transfer pricing today are derived either from the 1995 OECD transfer pricing guidelines or the U.S. Internal Revenue Code (section 482). To a greater or lesser degree, many states have been dealing with the matter. Despite a well-established regulatory framework, however, serious problems remain. Transactions performed in countries which promote tax havens and even in some European countries are not subject to transaction. Another difficult issue is the assessment of more intangible transactions – i.e. transfers of intellectual property, expertise (consulting) and knowledge and skills. An additional problem is that it is difficult to establish a fair market price for transactions that are not conducted between independent companies. It is hard to untangle this web as transfer pricing is also influenced by tariff structures, exchange rate fluctuations and risk profit repatriation policies, and asset capitalization policies. This means that it is very difficult to get a clear and transparent picture of what is really going on.

Why focus on global corporations? Precisely, because they are global they have opportunities to avoid their responsibilities to communities. National SMEs do not have the same opportunities.

This also links to the debate on **corporate social responsibility (CSR)**, since the global push for corporate philanthropy is in many ways a substitute for paying taxes in the jurisdictions where the corporations operate.² Conceptually, we will present the need for corporate social responsibility through fair and reasonable taxation in all national jurisdictions.

The report maps out the general context of the debate on taxation and society but places its main emphasis on the issue of **the payment of fair and reasonable taxation by global corporations. This is one piece in a new approach to growth which is outlined in the recent ITUC, TUAC and ETUI report *Exiting from the crisis: towards a model of more equitable and sustainable growth*.**³

Methodology

The study has been conducted by a 'taskforce' of trade unionists and scholars, who have overall responsibility for the project, under the auspices of the Council of Global Unions (CGU). This Taskforce includes Michael Kahn (NEA, USA), Pierre Habbard (TUAC), James Howard (ITUC), Jim Baker (CGU), Bob Harris (EI), David Robinson (CAUT, Canada) and Mechthild Schrooten (GEW, Germany).

² See the chapter on MSPE's in EI's recent report *Education International (2009) Public-Private Partnerships in Education* <http://www.ei-ie.org/research/en/documentation.php>

³ Coats, D. (ed) (2011) *Exiting from the crisis: towards a model of more equitable and sustainable growth*. Report of a Taskforce, ITUC, TUAC, ETUI: Brussels

The Taskforce has developed a structure for the study, reflected in draft chapter headings, and approached authors to develop each chapter. A Research Assistant, Laura Figazzolo coordinated work among the authors and assisted the Taskforce in identifying key sources and information. She prepared a selection of relevant literature and sources and wrote an overall background paper for the study. She then analysed and compared individual contributions, summarizing key findings. The draft report was reviewed by a Review Panel including Guntars Catlaks (EI), Andrew Watt (ETUI), James Howard (ITUC), John Evans (TUAC) and Frank Hoffer (ILO ACTRAV). Editing was completed by Bob Harris and Laura Figazzolo.

Structure of the Report

In Chapter 1, the stage is set for the discussion, presenting various estimates of the trillions of dollars lost to public revenues through different techniques of tax 'minimization' and amounts involved globally in the so-called 'offshore' economy. This section illustrates how multinational companies (MNCs) use their global reach to avoid their responsibility to contribute through fair and responsible taxation to national and community social needs, with harsh consequences for communities in both industrialised and developing countries.

Chapter 2 illustrates how globalisation has increased demands on communities for the provision of quality public services. Community expectations include services historically provided publicly such as health, education, utilities (sanitation, water and energy), essential services (police, and other security services including prisons, fire fighting and emergency services), municipal services and public administration, and the regulatory services required in every community, from national to local levels. Demographic changes and urbanisation have increased demands for public services, for example for the provision of services for the elderly. But increased pressure on virtually all community public services also flows from globalisation, notably as a result of migration. In many communities, additional pressures are becoming apparent because of the need to deal with the consequences of climate change, including changing weather patterns and desertification.

Chapter 3 offers an insight into the broad concept of quality in public services, presenting the priorities in both OECD and emerging countries, in terms of pressures to downsize budgets for public services due to growing state deficits, and the erosion of public services in the developing world, with the consequential increasing 'casualization' of public services. This chapter also focuses on key challenges to be addressed most immediately, including the need to combat corruption and development of effective tax collection systems.

Taxes are the price we pay for not only the public goods and services we need, but for living in a civilized and prosperous society. Without adequate tax revenues, we simply cannot hope to sustain public services, infrastructure, and programs that have been shown to be key factors in the economic growth and social development of nations.



That is why tax avoidance and tax evasion can be so disastrous for countries and their citizens. Chapter 4 shows how, today, the fiscal stability of governments in many parts of the world is being undermined by tax avoidance and evasion.

Chapters 5 and 6 explain that international corporate tax reform is long overdue, through analysis indicating that, for the United States alone, income shifting reduces U.S. government revenue by as much as 30% of total U.S. corporate tax revenues. Chapters show that there are several policy alternatives that would improve the current situation. The most transformative method would be to adopt a 'formulary' approach to the taxation of international income. However, more minor policy innovations are also worthy of consideration, such as rate-lowering, tax-base-broadening reforms, proposals to end deferral of domestic taxation on international income, and minor modifications of the tax treatment of foreign income.

Chapter 7 presents the OECD as a key player in international tax cooperation and in shaping the tax policy agenda of its member countries, with a focus on its initiatives for combatting tax evasion and avoidance and strengthening the tax systems of developing countries. The chapter provides a snapshot of selected OECD-led or supported instruments and initiatives for strengthening international cooperation on tax, curbing tax evasion and avoidance by MNCs and building the capacity of tax administrations in developing countries, with a discussion of the tax policy reform agenda. It also sets out the relevant trade union agenda. The Chapter provides a focus on the issue of taxation within the EU.

Chapter 8 by David Robinson presents the trade union perspective on strategies for change. After summarizing the main attempts to challenge tax arbitrage, transfer pricing, and other avoidance strategies illustrated more in details in the previous sections, this chapter highlights the need for a new compact: fair and reasonable taxation paid into public revenues by MNCs and the provision of effective quality public services in all communities.

Finally, Bob Harris draws key conclusions from the various contributions, underlining the need for a paradigm shift: global corporations should engage with global unions and civil society as partners in new thinking, leading to new and serious commitments to build better communities and better lives.

At the end of the report, Annex 1 estimates the consequences, in terms of revenue, of income shifting behavior. The consequences are calculated through regression analysis, focusing on data for the U.S. Annex 2 offers an insight into the political economies of taxation, using the example of the United States to show where corporate taxation fits in the overall framework for taxing MNCs, i.e. the rationale for Corporate Income Tax (CIT), the problems with and the solutions for strengthening corporate tax, and how they apply specifically to the case of the U.S. Three policy changes are presented which could strengthen the tax system, allowing states, governments and legislatures to increase corporate income tax from near irrelevancy as a source of revenue to a

significant source of income. Annex 3 focuses on pensions and their impact on government budgets, highlighting key elements for an effective reform of the public pension system, specifically in the U.S.

Scope of the Report

This Report investigates the issue of avoidance by global corporations of the payment of fair and reasonable taxation, illustrating the way in which existing tax regimes are manipulated particularly by corporations with global reach. It presents a snapshot of the various estimates and data on the extent of this tax manipulation and the consequent effects in terms of loopholes in taxation systems, as drawn from the key international sources on this subject. The study briefly explains the regulatory framework of corporate taxation at international level, providing examples of the way in which this is manipulated by MNCs to avoid taxes. Finally, it presents possible approaches for change, both to challenge tax arbitrage, abusive transfer pricing, and other avoidance strategies, and to promote a new compact for fair and reasonable taxation paid into public revenues by MNCs, and the provision of effective quality public services in all communities. This requires a paradigm shift that would be beneficial to MNCs, as well, as they will have a level playing field, quality services to support their operations, and well trained workforce to boost productivity and profits.

There are different estimates of the overall size of the offshore economy in today's world. By their very nature, flows of finance are opaque and thus difficult to quantify. It is clear that huge amounts are involved – trillions of US dollars annually for legal or quasi-legal transactions – and further substantial amounts that flow through illegal transactions, including the drugs and arms trades, human trafficking, and various forms of money laundering.

It is not surprising, therefore, given the role of the offshore economy in tax matters, that it is difficult to quantify reliably the losses to communities through global tax avoidance. The focus of this study is on known tax minimization and avoidance through legal or quasi-legal means. There are various estimates of the amounts involved, and several of these estimates are cited in the report. It would be particularly useful for a further study to compare these estimates and to seek some coherence among them, so that figures could be reliably cited in public debate. This report highlights the **need for further research on this topic**.

Informed public debate is fundamentally important in democratic societies. In addition to the need for good data, the public debate around taxation requires clarification of concepts – beyond the facile slogans that prevail. Among those concepts is the rationale for corporations to pay their fair share of taxes in modern societies. That issue is addressed early in the report. Again, the particular focus remains on the global enterprises, which play such significant roles in today's global economy, and use their global reach to minimize or avoid paying taxes. The time has come for these global enterprises to accept that good corporate citizenship requires paying fair and responsible taxes in all the communities where they operate.



CHAPTER 1

BILLIONS LOST TO COMMUNITIES by Laura Figazzolo

1.1. The magnitude: billions lost to communities

Starting with the Thatcher/Reagan era, which began 30 years ago⁴, a set of ideas about the role of government in society and the role of taxation became entrenched in conventional economic wisdom. Margaret Thatcher and Ronald Reagan succeeded politically in establishing the concept of small government linked with lowered taxation and deregulation in the United Kingdom and the U.S.. These radical changes in the understanding of a well designed and performing state were theoretically underpinned by many mainstream economists, arguing on the basis of the neoclassical framework. Whether reality matched the rhetoric is debatable, but it became the conventional wisdom that public budgets could not cope with the expansion of social needs, that the private sector was inherently more efficient than the public sector and that economic actors should be freed from the yoke of regulation. Reagan summed up his advocacy for tax cuts by proclaiming, in layman's terms, that citizens knew how to make better use of their money than governments. Theoretical arguments gained empirical support by the breakdown of the socialist countries. Since then, waves of privatization and liberalization have spread all around the globe. Nevertheless, the international financial crisis in 2008-2009 made it clear that, in practice, at least financial markets do not tend to find equilibrium by themselves. Market failures are not exceptions, but, rather, tend to be the norm.

Many governments implemented huge fiscal programs to counteract the economic downturn induced by the international financial crisis. As a result, governmental budgets in many developed countries are now showing huge deficits. These fiscal deficits are often taken as arguments for expenditure cuts in the social sphere.

Now, the time seems to be right to analyse the cost of liberalization and privatization. It is time to reaffirm the vital role of public services in the community – quality, effective, ethical and adequately resourced public services. The financial crisis has made it clear that there is a need for a strong and healthy governmental sector.

Today, one of the major issues for industrialized and developing countries alike is the question of resources for social needs – including education, health, safety nets for the poor, and services for migrants. Yet resource constraints derived from the dominance of the small government, low tax movement have militated against the provision of quality public services. It is also timely to engage in a renewed debate over

the role of taxation in society – both as a source of revenue for public services, and as a mechanism of equity. The financial crisis and the attention given to tax havens by the G20 and the OECD have brought the issue of tax avoidance within the global economy in public spotlight. That spotlight has also shone on bank bonuses and profits, which are, often, associated with tax minimization techniques. Debate has developed anew over the case for taxation in international transactions, and over the increasing "leakiness" (Palley, 2011)⁵ of the global system as far as taxation is concerned. However, the spotlight of the media has not yet shone on existing and mostly legal tax minimization by global corporations.

Preliminary work by the ICFTU in 2006⁶ showed that **Multinational Companies use their global reach to avoid their responsibility to contribute through fair and responsible taxation to national and community social needs.** This is done through different techniques of tax "minimization", which is the basis for a huge so-called 'offshore' sector that really represents a parallel global economy.

1.2. Offshore economy

As mentioned above, the size of the offshore economy remains difficult to measure precisely, as a consequence of its fragmented nature and blurry definition. International efforts to quantify it often focus only on some aspects of the issue. Detrimental financial flows and tax losses include the illegal (notably, tax evasion) as well as the legal kinds (particularly, tax minimization or avoidance), plus the large grey area in between the legal and the illegal.

There is a considerable body of research trying to get a picture of the amounts of capital involved. Considering individuals, as distinct from corporations, the Tax Justice Network published a report in 2005 based on data from Boston Consulting. McKinsey's, Merrill Lynch/Cap Gemini and the Bank for International Settlements, estimating that the world's so called 'High Net Worth Individuals' (HNWIs) held around \$11.5 trillion of assets offshore. On rates of return applying at that time, there was a consequent tax loss of \$250 billion as a result of the capital being held offshore, more than three times the OECD countries' official development assistance to the entire world at that time⁷. Richard Murphy commented that this figure was 'extremely conservative: it they did not include tax

⁵ Coats, David,(ed) (2011) *Exiting from the crisis: towards a model of more equitable and sustainable growth, Report of a Taskforce: ITUC, TUAC and ETUI: Brussels*

⁶ Weise, K. (2006) *Having their Cake and Eating it too: the big corporate tax break ICFTU*

⁷ see www.taxjustice.net and www.taxresearch.org.uk: Murphy, R. (2008) *The direct tax cost of tax havens to the UK, Tax Research LLP, <http://www.taxresearch.org.uk/Documents/TaxHavenCostTRLLP.pdf>*; see also Martens, J. (2007) *The Precarious State of Public Finance- Tax evasion, capital flight and the misuse of public money in developing countries – and what can be done about it. Global Policy Forum Europe, http://www.taxjustice.net/cms/upload/pdf/martens_precarious_finance__2007.pdf*

losses resulting from tax competition and trade mispricing... [nor]... corporations, which reportedly pass more money through tax havens than individuals.’⁸

The above figures included both residents (for tax purposes) and non-residents. In March 2010, five years later, Global Financial Integrity (GFI)⁹ published a study estimating that current total deposits just by non-residents in offshore and secrecy jurisdictions were close to US\$10 trillion, with the US, the UK and the Cayman Islands topping the list of jurisdictions (GFI, 2010a). Offshore deposit holdings in secrecy jurisdictions have expanded at an average of 9% per annum, outpacing the rise of world wealth in the last decade. Back in 1998, the IMF estimated the size of money-laundering transactions globally at 2 to 5% of global GDP, i.e. \$640 billion to \$1.6 trillion¹⁰. The World Bank calculated in 2004 that over a trillion dollars is paid in bribes each year. It is estimated that 60% of all global trade is actually routed through tax havens (GFI, 2010a).

These figures on the scale of the shadow economy and the extent of holdings in offshore havens are part of a much bigger picture that certainly includes the lost revenues from global corporations – which is the specific focus of this study.

It is even more difficult to get a picture of financial **flows**, as distinct from capital holdings. There are, essentially, two types of estimates on global flows of “dirty” money. One focuses on illegal flows. The other focuses on all kinds of abusive tax practices, whether legal or illegal. Below, a number of different estimates for different kinds of financial assets and flows (Table 1).

Table 1. Cross-border flows of global dirty money, estimates, US\$ billion, annual

| | LOW | HIGH |
|---------------------------------|--------------|--------------|
| Criminal | 331 | 549 |
| Corrupt | 30 | 50 |
| Commercial , of which: | 700 | 1,000 |
| <i>Mispricing</i> | 200 | 250 |
| <i>Abusive transfer pricing</i> | 300 | 500 |
| <i>Fake transactions</i> | 200 | 250 |
| TOTAL | 1,061 | 1,599 |

Source: www.taxjustice.net [consulted in 2011]

⁸ see www.taxjustice.net and www.taxresearch.org.uk: Murphy, R. (2008) *The direct tax cost of tax havens to the UK*, Tax Research LLP, <http://www.taxresearch.org.uk/Documents/TaxHavenCostTRLLP.pdf>; see also Martens, J. (2007) *The Precarious State of Public Finance- Tax evasion, capital flight and the misuse of public money in developing countries – and what can be done about it*. Global Policy Forum Europe, http://www.taxjustice.net/cms/upload/pdf/martens_precarious_finance__2007.pdf

⁹ At the Centre for International Policy in Washington, DC

¹⁰ Based on a figure of \$32 trillion for global GDP at the time; however, latest World Bank data put total Global GDP at \$45 trillion at market prices, of which the U.S. economy accounts for about \$12.5 trillion. Measured at Purchasing Power Parity, global GDP is estimated at \$61bn

1.3. Regional picture

In a 2003 report (cited in Tax Justice Network), the Boston Consulting Group estimated total HNWI assets at \$38 trillion, broken down regionally as indicated in Table 2.

Table 2. Total HNWI assets

| | \$ TRILLION | % HELD OFFSHORE |
|------------------------------|-------------|-----------------------------------------------|
| NORTH AMERICA | 16.2 | LESS THAN 10 |
| EUROPE | 10.3 | 20-30 |
| ASIA-PACIFIC AND MIDDLE EAST | 10.2 | JAPAN < 10 OTHER ASIA 30 MIDDLE EAST 70 |
| LATIN AMERICA | 1.3 | MORE THAN 50 |
| WORLD TOTAL | 38.0 | - |

Source: www.taxjustice.net

In **North America**, a May 2008 study by Léo-Paul Lauzon of the Université du Québec à Montréal (UQAM) estimated that Canadian banks avoided \$16 billion in taxes between 1993 and 2007 (Lauzon, 2008). The US IRS estimated in 2001 that the total tax gap in the United States stood at \$345 billion. Professor Reuven Avi-Yonah and tax expert Joe Guttentag estimate that offshore tax haven abuses by individuals alone cost the U.S. Treasury \$40-\$70 billion a year in unpaid taxes. Professors Simon J. Pak and John Zdanowicz found that transfer pricing abuses by corporations cost the U.S. Treasury about \$53 billion per year in lost tax revenue. The combined total of these two was been quoted by the U.S. Treasury in 2009 as a loss of up to \$123 billion annually.

A 2004 study by the journal Tax Notes found that American companies shifted \$149 billion of profits to 18 tax haven countries in 2002, up 68% from 1999. An estimate by Professor Kimberly Clausing of Wellesley College in 2009 that the U.S. Treasury lost over \$60 billion in tax revenues in 2004 from profit-shifting by corporations to low-tax countries; a preliminary update in 2011 suggested that estimate would be raised to \$90 billion¹¹.

A similar situation can be found in the **European Union**: tax evasion is in fact estimated at 2-2.5% of European GDP. According to a report by France's Union of Tax Civil Servants, tax evasion ran at approximately 45 billion Euros in 2006. Media reports quote a figure of tax losses to Germany of the order of 30 billion Euros per year, just from tax evasion. The discrepancy between the amount of federal taxes theoretically due and the taxes actually paid was, apparently, 17bn in 2005¹² (the info memo is quoted by the tax expert

¹¹ All studies are cited in Tax Justice Network: www.taxjustice.net, section Magnitudes: dirty money, lost taxes and offshore

¹² This figure is calculated by taking the difference between the earnings of German-incorporated tax companies, deduct losses brought forward and dividends from foreign equity holdings, and comparing this to the earnings reported to the German tax authorities. However, this is only part of the picture: most companies in Germany are neither limited companies nor joint-stock companies and therefore do not pay corporate taxes, but income taxes - and these are not included in the above figure. These company taxes cannot be separated out from household income taxes. Data about the taxation of companies in Germany therefore is not easily comparable with that of other countries.



Lorenz in the book *Unternehmenssteuerreform 2008: Kosten und Nutzen der Reformvorschläge*, Jarrass Jarrass, Lorenz; Obermair, Gustav, 2006). The Bank of Italy estimates that Italians hold some 500bn in undeclared funds outside the country (Banca di Italia, 2010).

Foreign private wealth managed in **Switzerland** is estimated to amount to between 2500 and 4000 billion Swiss francs. In February 2010, the Geneva-based research group Helvea produced estimates of approximately 500 billion in "black money" from Europe alone (TagesAnzeiger, 12.02.2010).

In February 2009, research for the BBC's Panorama programme calculated roughly that the UK loses about £18.5 billion per year to tax havens, including avoidance and evasion (Murphy, 2009). In February 2008, Britain's Trade Union Congress (TUC) published a report estimating that £25 billion annually is lost to the UK from tax avoidance: £13 billion per annum by individuals plus £12 billion per annum from tax avoidance from the 700 largest corporations (TUC, 2008).

In **Asia**, it is worth citing the case of India, as several Indian media articles have reported that Indian nationals hold 1.456 trillion US dollars in Swiss banks. GFI estimated in 2010 that, from 2000 to 2008, India had lost more than US\$125 billion in cumulative illicit capital flight. In March 2010, GFI evaluated that India had lost a total of US \$213 billion in illicit financial flows, with a present value of at least US \$462 billion (GFI, 2010b).

In April 2008, James Boyce and Léonce Ndikumana of the University of Massachusetts, Amherst, published a research study estimating that capital flight from 40 sub-Saharan **African countries** from 1970-2004 stood at \$607 billion in 2004 dollars (including interest earnings), compared to a total \$227 billion external debt owed by those countries in 2004. In other words, **Sub-Saharan Africa** is a net creditor to the rest of the world: external assets, as measured by the stock of capital flight, exceed external liabilities, as measured by the stock of external debt, with the difference that, while assets are in private hands, liabilities are essentially the public debts of African governments. The real counterpart of many assets on the balance sheets of creditor banks are private deposits in many of the same banks by individuals belonging to Africa's political and economic elites (see the April 2008 edition of Tax Justice Focus for more details).

If we look at **Latin America**, it is estimated that over 50 per cent of the cash and listed securities of wealthy individuals in the region is held offshore¹³. In a report on Latin America (Poverty Reduction and Growth: Virtuous and Vicious Circles, published in 2006), the World Bank argues that Latin American governments must give higher priority to spending on infrastructure likely to benefit the poor and increase expenditure on education and healthcare. A large proportion of government spending in Latin America is skewed in favour of the well off, and governments are collecting far too little tax, especially from the wealthy. The World Bank hence concludes that: "on the

¹³ Christensen, J. (2006) *Why capital flight? How plugging the leaks could contribute to poverty alleviation*. Tax Justice Network

tax front, first items in the agenda would be strengthening anti-tax evasion programs and addressing the high levels of exemptions.”¹⁴

1.4. Corporate taxation vs. corporate profit

Multinational companies (MNCs) use their global reach to avoid their responsibility to contribute through fair and responsible taxation to national and community social needs and public services upon which corporations themselves, their employees, and owners depend in different ways. Multinational and foreign-owned companies operate alongside national ones, but often do not pay the same levels of taxation. Multinational companies may play countries off against each other, moving, or threatening to move to countries that either have a low tax level or offer them special tax incentives, with consequent pressure on governments to reduce corporate income taxes in order to remain attractive as investment locations. This holds true, with harmful consequences, even if these countries' need for public services and infrastructure has risen (Hall, 2010). Taxation has thus become an instrument for attracting and maintaining capital, with most cuts in corporate tax rates within the last ten to fifteen years justified by international tax competition and the need to stay attractive to multinational capital (Morisset, 2003). But, as the advantage of such cuts in corporate tax rates is often negated by similar or further cuts in other countries, the gains of this continuous cutting are indeed short term, and they tend to lead to long term losses in all countries engaged in a race to the bottom (ICFTU, 2006).

Broadly speaking, within the last twenty years, statutory corporate tax rates have fallen by a third, from around 45% to less than 30% on average in the thirty OECD countries, and a similar development has taken place in the forty five non-OECD countries, where rates have dropped from just above 40% to a little less than 30% (ICFTU, 2006). Between 2000 and 2005, 24 out of the 30 (in 2006) OECD countries lowered their corporate tax rates. Only 6 of them kept rates steady, and no OECD country raised its rates in that period. Major cuts took place in Austria, which cut its corporate tax rate from 34% to 25%, in Germany, from 52% to 39%, in Greece, from 40% to 32%, in Iceland, from 30% to 18%, in Ireland, from 24% to 12.5%, in Poland, from 30% to 19%, in Portugal, from 35% to 27%, and in the Slovak Republic, from 30% to 19%. These cuts mean that average rates in all OECD countries have dropped from 33.6% in 2000 to 28.6% in 2005 (OECD Tax Database). Outside the OECD, during the same years, rates have generally fallen: in Bangladesh, from 35% to 30%, in Brazil, from 37% to 34%, in India, from 38.5% to 33.5%, in Pakistan, from 43% to 35%, in Panama, from 37% to 30%, and in Singapore, from 26% to 20%.

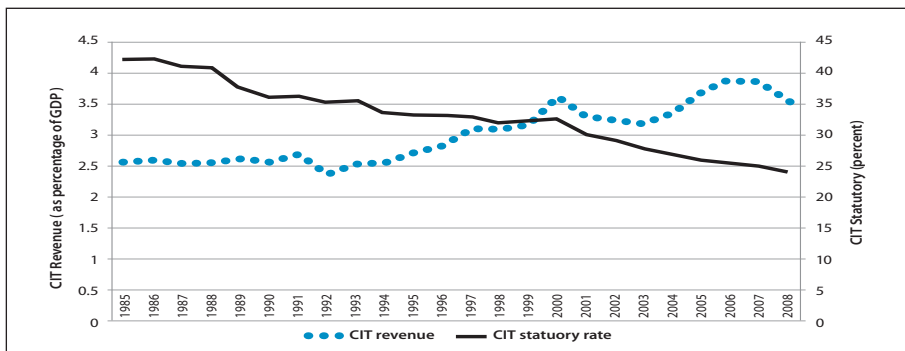
If we express corporate tax revenue as a proportion of GDP, in fact, (theoretical) tax revenues from corporate profits have remained at the same level since 1965, while

¹⁴ Lopez, J.H. et al (2006) *Poverty Reduction and Growth: Virtuous and Vicious Circles*, The World Bank, p.101

profits have risen as a share of GDP. As a share of total tax revenue, tax revenues from corporate profits have been relatively constant since the 1980s, after a decline until 1980. However, tax competition has intensified within the last decade, with increasing mobility of multinationals and, over the last decades, some of the world's largest economies – the US, Japan, Germany, the UK and Italy – have seen their actual revenue from corporate taxation decline substantially. These countries do not appear to have engaged too actively in tax competition (only cutting their statutory corporate tax rates moderately during this period), but are indeed the countries that have lost most public revenue from corporations.

This may suggest that real tax contribution from the corporate world to public finances and society in general is declining (in spite of a rising profit share) not just by way of reductions in statutory corporate tax rates, the upsurge in export processing zone, and the proliferation of tax havens. The basis on which corporate taxes are collected and the extent of deductions, exemptions and other loopholes enacted by governments is just as significant as the developments in tax rates, tax holidays and tax havens (ICFTU, 2006). In fact, whether through political pressures, or simply via tax evasion, the actual revenue from corporate income tax has fallen from about 4.2% of GDP in 1985 to about 2.4% of GDP in 2008. However, over this same period, corporate profits have increased their share of GDP in the major OECD countries, so that it now represents about 35% of GDP, compared with only about 25% in the early 1980s. Yet the effective rate of tax paid has halved. If corporations were still paying at the same effective rate as in 1980, they would be contributing tax equivalent to about 5% of GDP. Instead, half of that amount of revenue is lost, and has to be found from other sources (Hall, 2010) (Figure 1).

Figure 1. Corporate Income Tax Revenue in OECD countries, 1985-2008¹⁵

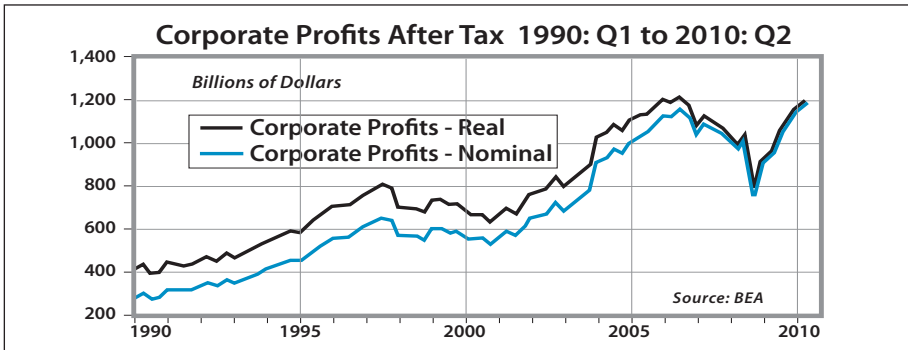


Source: IMF, 2010

⁵ In the table: the revenue from corporate income tax (referred to as CIT statutory rate) has fallen from about 4.2% of GDP in 1985 to about 2.4% of GDP in 2008; over the same period, corporate profits (indicated as CIT revenue) have increased their share of GDP to reach 35% of GDP, compared with only about 25% in the early 1980s

In the U.S., statutory corporate tax rates have been kept at 39% since the mid 1990s. Yet, over the last decade, the country's largest corporations have paid less and less: overall, corporate taxes in the U.S. have dropped from 9.4% of total tax income in the 1990s to 7.5% in the first four years of the new millennium, and from 2.6% of GDP in the 1990s to 2.1% of GDP in the years between 2000 and 2003. Extending the view and counting in a couple of other decades, the fall is even more drastic: in the 1970s and the last five years of the 1960s, corporate taxes on average made up 11.7% and 16.1% of all tax revenue, and 3.0% and 4.2% of GDP (OECD Tax Database). In Japan, corporate taxation had for several decades made up a substantial part of total taxation. Yet corporate taxation made up 13.0% of total tax revenue in the first four years of the new millennium, a marked decline from 16.8% in the 1990s and 21.6% in 1980s. And, as a share of Japan's GDP, corporate taxation is down from 6.0% in the 1980s and 4.6% in the 1990s to 3.4% from 2000 to 2003. These developments are beyond economic cycles, as companies actually have seen larger profits in the new millennium than in many of the years of the 1990s (OECD Tax Database) (Figure 2).

Figure 2. Corporate profits after tax, 1990 to 2010 (U.S.)



Source: BEA and Haver Analytics, 2010

In the forgoing discussion we have mostly reviewed corporate tax revenue as percentages of GDP and of total tax revenue. However, the figures do not suggest that lower statutory tax rates contributed to the big increase in corporate profits of recent decades, nor that corporate tax cuts paid for themselves, as advocates for those measures claim. In general it is valid to measure corporate tax revenue as a percentage of corporate profits – and on that measure there have been sharp declines.

The latest KPMG's *Corporate and Indirect Tax Survey* (2010) suggests that there seems to be a common priority for national economies: competition for investment to grow the tax base, and the need for tax revenues to help pay down deficits. The typical global action taken is to reduce the top corporate tax. In particular, according to KPMG, we are witnessing a combination of reduced corporate tax relief, strengthened transfer



pricing regulations, together with a shift to indirect taxes to create a more stable source of tax revenues – as such, we are seeing a shift from tax on profits to real time transactions taxes. In the UK, the corporate tax rate will fall to 24% over 4 years; one percentage point taken off the rate every year until 2014. Australia's Future Tax System Review Panel recommended that corporate tax be reduced to 25% over the short to medium term. The government has partially supported this recommendation by moving the corporate tax rate to 29% for the 2013/14 income year, and 28% from the 2014/15 income year, with possible further reductions as revenue allows. New Zealand has announced a reduction in the corporate tax rate to 28% (from the current 30%) effective from the beginning of 2012. In Korea, the highest corporate income tax rate was scheduled to be lowered from 22% to 20% for tax years commencing on or after January 1st 2010, but has been postponed for another two years until the end of 2011. In Hungary, corporate tax has been proposed to be cut from 19% to 10% for companies whose annual profits are less than Ft500 million (US\$2.2 million) (KPMG, 2010).

In a global context where authorities in different countries need to regain lost revenues (while at the same defending their own goals against those who are similarly reducing their corporate tax rate to maintain a competitive appearance in the global marketplace), indirect taxes such as consumption taxes like VAT have become popular ways of gaining back some of the revenue, the argument being that they shift the collection burden to the company rather than the revenue authorities. We also expect to see many countries further broaden the tax base. Germany and Sweden are good examples, where deductibility of interest has become more difficult (KPMG, 2010).

Indeed, tax authorities around the world are focusing on foreign investors seeking tax advantages, and, as a consequence, many regulators are re-evaluating their rules. As companies seek favourable tax environments, "treaty shopping or anti-treaty shopping court cases are likely going to be on the increase" (KPMG, 2010): many cases have already occurred whereby governments (Korea, Australia, and several developing nations) have ignored existing tax treaties to protect this lucrative source of income. As such, those companies which operate in multiple jurisdictions are advised to be highly aware of the regulations as well as the change in behaviour and approach of the tax authorities, the rationale being that they should avoid the risk of double, or even triple, taxation (KPMG, 2010).

In other words, tax competition does not only take place in the form of cutting rates, although, as we have seen, countries are under pressure to reduce their levels of company taxation in order to attract investment (Hall, 2010). In many countries, questions on how and on what basis corporate taxes are collected are also used to attract capital. And, in several developing countries, tax exemptions and tax holidays – often given within the borders of export processing zones – have become the favoured means of appealing to foreign investors. Techniques for "minimization" of corporate tax include the use of offshore tax havens, setting up competition between localities and countries for tax advantages ("arbitrage"), and the technique of "transfer pricing".

1.5. Transfer Pricing

Transfer pricing, in particular, plays on the fact that an estimated 40% of global commerce occurs within global corporations, enabling them to avoid national taxes by manipulating the prices charged for the transfer of goods and services. This phenomenon has developed dramatically since the mid 1990s. The technique is more easily available to global companies, rather than to national small or medium enterprises (SMEs). It is estimated that several trillion U.S. dollars of tax revenues are lost to national budgets annually through the use of such techniques – enough to provide the resource needs of the UN Millennium Development Goals (MDGs) and the budget requirements for social services in industrialized countries, including the growing costs associated with migration and global mobility.

Attempts to regulate transfer pricing began as far back as the time of the League of Nations in the inter-war period. Today, most developed countries have well-established transfer pricing regulations, derived either from the 1995 OECD transfer pricing guidelines or the U.S. Internal Revenue Code (section 482). Both the OECD and U.S. approaches are based on the so-called “arms-length” principle – in simple terms, requiring that intra-firm transactions be based objectively on what a company would have charged an external/independent firm in an open market. They differ substantially, however, in the mechanisms used to determine or assess objective transactions, and in the allocation of the burden of proof in the U.S., it is the MNC and not the tax authority that bears the burden of proof, which is opposite to the OECD guidelines. In terms of assessment mechanisms, the OECD guidelines focus on determining whether prices are fair. The U.S., by contrast, favours an approach that measures profits – it commonly employs the comparable profits method (CPM) which tries to assess the amount of operating profit a MNC would have earned on a transaction with a controlled affiliate if the transaction had been with an independent company. The U.S. also tries to tax MNCs on the basis of their worldwide profits.

Many national jurisdictions have been dealing with the matter to a greater or lesser degree. Despite this well-established regulatory framework, however, serious problems remain. Transactions performed in tax havens and even in some European countries pose difficulties. Another issue is the assessment of more intangible transactions – i.e. intellectual property, expertise (consulting), know-how etc. entered into by related parties. It is difficult to establish a fair market price for transactions that are not conducted between independent companies. It is complicated to untangle this web as transfer pricing is also influenced by tariff structures, exchange rate fluctuations and risk, profit repatriation policies, and asset capitalization policies. This means that, while it is very hard to get a clear and transparent sense of what is really going on, there is ample scope for global corporations to play on the complexities to their advantage.



1.6. Implications for developing countries

As highlighted above, revenue losses from corporate profits have detrimental implications on public resources.. This holds true in terms of national budgets of developing countries as well as foreign aid to them. In January 2009, GFI published a report on illicit flows from developing countries, estimating that, in 2006, developing countries lost \$858.6 billion – 1.06 trillion in illicit financial outflows (GFI, 2009). In February 2010, GFI published another report calculating roughly that developing countries are losing \$98 billion to \$106 billion each year due solely to re-invoicing; approximately 4.4% of the developing world's total tax revenue (GFI, 2010b). James Henry, a former chief economist at McKinsey & Company, says that foreign aid into developing countries has been accompanied by very large outflows of private capital, producing the largest wave of capital flight in history, revolutionizing at the same time the world's offshore private banking market (Hiatt and Perkins, 2007). He has estimated the outflows resulting from such debt-flight cycle at an average of \$160 billion per year (in real 2000 dollars) from 1977 to 2003. By the early 1990s, the total amount of untaxed Third World private flight wealth exceeded the value of all outstanding Third World foreign debt. In a March 2009 analysis for Oxfam, Henry found that at least \$6.2 trillion of developing country wealth is held offshore by individuals, depriving developing countries of annual tax receipts for an amount of \$64 to \$124 billion. The scale of the losses could outweigh the \$103 billion developing countries receive annually in overseas aid. Capital flight is a growing problem, too, with an additional \$200-300 billion being moved offshore each year (Oxfam, 2009).

1.7. Taxation and the public good

Without taxes, there would be no civilized society, nor legal system, public administration, national defence, police and emergency services, nor public education and health, nor investment on infrastructure such as public roads or communications, nor social protection, nor adequate environmental conservation. Therefore, taxes are necessary. They are integral to the construction and maintenance of societies.

“Taxes are also used to ensure some degree of income distribution, equal opportunity, and a minimum of living standards. In short, the sustainability of any modern society and economy requires the state to have sufficient revenue to fund the physical and social infrastructure essential to economic welfare, development, stability and security.”¹⁶

Over the years, there have been different kinds of taxes – on income, consumption, trade, property and profits – and the mix has varied both over time and among countries.

¹⁶ Weise, K. (2006) *Having their Cake and Eating it too: the big corporate tax break*, ICFTU

The design of tax systems basically depends on two considerations: what taxes should be used for, and what sources should be taxed. The debate about the sources of tax and the need to balance tax revenues with the needs of society is one of the most important ongoing political debates in democracies.

The trends in corporate taxation and tax contributions by the super rich (top one percent) has been disturbing to say the least. Tax contributions by the super rich is not the focus of this document, it is important to understand the consequences of downward trend in taxation of super rich. Among other things, this trend causes income inequality and budget shortfalls, and perhaps responsible for economic downturns.

“Taxes derived from corporate profits have played an important part in building the societies of the twentieth century, thus ensuring the continuing success of the companies that contributed to their establishment. This has been a virtuous cycle: corporations have financed societies, which in turn have made the corporations flourish, increasing their contributions to society, which again strengthened and enhanced corporation operations.”

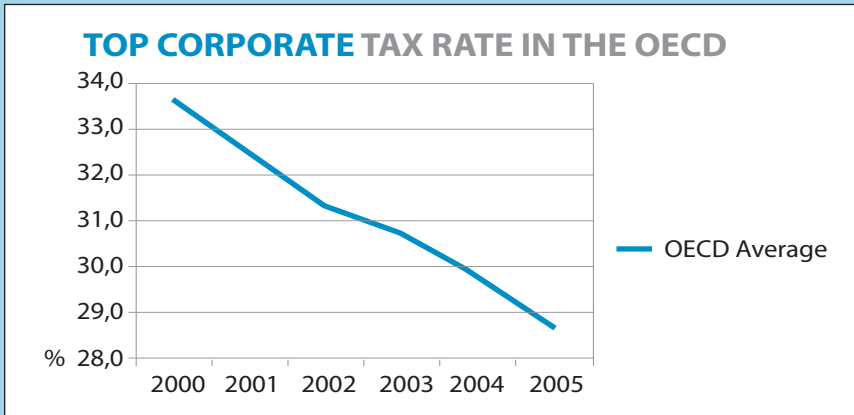
In the global economy, corporate taxation has become more of an issue internationally, although the rules and regulations which govern this and most other forms of taxation remain essentially national. Most if not all countries in the world have global corporations operating within them. This has made corporate taxation all the more tricky and complex. That being said, the need for common understandings among nation-states has grown with globalization, and is seen most clearly with the OECD Guidelines on taxation which serve as a reference, regularly updated, for the industrialized economies. Corporate taxation is an important focus of these guidelines. Since the 1950s, however, corporations have shared less of their profits with societies though they have become more and more dependent on their functioning and quality.

Over the last three decades, corporations have allocated less and less of their profits to the communities in which they operate. Tax minimization and avoidance has been legitimised, and have been not only accepted but also promoted. Global companies play countries off against each other, moving away, or threatening to do so, from countries they believe charge them too many taxes and into those that either have a low tax level in general or offer them special tax incentives. This has put pressure on governments to reduce corporate income taxes in order to remain attractive as investment locations and sites for capital accumulation. Taxation has thus become a much used tool in attracting and maintaining capital, with most cuts in corporate tax rates within the last ten to fifteen years explained and justified by international tax competition and the need to stay attractive to multinational capital. But as the advantage of such cuts in corporate tax rates is often negated by similar or further cuts in other countries, the gains of this kind of continuous cutting are indeed short term. And what is worse, they tend to lead to long term losses in all countries that engage in such rivalry.

Box 1.2. Corporate tax rates in the OECD

The results of tax competition in the era of increasing globalisation and mobility of corporations and capital are clear: within the last twenty years, corporate tax rates have fallen by a third, from around 45% to less than 30% on average in the thirty OECD countries. And a similar development has taken place in the forty five non-OECD countries where rates have dropped from just above 40% to a little less than 30%. If these linear trends were extrapolated and extended into the future, tax rates would hit zero by the middle of the present century.

As mobility of multinationals in the last five to ten years has increased, tax competition has intensified and the lowering of corporate taxes rates has sped up. Thus, between 2000 to 2005, 24 out of the 30 OECD countries lowered their corporate tax rates. Only 6 of them kept rates steady. And no OECD country raised its rates in this period. In these years, major cuts took place in Austria, which cut its corporate tax rate from 34% to 25%, in Germany, from 52% to 39%, in Greece, from 40% to 32%, in Iceland, from 30% to 18%, in Ireland, from 24% to 12.5%, in Poland, from 30% to 19%, in Portugal, from 35% to 27%, and in the Slovak Republic, from 30% to 19%. These cuts, plus a series of cuts of less magnitude in other OECD countries, mean that average rates in all OECD countries have dropped from 33.6% in 2000 to 28.6% in 2005.



Outside the OECD this practice has been mirrored during the same five years, from 2000 to 2005, in countries such as Bangladesh, where rates have fallen from 35% to 30%, Brazil, from 37% to 34%, India, from 38.5% to 33.5%, Pakistan, from 43% to 35%, Panama, from 37% to 30%, and Singapore, from 26% to 20%.⁵ In general, and not only in the new millennium but over recent decades, reducing statutory corporate tax rates has manifested itself as a global phenomenon. But tax competition, as will be elaborated later on, does not only take place in the form of cutting rates. In fact, in many countries, questions of how and on what basis corporate taxes are collected are used just as actively to attract investments and capital. And in many developing countries, tax exemptions and tax holidays – often given within the borders of export processing zones – have become the favoured means of appealing to foreign investors¹⁷.

¹⁷ Weise, K. (2006) *Having their Cake and Eating it too: : the big corporate tax break*, ICFTU, 2006

1.8. An issue of real Corporate Social Responsibility (CSR)

Corporate Social Responsibility (CSR) represents, broadly speaking, an attempt to conciliate MNCs' practice with the respect of the community. The term, in fact, identifies a broad range of instruments available in attempting to hold MNCs responsible for their actions; it covers an ample spectrum of subjects, ranging from labour rights and social protection and the discipline of human rights, to philanthropy activities undertaken by MNCs. A well-known description of CSR is the so-called 'triple P bottom line', which proclaims that companies have a threefold responsibility: care for Profit, People and for the Planet (Elkington, 1998). In the light of this analysis, CSR refers especially to those (very often philanthropic) activities that allow corporations to bypass their responsibility towards the community in terms of taxation. In other words, MNCs' care for profit should be held responsible towards people within the community, especially as far as the provision of public services through government resources is concerned, through fair and reasonable taxation.

Of course, the ground of such discourse on CSR and taxation relates to the existence of the economic will, by governments and companies, to really hold MNCs responsible for their activity. According to Addo (1999), resistance against forms of strict regulation or additional legislation generally comes from both industry and politicians. Industry, fearing the introduction of regulations perceived to be anti-competitive and willing to maintain their privileges, strongly lobbies at the level of the national government; at the same time, politicians tend to resist to additional regulations to attract FDI in their country. This can be the case of developing countries, where national governments may tend to be particularly keen on accommodating foreign investment without broader social concerns (Lippman, 1985; Meyer, 1998; Addo, 1999; Hensman, 2001). The result is, often, as highlighted in the first paragraph, a weak regulatory framework, or a feeble ability to implement such a framework to hold MNCs responsible, particularly in terms of taxation. In this context, MNCs tend to adopt the so-called 'basic minimum compliance' approach: they simply comply with the domestic laws of the countries where they operate, which are usually quite minimal for the reasons illustrated above (the 'race to the bottom' to attract FDI), hence limiting their risk in terms of international legal liability (O'Reilly and Tickell, 1999). CSR, especially in the form of philanthropy, may represent, for MNCs in this framework, an easy way to salve their conscience (and reputation).

Box 1.1. Why We Must Raise Taxes on the Rich – evidence from the U.S.

A recent article issues by AlterNet suggests that the top 1 percent's share of national U.S. income has doubled over the past three decades (from 10% in 1981 to well over 20% now). Yet, remarkably, taxes on the top have plummeted. From the 1940s until 1980, the top tax income tax rate on the highest earners in America was at least 70%. In the 1950s, it was 91%. Now it is 35%. The estate tax (which only hits the top 2%) has also been slashed. In 2000 it was 55% and kicked in after \$1 million. Today, it is 35% and kicks in at \$5 million. Capital gains – comprising most of the income of the super-rich – were taxed at 35% in the late 1980s. They are now taxed at 15%. If the rich were taxed at the same rates they were half a century ago, they would be paying in over \$350 billion more this year alone, which translates into trillions over the next decade. That is enough to accomplish everything the nation needs while also reducing future deficits.

Source: <http://www.alternet.org/module/printversion/150497>



CHAPTER 2

COMMUNITY NEEDS by Laura Figazzolo*

This chapter aims at demonstrating that recent arguments - put forward by some governments and notably by the international rating agencies – that the deficits used to create the stimulus must be cut back by reducing public spending on a grand scale are wrong, both in the short and in the long term, and so are the policies arising from these arguments (Hall, 2010). Far from being a burden on economies, public spending has historically proven to be an essential driving force, providing universal services for human development – healthcare, education, social security – and also the key infrastructure making economic activity possible - water, electricity, roads. Hence, if there is to be future growth and development, particularly in a time of severe economic crisis, public spending should be expected to grow, not to be cut back. By the same token, revenue systems must be reformed and brought into line with the new economy and evolving community needs.

2.1. Why we need public spending

As we have seen earlier in this Report, globalisation has increased demands on communities for the provision of public services, creating new requests that are both *quantitative*, because of changing demographics linked to migration flows and the evolving character of communities, and *qualitative*, because of language and cultural issues. Hence, besides the 'traditional' expectations – i.e. those services historically provided publicly such as health, education, utilities (sanitation, water and energy), essential services (police, and other security services including prisons, fire fighting and emergency services), municipal services and public administration, regulatory services required in every community, from national to local levels – communities are asking governments to provide services for ageing populations, services dealing with the consequences of climate change, and services responding to increasing migration flows.

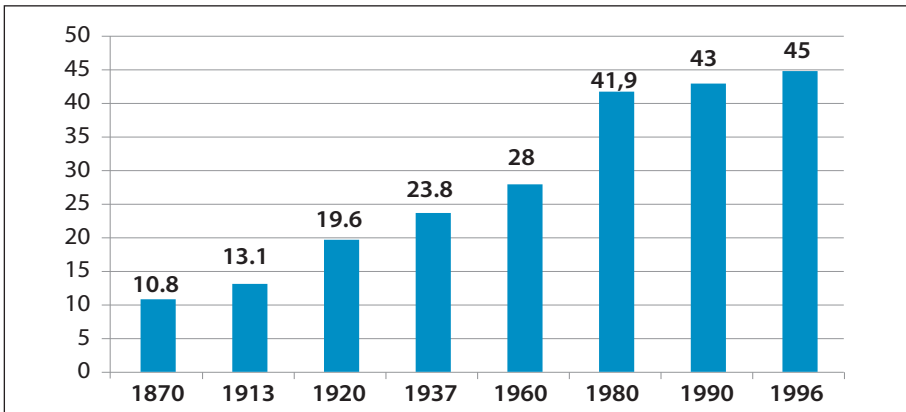
At the same time, during the recent global economic crisis, communities have witnessed an increasing attack on the provision of publicly funded services. Moreover, the last decades' globalisation of the economy has been accompanied by a major drop in tax revenues from the corporate sector, because MNCs minimise their tax payments to all the countries where they operate. A profound imbalance has thus developed between resources available and demands for quality public services – an imbalance felt most keenly at the local level.

As David Hall highlights in the 2010 PSI publication *Why we need public spending*, "there are two major reasons why public spending needs to grow, not fall back. One

is the need for essential infrastructure in the global south – for human and economic development – which will require significant investments over time and the creation of lasting universal public education and health services. The other is the massive effort to combat climate change, which is overwhelmingly dependent on public finance" (Hall, 2010:9). More than that, infrastructure and social services of good quality have to be maintained and sustained in industrialised countries as well.

For the past 150 years, in fact, public spending has been driving economic growth and development. As such, economic growth has gone in parallel with a rising proportion of public expenditure since the mid-19th century. Taxation and spending in high-income countries as a proportion of gross domestic product (GDP) peaked during the two world wars of the 20th century, but the level of state spending and taxation remained high and continued to rise again after World War II until the 1990s (Hall, 2010). This pattern can be observed not only in European social democrat countries, but it can be seen in the USA and Japan, as well. The pattern does not just show public spending rising in line with GDP; it shows public spending rises as a proportion of GDP (Figure 1).

Figure 1. Government spending as % of GDP, 1870-1996, average of 14 high-income countries



Source: Tanzi and Schuknecht, 2000

There is a statistically significant link between rising levels of public spending and economic growth, in developing countries as well as high-income countries¹⁸.

First of all, public spending has a key role in investment in infrastructure. The whole economy benefits from having good roads, railways, electricity and water supplies, sanitation, and in the 21st century, broad band networks. The case can be made that the private sector has successfully developed certain infrastructures such as ports, airports, oil and gas supply lines and toll ways. Public private partnerships (PPPs) have also developed significantly

¹⁸ Known as 'Wagner's Law' after the economist who first identified it in the 1880s.



in recent years. However, a recent study by Education International¹⁹ presented compelling evidence that PPPs in field like health and education have been mostly of benefit to private participants, and often ended up costing taxpayers more than straight public investment would have. The story-line from the Thatcher/Reagan era has been that the private sector has driven productivity, while the public acted as a brake. In fact, the evidence shows that infrastructure investment has generally been driven by the public sector: most of the productivity gains in the 'golden age' of the U.S. economy were due to public investment in infrastructure, including roads and electricity.

Secondly, public spending is a more efficient way of producing many services. A recent study on health and education spending in OECD countries found that public expenditures impact positively on GDP growth more than private expenditures (Beraldo, Montolio and Turati, 2009). This is consistent with the strong evidence that public spending on social services is generally *much* more efficient, in economic terms, and more effective, in terms of achieving objectives, than private spending. If we consider public services such as education and health, for instance, it is proven that a healthy, well-educated workforce is more productive, and a healthy and well-educated workforce can develop where all citizens have access to public services of good quality.

Thirdly redistribution of income through efficient social services increases consumer demand. This is because poorer people spend a much higher proportion of their income; hence, the redistribution of income from the rich to the poor, through a benefits system that stimulates economic growth, may accelerate the pace of economic activity to the extent that these benefits place additional income in the hands of families with relatively high marginal propensities to consume (Cameron, 1982).

Fourthly, public services are an efficient, collective long-term insurance mechanism. In industrialized economies, a public system of collective support in sickness, unemployment, retirement, replaces the role of the extended family in agricultural societies. As such, *social security* normally should allow people to spend more in consumption instead of using savings to protect themselves. Not only public spending on public services is efficient, but also good for economic growth. On the contrary redistribution of income from the poor to the rich increases income inequality and poses a drag on the economy. This is the point made by Joseph Stiglitz, Nobel Laureate in Economics, in his foreword to *Exiting the Crisis*. But, around the world, workers and pensioners have been hit hard by the recent economic crisis. Strikes and protests erupted in France when the government recently raised the retirement age from 65 to 67; Greece also increased the retirement age by two years, cut the basic monthly pension from 400 Euros to 360 Euros a month, and raised taxes on pensions; in the United Kingdom, technical changes in pension plan design will cut 25 percent from the lifetime value of a pension. Hungary is attacking pensions, disability benefits and raising the cost

of prescription drugs; Ukraine, too, is cutting pension, medical and health benefits for the workers who risked their lives to clean up the world's worst nuclear crisis. Public employees (including nurses, child care workers, police officers, fire-fighters, social workers, teachers and health inspectors) are facing particularly heavy attacks on both their pay and pensions, even though they are often paid less than their private sector counterparts and personally contribute a high percentage of their pay to their pension plans. There is no doubt many governments have deficits; however, the shortfalls were not caused by workers and pensioners, but more by corporate bailouts and tax giveaways. Pensions are deferred wages, and people have worked for years to earn their retirement security and a fair social security system, which is in their right and cannot now be taken away.

Finally, there is a general benefit to social and economic stability from appropriate levels of public spending invested in quality public services (see Gintis and Bowles, 1982). Taking *gender equality*, for instance: quality public services are essential to achieving fairness, equality and opportunity for women (QPS, 2010). First, public health care prevents needless deaths of thousands of women in pregnancy or childbirth each year. Second, public education for all means more education for girls, too, which is particularly relevant for developing countries where two-thirds of illiterate adults are women. Third, higher levels of education are associated with lower rates of violence against women, while more security provides protection from violence, including rape, and a better health sector helps recovery from violence. Moreover, the provision of opportunities for child care allows women to invest their skills and abilities in economic activities also after giving birth. Finally, public spending in quality public services promotes the enforcement of equality and equal pay laws. Achieving true equality and opportunity for all women – in society, politics and the economy – requires quality public services, since these help create political stability and security for families, and thereby create new opportunities for sustainable economic growth.

Box 2.1. Quebec's universal public child care system

Ten years ago, the government of Quebec made a major investment in setting up a universal public child care system. Since it took that action, Quebec has cut its poverty rate by almost half. It now has the highest participation of women in the workforce in the country. Women are able to contribute their talents and abilities to society as a whole. The government immediately recoups 40 percent of its investment in income taxes from parents who are now able to work. Moreover, the longer-term benefits of increased literacy, and reduced demands for justice and social service supports, are lifetime savings. Child care workers, including home-based child care workers, have achieved widespread union representation and pension benefits. And, above all, Quebec's children are well cared for..

Source: QPS, 2010

A fair level of public spending is necessary if governments want to tackle the biggest environmental challenge of the 21st century, i.e. *climate change*. At least three quarters of the global effort to reverse the damage will come from public finance, as this challenge requires collective action through governments. In light of the need to protect



communities, it is ironic that governments around the world are continuing to cut taxes on profitable corporations, since it is particularly the corporate sector that must accept considerable responsibility for environmental damage. The challenge of climate change requires powerful public sector investment in transit, water and sewage treatment, green technologies, and other measures to cut greenhouse gas emissions. Cutting public sector expenditures in these and other areas in order to pay for corporate tax giveaways is undesirable and illogical. The further swelling of MNCs' profits must not be given a greater priority than the health and welfare of communities and families (QPS, 2010).

2.2. Why cutting public spending is dangerous

On the other side of the spectrum, *privatization* of public good carries substantial and often hidden costs. In its various forms, privatization is in general a transfer of wealth from citizens to the corporate sector. Communities are asked to pay more as services previously provided at cost are transformed to a for-profit model. In the QPS Campaign, PSI brings several examples of this phenomenon. Zambia, for instance, was told by the IMF to privatize all its municipal housing and water services in the 1990s; the municipalities lost the rental and water income, which they had used to finance other services. In the United Kingdom, electricity companies were sold for a third of their asset value, and water companies for 4 percent of their replacement value - English water users now pay £1 billion a year more than they would under public ownership. Water prices in France are 15 percent higher under private companies than in systems run by municipalities. In the small town of Felton, California (population 6,000), the water system was privatized in 2002: the company which bought it immediately sought to increase water rates by 78 percent, and angry residents had to organize to bring the system back into public ownership. Overall, privatization of public assets and services has many potential drawbacks, including higher costs (for both new infrastructure and privatized services), loss of accountability and transparency, lower quality, and reduced access to services (QPS, 2010).

Box 2.2. The *Water Re-municipalisation Tracker*

Water privatisation has spread rapidly throughout the world over the last decade, particularly in the South. But the tide now seems to be turning. Increased tariffs and a failure to deliver promised improvements, have left water multinationals facing increasing opposition. A major trend has emerged as more and more communities insist on returning water and wastewater services to public management through re-municipalisation, forcing water multinationals to pull out of services in Latin America, the United States, Africa and Europe. The *Water Justice* project has compiled examples of how communities in different parts of the world are moving from failed privatised water management to successful publicly managed water and wastewater services; these examples are presented on the *Water Re-municipalisation Tracker*. Approaches differ depending on local circumstances; however, many lessons can be learned from the different but inspiring experiences of re-municipalisation.

Source: *Water Remunicipalisation Tracker*, 2011, <http://www.remunicipalisation.org/>

It has been recently estimated (QPS, 2010) that public service job cuts in Europe will reach at least one million over the next few years, while another one million public service jobs are being cut in the U.S.. These cuts represent an attack to communities' economic and social well-being, as they target those services that help provide fairness, equality and opportunity for communities. In order to achieve a sustainable economic recovery, though, governments should on the contrary take care of people's most basic health needs first; in other words, cuts in basic services are counter-productive. Cuts in education steal opportunities from children, and from workers who need re-training to find a new job. Cuts in child care harm the ability of families to support themselves. Cuts in pensions hurt seniors who have worked a lifetime for a secure retirement. Cuts in infrastructure development and environmental protection hurt communities' future capacity to create jobs and the planet's capacity to support life itself. Above all, privatisation of public good is harmful to our collective economic future.

2.3. Quantifying the resources needed

Quantifying the size of resources needed globally for creating or maintaining quality public services is not an easy task. However, based on the work of IMF, WHO, UNESCO and others, we can get a rough idea of the extent of these needs. For example, the need to deal with climate change alone will add about 1.5% of GDP to public spending levels, globally, and for decades. The increased needs of aging northern populations for pensions and healthcare are estimated by the IMF to account to an extra 4.5% of GDP; a figure that may eventually decline again as the populations change once more, but, in any case, further demographic developments may replace this factor with other demands. And, finally, the economic crisis is far from over, and even northern governments which wish to cut public deficits and spending may find – as did Germany's Angela Merkel after her re-election as Chancellor in 2009 – that economic realities require deficit reduction to be deferred to avoid large-scale unemployment and to maintain investment in growth.

Looking more closely at *health*, for instance, universal coverage through publicly funded education requires countries to raise sufficient funds, reduce their reliance on direct payments to finance services, and improve efficiency and equity. Countries should increase the efficiency of revenue collection, which would make more funds available that can be used to provide services or buy them on behalf of the population. Indonesia, for instance, has totally revamped its tax system with substantial benefits for overall government spending, and spending on health in particular. Government budgets should be prioritized in a different way: governments sometimes give health a relatively low priority when allocating their budgets. For example, few African countries reach the target, agreed to by their Heads of State in the 2001 Abuja Declaration, to spend 15% of their government budget on health; 19 of the countries in the region who signed the declaration allocate less now than they did in 2001. The United Republic of Tanzania,



however, allots 18.4% to health and Liberia 16.6% (figures that include the contributions of external partners channelled through government, which are difficult to isolate). Taken as a group, the 49 low-income countries could raise an additional US\$ 15 billion per year for health from domestic sources by increasing health's share of total government spending to 15%.

The World Health Organisation has recently called for innovative financing. Attention has until now focused largely on helping rich countries raise more funds for health in poor settings. *The new Taskforce on Innovative International Financing for Health Systems* lists increasing taxes on air tickets, foreign exchange transactions and tobacco as ways to raise an additional US\$ 10 billion annually for global health. A levy on foreign exchange transactions could raise substantial sums in some countries. India, for example, has a significant foreign exchange market, with daily turnover of US\$ 34 billion; a currency transaction levy of 0.005% on this volume of trade could yield about US\$ 370 million per year. Other options include diaspora bonds (sold to expatriates) and solidarity levies on a range of products and services, such as mobile phone calls. Every tax has some type of distortionary effect on an economy and will be opposed by those with vested interests. However, governments should implement those that best suit their economies, recognizing that they have to win political support. On the other hand, taxes on products that are harmful to health have the dual benefit of improving the health of the population through reduced consumption while raising more funds. A 50% increase in tobacco excise taxes would generate US\$ 1.42 billion in additional funds in 22 low-income countries for which data are available; if all of this were allocated to health, it would allow government health spending to increase by more than 25% in several countries, and at the extreme, by 50%. Raising taxes on alcohol to 40% of the retail price could have an even bigger impact. Estimates for 12 low-income countries where data are available show that consumption levels would fall by more than 10%, while tax revenues would more than triple to a level amounting to 38% of total health spending in those countries (WHO, 2010).

Global solidarity is required. The funding shortfall recently faced by low-income countries highlights the need for high-income countries to honour their commitments on official development assistance (ODA), and to back it up with greater effort to improve aid effectiveness. While innovative funding can supplement traditional ODA, if countries were to immediately keep their current international pledges, external funding for health in low-income countries would more than double overnight and the estimated shortfall in funds to reach the Millennium Development Goals (MDGs) would be virtually eliminated (WHO, 2010).

Box 2.3. Health Systems Financing: The path to universal coverage

The *World Health Assembly* resolution 58.33 (2005) says everyone should be able to access health services and not be subject to financial hardship in doing so. On both counts, the world is still a long way from universal coverage: the proportion of births attended by a skilled health worker can be as low as 10% in some countries, for example, while it is close to 100% for countries with the lowest rates of maternal mortality. Within countries, similar variations exist: rich women generally obtain similar levels of coverage, wherever they live, but the poor miss out. But income is not the only factor influencing service coverage. In many settings, migrants, ethnic minorities and indigenous people use services less than other population groups. Globally, about 150 million people suffer financial catastrophe annually, while 100 million are pushed below the poverty line. The other financial penalty imposed on the ill (and their careers) is lost income. Only one in five people in the world has broad-based social security protection that includes cover for lost wages in the event of illness, and more than half the world's population lacks any type of formal social protection.

The path to universal coverage is relatively simple: countries must raise sufficient funds, reduce the reliance on direct payments to finance services, and improve efficiency and equity. Many low- and middle-income countries have shown a consistent move closer to universal coverage. For example, Gabon has introduced innovative ways to raise funds for health, including a levy on mobile phone use; Cambodia has introduced a health equity fund that covers the health costs of the poor and Lebanon has improved the efficiency and quality of its primary care network. Even high-income countries must continually reassess how they move forward in the face of rising costs and expectations. An ageing population means wage and salary earners have declined as a proportion of the total population, making it more difficult to fund its social health insurance system from the traditional sources of wage-based insurance contributions: European governments should hence inject additional funds from general revenues into the system. Although domestic financial support for universal coverage will be crucial to its sustainability, it is unrealistic to expect most low-income countries to achieve it without help in the short term. The international community needs to financially support domestic efforts in the poorest countries to rapidly expand access to services. Recent estimates of the money needed to reach the health MDGs in 49 low-income countries suggest that, on average, they need to spend about US\$ 60 per capita by 2015, considerably more than the US\$ 32 they are currently spending.

Source: WHO, 2010

Education is another public service that requires the maintenance of appropriate levels of public spending to be sustained in the industrialized world, while being strengthened in developing countries. Less than five years to the 2015 MDGs target date, national governments and donors need to redouble their efforts to close the Education for All (EFA) financing gap. Although low income countries have increased the share of national income spent on education from 2.9% to 3.8% since 1999, some regions and countries have continued to neglect education. Central, South and West Asia invest the least in education. With increased revenue mobilization and a stronger commitment to education, low income countries could raise Education for All spending from about US\$12 billion to US\$19 billion annually – an increase equivalent to around 0.7% of GNP (UNESCO, 2010).

According to the 2010 Education For All Global Monitoring Report, seven of the eighteen low income countries surveyed cut education spending in 2009, with 3.7 million children out of school. Overall, aid to basic education has doubled since 2002 to US\$4.7 billion, supporting policies that accelerate progress in Education for All; however, current aid levels fall far short of the US\$16 billion required annually to close the external financing gap in low-income countries. Donors have not met the commitments they made in 2005 to increase aid, and the OECD estimates the projected global shortfall at US\$20 billion annually. Current aid trends are a source of concern, as development assistance to basic education has stagnated since 2007. If all donors allocated at least half their education aid to the basic level, an additional US\$1.7 billion could be mobilized annually. UNESCO talks about new and innovative funding solutions that could help fill the Education for All financing gap: for instance, an International Finance Facility for Education, based on a similar model in the health sector, could help donors mobilize new resources in a difficult economic environment; issuing bonds could raise US\$3 billion to US\$4 billion annually for education between 2011 and 2015; a 0.5% levy on mobile phone transactions in Europe could raise US\$894 million annually (UNESCO, 2010).

2.4. Quantifying demanded cuts on public spending

Despite these tremendous needs for resources, key international institutions such as the IMF and the EU have been arguing for 'exit strategies' to unwind the stimulus packages in order to avoid increases in public spending (Hall, 2010). Even before the crisis, in fact, both institutions believed that public spending was already rising too fast, and, above all, that demographic changes were going to increase public spending even more, throughout northern countries. Unfavourable economic trends in the North pose indeed a major threat to long-term fiscal solvency (Council of Europe 2009 and IMF, 2009). According to the IMF, rescue and stimulus packages, coupled with the fall in tax revenues, have increased deficits in high-income countries by on average 7.5% of GDP. Demographic changes are expected to lead to a further 4–5% (of GDP) increase in spending in high-income countries. Hence, the IMF calls for avoiding these increases by general adjustments in public finances equivalent on average to a cut of 8.7% of GDP by 2030 in high-income countries - "To give some perspective on the scale of this demand, it is the equivalent of halving the procurement spending of such countries, or halving the number of public employees" (Hall, 2010) (see Table 1).

Table 1. Effects of crisis on public spending and IMF targets for reducing spending

| | Primary public expenditure as a % of GDP | Annual real growth 2008-2010: Primary public expenditure | Annual real growth 2008-2010: GDP | Average adjustment called for by IMF |
|-----------------------|------------------------------------------|----------------------------------------------------------|-----------------------------------|--------------------------------------|
| High-income countries | 35.8 | 4.30% | -0.20% | -8.70% |
| Developing countries | 24.5 | 9.30% | 5.10% | -2.75% |

Source: IMF, 2010

The IMF proposes policy measures overwhelmingly based on spending cuts. In particular, in healthcare, the Fund focuses on reductions in public spending, as projections show that health spending could rise by 3.5 percentage points of GDP over the next 20 years in advanced countries. This in spite of the clear evidence that public healthcare is both more efficient, and more effective, and more economically beneficial, than private spending. In pensions, a further increase in statutory retirement ages of two years could offset the projected rise of spending of 1 percentage point of GDP over the next 20 years in advanced economies (IMF, 2010). In other public spending, the IMF calls for a reversal of the growth in public spending as a proportion of GDP, through a 10 year freeze, and specifically encourages a freeze on the wages bill; this would save 3–3.5 percentage points of GDP, even if it would require deep spending reforms. On its side, the European Commission more simply continues insisting on the existing limits on public deficits (3% of GDP) and public debt (60% of GDP), with clear consequences across Europe of cuts in spending, services and jobs, and wage freezes and cuts for public employees (Hall, 2010).

2.5. Conclusion

Choices about public spending are of course political, as they imply to focus on higher and more fairly distributed contributions, and to give priority to different segments of the population and their needs. Global Corporations have been taking a larger share of the economy in profits, while paying less and less in taxation, through tax havens, transfer pricing and other forms of evasion, as shown earlier by this study. Financial companies pay minimal taxes on the transactions that generate their profits, though they have drawn upon billions of dollars of public money in the bailouts. Deficits reduction strategies are more likely to succeed when they are based on rising revenues as a result of growth and employment, as well as fairer taxation policies.

In order to build a strong economy that works for people, communities need quality public services to limit corporate excesses, to redress the growing income inequalities created by an unregulated market, and to develop fairer and more equal opportunities for all citizens through an effective system of redistribution of resources. Priority investment in public services enables the creation of jobs and stimulates sustainable economic growth and development. To this end, governments should develop fair taxation systems, based on people's actual ability to pay, and stop tax shifts from corporations and the super-rich to ordinary people. They must crack down on corporations, particularly the multinationals, that evade their responsibilities by hiding their profits in foreign tax havens and use the other minimization and avoidance techniques described in this report.



CHAPTER 3

AN AGENDA FOR QUALITY SERVICES by Jim Baker

The following chapter provides an insight in the concept of quality in public services, presenting the relevant priorities in both OECD and emerging countries, responding to pressures to downsize budget for public services due to larger and larger state deficits, the erosion of public services in the developing world, and the increasing 'casualisation' of public services in most countries. The author also focuses on key challenges that are to be addressed: the need to combat corruption and the urgency of developing effective tax collection systems.

3.1. The concept of quality in public services

One of the first barriers in arguing for quality public services (QPS) is the effect of years of demagogic attacks on public services in some countries, even if the services are efficient and of good quality. In this sense, the notion of QPS is an easier concept to explain if there is a common understanding that collective solutions to many of the challenges of society are fairer and more efficient than for everybody to fend for themselves individually in the market.

However, this consensus has become weaker in many countries. If one were to argue that the economy would function better if there were no enterprises employing workers, but there were only self-employed workers, everybody would consider the idea to be foolish. But, arguing that having the smallest government possible, with limited means due to low taxes, while based on the same lack of logic, does not always elicit that same instinctive and wise reaction.

A government that functions effectively and good public services are important for all communities. However, their absence has a very unequal impact. If it is true that "the rich and the poor both have the same opportunity to sleep under a bridge at night", the same kind of "equality" can hardly be found when it comes to getting a good education, having access to health care services, transport, security, etc. If these services are not provided publicly and universally, in fact, only those with the financial means will have the opportunity to enjoy them.

One of the earliest demands of the trade union movement, dating back to the 19th century in many countries, was free public education. This claim was not put forward to give teachers work, but, rather, as a way to provide opportunities for the children of workers. It was a demand for equality, and one that is not yet fulfilled. Similarly, in a fight that is far from over, providing equal education for girls and boys remains a central priority for equality, for public services, and for democracy.

Quality public services are not just about good, affordable services; they are the “delivery system” for democracy and the infrastructure for governance. What would it mean, for voters, to make choices if their decisions could not be implemented? And laws, as well, even if interpreted by an independent judiciary, do mean little without enforcement.

But quality public services are related to more than democracy, governance, equality and fairness. They are also vital to the economy: an un-regulated economy, left to its own devices, is likely to collapse in little time. For example, the recent financial crisis, as dramatic as it has been, would have been far worse without the timely intervention of governments to save the financial system. Rules not only set the limits of what is subject to competition and the manner in which competition functions, but also regulate the numerous interactions between government and the economy. Fair procurement rules, for example, not only protect government funds and provide for a fair basis for competition, but also protect workers’ rights so that public expenditures support rather than undermine economic development and social justice. Government is an economic “player”, but not necessarily a positive one without the proper frameworks.

There are a wide range of other interventions in the economy to make it work or to try to ensure that economic activity does not contradict public policy. They include the protection of public and private workers, in areas such as trade union rights - an essential element of the bulwark of democracy. Added to these enabling rights are the protection of other fundamental workers’ rights, occupational health and safety, and wage and hour protection. Such rights and protections are not real without a combination of a proper normative framework, an independent judicial system that works fairly and in a timely manner, and honest and vigorous labour inspections. Moreover, there are a broad range of social protections and social security systems that help to make society more fair and equal, and support the economy by providing the means for people to live even in difficult times. The economic value of such systems is often under-estimated, but, at large, those countries that have done the best, in the crisis that began in 2008, are the ones that did not simply let the bottom fall out, but moderated the effects of the rapid fall of markets - particularly with respect to employment.

The fairness impact of government and public services is not defined only in terms of programmes that increase equality in society or underpin social justice, but it is also related to the manner in which tax revenue is raised. Both parts of the equation should be considered at the same time. Some social security systems, for example, are financed in a way that may not be quite as progressive as fair income tax systems, but, if the redistribution effect favours low-income groups, this may offset such apparent inequity.

Measures taken by governments in response to the financial and economic crisis actually resulted in harmful consequences for ordinary people. Massive expenditures were made by governments to save the financial system and liquidity was eased quantitatively by central banks. While necessary for the immediate survival of the system, those



expenditures and easing of liquidity have had the effect of providing resources for very wealthy individuals and funds to return to their speculation. Yet the fiscal expenditures were financed by a tax system that had become less progressive because of tax cuts on wealthy individuals and corporations. The combination of taxes and expenditures constituted a transfer system with too many of the transfers going the wrong way.

In addition to distorting the picture of government receipts and expenditures, productive capital and their workers have paid for the financialisation of the economy. This has imposed sacrifices that were only justified by artificial return requirements not related to the real value and potential of enterprises. The damage done to many companies in the real economy has also been costly in terms of public economic and social support, while reducing tax revenue from both workers and their employers.

Quality public services are also highly relevant to the environment and for issues clearly related to communities' "quality of life". It is a mistake to think that they are an unaffordable luxury for people from developing countries and only relevant to those who have already satisfied many of their material needs - for a worker who must spend three hours travelling to work in a stifling, over-crowded private bus with irregular service in heavy traffic, quality of life and the environment are not only relevant, but quite compelling issues. On the question of climate change: market mechanisms like carbon trading, on their own, will never be sufficient to deal with this threat, as it requires global action, which must be implemented at national level through competent and effective public services, capable of consultation and consensus-building as well as enforcement.

Unfortunately, the assaults on public services in both developing and developed countries have obscured to some degree the necessary debate on "quality" in "quality public services". Trade unions do not consider that they are defending the status quo in calling for quality public services. In fact, they are aspiring to something much better. However, they will not achieve their goals in an environment of confrontation – but rather one in which such an important, reasoned and inclusive debate can easily take place.

There is also a more philosophical, less concrete question of public service values. Does anybody, including the most privileged of citizens, really want to be part of a society where the only thing that weights is counting money? It has often been said that "the market knows the price of everything, but the value of nothing". A society which is less deferential to private gain and more solicitous of the public good would be a better one. And, to get there requires quality public services.

3.2. Priorities in OECD countries

Trade unions in OECD countries have been forced into a largely defensive strategy. In nearly all countries, there is budget pressure related to public deficits. Even if some of such deficits went to save banks, that does not make them any less real. In reacting

to those pressures, some governments are sitting down and engaging social partners in discussions and trying to find solutions that include, for example, finding new sources of revenue.

The difficulties in the Eurozone, particularly in Greece, Portugal, Spain and Ireland are, in part, produced by rating agencies and their effect on financial markets through raising the interest rates on government bonds. In other words, the very agencies that were among those blamed for not being responsible concerning banks that failed, often appear to be “calling the shots” on European policy.

With the EU working with the IMF in putting together plans and packages and, in effect, forcing budget cuts, changes in pension systems and privatisations, there seems to be a sort of convergence with the experience of many developing countries forced for many decades to adopt anti-social policies in order to survive. The impact on public services has been devastating. This contributes to a problem that had already been developing of precarious work, that is work that had been contracted out or been done by people on precarious contracts or with disguised employment relationships.

In the United States, in addition to budget pressure that is producing severe cuts in the federal budget that could jeopardise recovery, budget battlegrounds are taking place at the state level. Even in several states with “friendly” governors and legislatures, negotiations and imposed austerity programmes have caused problems for public employees, but also, more broadly, with the provision of public services. However, in other states, governors and legislatures are using the excuse of budgetary constraints to attack the rights of public sector's workers to organise and bargain. This has produced a united reaction of the trade union movement, from both the public and the private sector, and a reaction against unfairness of treatment and confiscation of rights from the public opinion.

In many OECD countries, progress must be made in the general political, social, and economic policy discussion in order for the really substantive dialogue needed to produce quality public services to take place. Perhaps, at that time, elected officials will remember the commitments that they made at the commencement of the crisis to address the serious need for renewed public investment in education and other public services, social protection and infrastructure.

3.3. Priorities in emerging and developing countries

Many developing countries have already seen, sometimes for decades, a serious erosion of public services, both through a combination of mistakes of their governments and conditionality imposed by international financial institutions to “correct” those mistakes. In some countries, public enterprises were major employers. As part of structural adjustment



programmes, these countries were forced to slim down and/or privatise production, but also many public services. Good jobs, with workers covered by collective bargaining agreements, disappeared, while unprotected and informal work exploded. Precarious work in public services has also emerged to an even greater extent than in OECD countries. The “casualisation” of the public sector has increased in many countries; for example, in Africa, thousands of teachers are employed under sub-standard wages and working conditions. In Brazil - one of the greatest success stories among emerging countries-, social policies and an active role for government have been central to economic development and to an exceptional increase in social justice, including through measures, for example, to significantly reduce child labour by placing children in schools. Progress needs to be made in quality public services, but the appropriate environment should be one of consultation and social progress, instead of a negative, politically motivated, aggressive assault on workers in the public sector.

One of the weaknesses of development policies in the last decades has been the notion that the path to development was to leave the field free for the markets, except for incentives to attract and safeguard foreign investment. In many cases, instead of companies competing against each other, governments are competing for investments, not only against other developing countries, but, sometimes, against developed countries as well.

There is another set of development strategies that is based on having sound, effective public services grounded in governments that govern, function and work for everybody. This provides a real framework for economic development in the private sector that is much less ephemeral than a tax holiday or poor or unenforced labour laws. It is based on such “sustainability” factors as rule of law, having an educated workforce, good health care, efficient infrastructure and good economic opportunity.

Another handicap for development in many (developed or developing) countries is the issue of growing inequalities. And this is not only a question of fairness, but also a question of having economies that work, as distortions in the economy are often based on distortions in power, limits on democracy, mistreatment of minorities (including migrant workers), discrimination against women, and lack of transparency.

Quality public services are an essential element in any sensible development strategy. Economic development in isolation does not work or, at least, does not produce decent societies.

3.4. Combating corruption

integrity, but this means more than not taking bribes; it also implies, for instance, the proper enforcement of laws, the reduction of the size of the informal economy, the protection of citizens' rights. Moreover, it is a mistake to define corruption too narrowly: it is not as simple as a bribe to a public official or a return for a favour; and, it is not limited to developing and transition countries. It also may have to do, for instance, with the nearly unlimited corporate spending allowed on issues and on political candidates in the U.S. As such, corruption produces a diversion of public goods into private hands in the form of policy positions that benefit the few. In some countries in Central and Eastern Europe, corruption has become the major theme for successive political campaigns to throw a party or coalition out of power. The only problem is that the successors are often as or more corrupt than the people they replace. The problem with corruption is not just that it can discredit public service. It is more fundamental. It can destroy democracy or transform it into a simple act of voting - sometimes for a price.

It is not surprising that the uprisings in the Middle East and North Africa were, at the same time, against corruption and for democracy, human rights and social justice. To have a complete trade union strategy in most countries in the world, it is necessary to make that same association. Corruption is normally worse the higher one goes. But, the public perceives the bill slipped to somebody to obtain a driver's licence or to the police at an impromptu roadblock or to a customs agent. Corruption is not easy to fix. But it must be addressed. It is not only debilitating for democracy, but a barrier to quality public services.

3.5. Effective tax collection

Corruption hits particularly hard in tax collection and in labour inspection. However, the failure to perform one's duties is not only due to corruption, as, in some cases, it is linked to fear. Life is often cheap to those threatened by enforcement of either tax or labour laws.

If taxes had been collected properly in recent years in Greece, it can be argued that there would have been no budget crisis, no cuts in pensions, no increase in the retirement age, and no foolish privatisations of public infrastructure. In other words, effective tax collection is directly linked to the capacity to generate enough revenue for quality public services.

As sources of tax revenue decrease in some cases, the collection of taxes that can be touched becomes even more important. For example, many developing countries depend heavily on customs as a source of government revenue just as developed countries did in the 19th and most of the 20th centuries. With successive rounds of tariff reductions, that revenue is shrinking. What is left must be collected and other sources



of revenue must be found. Collection requires capacity, but it also requires “organisation” in society and a legal system that will act on tax evasion and avoidance.

There have been revenue reductions from cuts in corporate taxes and on people in higher income levels in most developed countries. But, there are also tax deficiencies and opportunities in many developing countries. Some emerging economies have reached the point where progressive income taxes could provide considerable revenue while playing a very positive role in terms of equality and more sustainable development.

Globalisation has increased the opportunities for both evasion and avoidance. Although some progress has been made through the work of the OECD on tax havens, much more must be done. Something as basic and fundamental as collecting taxes has become, like so many other issues, a question of global coherence and co-operation.

CHAPTER 4

EVADING RESPONSIBILITY, SHAKING FINANCIAL STABILITY

by David Robinson

Taxes are the price we pay for the public goods and services we need. Without adequate tax revenues, we simply cannot hope to sustain the public services, infrastructure, and programs that have been shown to be a key factor in the economic growth and social development of nations. In fact, there is convincing evidence to show that a country's ability to achieve its social and economic objectives is directly related to its ability to collect sufficient tax revenues.²⁰ That is why tax avoidance and tax evasion can be so disastrous for countries and their citizens. In this chapter, the author shows how, today, the fiscal stability of governments in many parts of the world is being shaken.

4.1. Introduction

While the current public debt crisis in many nations clearly stems in large measure from the fallout of the economic crisis of 2008, deeper more systemic problems are also at play. Long before the market meltdown, global economic integration had provided multinational enterprises with greater opportunities and incentives to avoid paying their fair share of taxes. An entire industry of accountants, tax lawyers, and financial advisors has sprung up with increasingly sophisticated schemes and aggressive strategies to reduce the tax bills of their clients. These schemes include the use of tax havens and offshore financial centres to hide or transfer income; tax arbitrage to exploit differences in national tax rules; and private equity funds that transfer income into lower-taxed capital gains.

While ubiquitous, the shadowy nature of these tax avoidance and evasion strategies makes it difficult, if not impossible, to provide a reliable estimate of the loss in revenues and the price paid by citizens, as highlighted in Chapter 1. Nevertheless, the costs are real and show up as lost investment in public services and programs, reduced economic growth, widening inequality and an unfair and less progressive tax system.

4.2. Tax Avoidance Strategy 1: Tax Havens

The term "tax haven" has been in wide use since the 1950s to refer to any jurisdiction with very low or no corporate and personal income tax rates. For most people, reference to tax havens usually conjures up images of exotic Caribbean islands populated by jet-setting tax dodgers and shady underworld figures. In fact there are

²⁰ See N. Brooks and T. Hwong, *The Social Benefits and Economic Costs of Taxation: A Comparison of High- and Low-Tax Countries* (Ottawa: Canadian Centre for Policy Alternatives, 2006).



a number of different tax havens around the world that attract wealthy individuals and corporations not just because of low taxes. Today's modern tax havens share a number of other important characteristics, including:

- a weakly regulated financial system;
- preferential tax treatment for non-residents;
- simple incorporation rules for non-residents; and,
- strict banking secrecy laws protecting account holders.

When combined with low rates of taxation, these features permit corporations and wealthy individuals to easily transfer income to tax havens beyond the watchful eye of their domestic tax authorities. Nevertheless, there are some important variations in the types of tax havens today. Ronen Palan helpfully identifies four distinct types of tax havens:

- Jurisdictions with no individual or corporate income tax and where foreign corporations pay only license fees to operate (e.g. Anguilla, the Bahamas, Bahrain, Bermuda, the Cayman Islands, Cook Islands, Djibouti, Turks and Caicos, and Vanuatu).
- Jurisdictions with extremely low taxation (e.g. Liechtenstein, Oman, Switzerland, Jersey, Guernsey, and the British Virgin Islands).
- Jurisdictions that levy taxes on internal transactions only, and where profits from foreign sources are taxed at low rates or not at all (e.g. Liberia, Panama, Philippines, Venezuela, and Hong Kong).
- Jurisdictions that grant special tax privileges to certain types of businesses, such as holding companies (e.g. the Channel Islands, Liechtenstein, Luxembourg, the Isle of Man, Monaco, the Netherlands, the Netherlands Antilles, Austria, and Singapore).²¹

In most tax havens, there is actually little or no real economic activity aside from finance and banking. For this reason, these tax havens are also referred to, sometimes euphemistically, as Offshore Financial Centres (OFCs). OFCs specialize in supplying financial services to non-resident companies and individuals in exchange for low taxes, stability, and secrecy (see Box 4.1).

The attractive financial and tax features of OFCs have allowed these tax havens to gain an increasingly large share of the global market in financial transactions. One estimate suggests that in 2009, just 40 OFCs held assets and liabilities of close to \$5 trillion. To put that into perspective, the IMF reports that the total cross-border assets and liabilities held by the United States, Germany, and France combined amounted to \$8 trillion in 2009.²²

²¹ R. Palan, "Tax Havens and the Commercialization of State Sovereignty," *International Organization* vol. 56 no. 1 (Winter, 2002), p. 154.

²² M. Gonzalez and A. Schipke, "Bankers on the Beach," *Finance and Development*, vol. 48 no. 2 (June 2011), p. 43.

Box 4.1. How do tax havens work?

Wealthy individuals can use tax havens to deposit money in an offshore account but not declare the interest or other investment income. Even more unscrupulous characters may receive income in cash or another non-traceable form, and deposit the money in a tax haven account without declaring the income in the home country.

A company can avoid taxes by establishing a subsidiary or other offshoot in a tax haven that allows them to shift corporate income into the low-tax jurisdiction. Once the subsidiary is established, the parent company can make payments to its offshoot for over-inflated or non-existent services – this is one form of widely used and abused transfer pricing.

While there is a long history of tax havens, the emergence of modern tax havens can probably be traced to the United States in the late 19th Century. At the time, the states of New Jersey and Delaware introduced the idea of “easy incorporation” for non-resident companies – a characteristic of all tax havens today – along with relatively low corporate tax rates. The success of New Jersey and Delaware in attracting corporations to move or establish their headquarters in those states prompted other jurisdictions to emulate them. In Europe, some Swiss cantons also reformed their regulations around the same time to offer more attractive environments for non-resident companies.²³

Other tax havens emerged around the beginning of the 20th Century as the British Empire began ceding independent governance over economic affairs to protectorates like Gibraltar, Hong Kong, and the Channel Islands. These jurisdictions soon became places where wealthy individuals could create offshore accounts shielded from their local tax authorities.

Tax havens became more popular following the First World War. Governments at the time began raising personal and corporate income taxes to pay for reconstruction. In response, some wealthy individuals were converging on small islands like Monaco, Bermuda, and the Bahamas whose governments provided the very rich with a luxurious tax-free environment.²⁴ In Europe, Liechtenstein, Luxembourg and Switzerland also emerged at this time as places where wealthy Europeans could shelter their money from their tax authorities.

Many of these new tax havens also adopted rules to make it easier for companies to set up subsidiaries to avoid taxes. In 1929, Luxembourg became one of the first countries

²³ R. Palan, “The History of Tax Havens,” *History and Policy*, October 2009.

<http://www.historyandpolicy.org/papers/policy-paper-92.html>

²⁴ M. Woolsey and E. Eaves, “Tax Havens of the World,” *Forbes*, March 16, 2007.



to introduce in law the concept of the holding company and to exempt such entities from taxation. Liechtenstein also passed a new corporations law that imposed no requirements or restrictions regarding the nationality of shareholders of companies registered in the country.

In 1934, a further defining characteristic of modern tax havens was established. Switzerland enacted a strict bank secrecy law making it a criminal offence for financial institutions to provide any information about their account holders. Moreover, it was also made illegal for anyone, including government authorities, to inquire into “trade secrets” of banks. The new law demanded an “absolute” confidentiality with respect to any information concerning a Swiss bank account which in effect imposed an iron veil of secrecy over the entire financial sector.

Meanwhile, a series of court rulings in the United Kingdom allowed corporations to more fully exploit tax havens. The mining company de Beers won an important legal decision before the British Courts that established a company's residence for taxation purposes was the country in which its directors met. Suddenly, corporate meetings were being convened in out of the way places like the Channel Islands so that companies could avoid UK taxes. This tax avoidance strategy continued until the 1990s when the residency rules were finally overturned.²⁵

A final critical moment in the development of modern tax havens occurred in 1957 when British authorities determined that financial transactions undertaken by UK banks on behalf of non-residents were not subject to domestic regulation. This unleashed an unregulated “Euromarket” in London involving the trade in “offshore” financial transactions. British banks quickly expanded their Euromarket activities to the tax havens of Jersey, Guernsey, and the Isle of Man and were soon followed by several American banks. In 1966, the Cayman Islands looked to emulate these jurisdictions and adopted a series of financial and corporate reforms that mirrored a classic tax haven model. By 2008, the tiny Cayman Islands, with a population of about 56,000 people, had unbelievably become the fourth largest financial centre in the world.²⁶

By the 1960s, more and more tax havens emerged based upon the principles of low or no taxation, lax incorporation rules, and strict secrecy laws governing financial transactions. Today, tax havens have become an integral part of the global financial system and are a major instrument for tax avoidance and evasion worldwide. Modern tax havens work in several ways. They allow overseas companies to easily register and pay little or no taxes on the profits of holding companies. Holding companies are in effect shell organizations through which a parent company can funnel revenues out of jurisdictions where they are subject to higher tax rates. Every major multinational

²⁵ *Christian Aid, Death and taxes: the true toll of tax dodging, May 2008.*

²⁶ *Palan, op.cit.*

corporation uses holding companies based in tax havens. BP and Wal-Mart have made use of holding companies in the Cayman Islands. Royal Dutch Shell has a number of subsidiaries in Bermuda while ExxonMobil has companies in both the Cayman Islands and Barbados. More recently, new global giants like Google have exploited holding companies in tax havens to dramatically reduce their tax obligations (see Box 4.2).

Box 4.2. Google's Bermuda Tax Holiday

Google has become one of the largest and most profitable multinational companies in the emerging new information technology sector. But its business acumen now extends far beyond the routine affairs of software development and marketing. The company's accountants and tax consultants have been able to make good use of tax havens to reduce its taxes. Thanks to a complicated legal structure and complex set of financial transactions, Google saved \$3.1 billion in taxes between 2007 and 2009 and lowered its reported income tax rate to just 2.4%.

Google's tax avoidance strategy works through a convoluted process known as the "Double Irish" and the "Dutch Sandwich." When a Google search ad is purchased in Europe, the Middle East, or Africa, the revenue is claimed by Google Ireland. Corporate taxes in Ireland are already low by international standards – just 12.5%. But Google is able to avoid even this light burden because earnings don't stay in the Irish subsidiary. Instead, Google is able to send the money to Bermuda where there is no corporate tax, via a quick detour through the Netherlands. Under Irish tax law, companies that transfer money directly outside the European Union will be assessed taxes, but not so if the transaction is with a subsidiary in another EU state. So Google Ireland passes its revenues on to a holding company in the Netherlands where it can take advantage of generous Dutch tax laws that allow revenues to be easily transferred to Bermuda. Google Netherlands Holdings, which has no employees, then passes on about 99.8 percent of its revenues to a Google holding company in Bermuda that is technically an Irish company -- hence the "Double Irish" nickname.

Source: Jesse Drucker, "The Tax Haven That's Saving Google Billions," Bloomberg Business Week, October 21, 2010. http://www.businessweek.com/magazine/content/10_44/b4201043146825.html

Wealthy individuals and corporations may also take advantage of the secrecy of tax havens to establish trust funds to keep their money offshore and out of reach of prying domestic tax collectors. A trust is basically a financial instrument that places a variety of assets in the care of a third-party trustee who agrees to manage it on behalf of a beneficiary. A wealthy individual, for instance, may establish a trust for their children. Setting up such a trust in a tax haven means that no tax, such as inheritance or capital gains taxes, will be paid when the trust matures.

Corporations and individuals have also used complex trust arrangements in tax haven countries to engage in abusive tax evasion. Typically, these arrangements enable taxable funds to flow through a series of domestic and offshore trusts until they are finally distributed to the original owner tax-free. These schemes often begin with the



creation of two domestic trusts to give the appearance that the taxpayer is no longer in control of the business or its assets. One of these trusts is put in charge of the daily operations of the company, while a second may be set up as an equipment trust. Equipment is leased back to the domestic trust at inflated prices, thereby reducing the income reported to tax authorities. Next, two foreign trusts located in tax havens are created. The income from the equipment trust is distributed to the first foreign trust and then passed on to the second foreign trust so that the flow of money is more difficult to trace. This second foreign trust then makes a loan to the original company in the domestic jurisdiction. Because the transaction is considered a loan, it is not taxed.²⁷

Despite a number of efforts to crack down on tax havens, they continue to flourish. In doing so, they also undermine the fiscal stability of nations around the world, particularly those in developing countries. More ominously, because of their strict secrecy laws, tax havens and offshore financial centres have blurred the lines between the legal economy and the illicit shadow economy.

4.3. Tax Avoidance Strategy 2: Tax Arbitrage

Tax arbitrage at the international level refers to practices whereby companies subject to tax in multiple jurisdictions take advantage of “inconsistencies between different countries’ tax rules to achieve a more favourable result than that which would have resulted from investing in a single jurisdiction.”²⁸ Unlike tax shelters or tax havens that use low or weak tax regimes to encourage companies to shift income and investment, tax arbitrage involves the exploitation of differences between the tax rules of different systems independent of the statutory tax rate.

For example, one common form of arbitrage involves exploiting the way different countries define the residency of corporations for tax purposes in different ways. Country A may determine residency to mean the jurisdiction in which a firm is incorporated, while Country B may define residency as the jurisdiction in which a firm is centrally managed and controlled. This can lead to cases in which a multinational company may be a dual resident company (DRC) of both countries. This may permit it to lower its overall tax bill by consolidating its tax returns and applying any worldwide losses in each jurisdiction.²⁹ A related scheme involves the use of so-called “hybrid entities”. A hybrid entity arises in situations where different jurisdictions classify a business organization

²⁷ S. Rath, “Tax Evasion and Trust Schemes,” in F. Shanty and P.P. Mishra, *Organized Crime: From Trafficking to Terrorism* vol. 1 (Santa Barbara, CA: 2008), p. 269.

²⁸ H.D. Rosenbloom, “International tax arbitrage and the international tax system,” *Tax Law Review* (53), 2000, p. 137.

²⁹ M. Boyle, “Cross-border tax arbitrage: Policy choices and political motivations,” *British Tax Review*, No. 5, 2005, p. 528.

differently for tax purposes. For instance, one country may consider a business to have the legal status of a partnership while another treats it as a corporation. Generally, corporations are considered to be taxpayers separate from their shareholders, while partnerships are normally treated as “conduits” that are ignored for income tax purposes, with tax instead assessed on partners or equity investors. This inconsistency can allow a company to take advantage of the tax treatment of different entities to lower its total tax payable. For instance, if a company is treated as a corporation by one country, any interest income it earns is taxable. However, if a second country considers its operations there to be a partnership then no tax on the interest would be paid by the company.³⁰

Another cross-border tax arbitrage strategy involves so-called “double-dip” or “cross-border” leases. In this scenario, multinational enterprises take advantage of common differences in national tax rules determining ownership for the purposes of capital depreciation write-offs or deductions. Normally, depreciation deductions can be claimed only by the owner of an asset. Some jurisdictions, such as the European Union, determine that the holder of legal title to an asset is the owner, while others, including the United States, consider a range of factors in determining economic ownership. These differences can be exploited by way of a double-dip lease where a multinational company sells an asset to a foreign subsidiary who then leases it back to the main company. In this case, two separate tax authorities may each consider the domestic entity to be the owner of the asset, allowing it to be fully deductible in both countries.³¹

Box 4.3. One Truck, Two Taxpayers

To better help understand how tax arbitrage works, consider this simple example of a double-dip leasing scheme. Acme Transport is based in the United States but has a subsidiary in Belgium, Acme Trucks. Acme Transport leases a truck from its Belgian company. For tax purposes, Belgium determines that the Acme Trucks is the owner of the truck, but U.S. authorities determine that the lease transaction makes Acme Transport the legal owner. When tax time rolls around, both Acme Transport and Acme Trucks claim ownership of a single truck and both claim depreciation plus any other available tax credits.

Also common is a tax arbitrage practice known as a “hybrid equity” transaction. In this instance, a company lends money to a foreign subsidiary. It treats the loan as a form of preferred equity for domestic tax purposes and as a debt for the foreign country. This allows the subsidiary to deduct the interest on the debt, while under domestic rules accrued interest on preferred equities is not taxable.³²

³⁰ T. Edgar, “Corporate income tax coordination as a response to international tax competition and arbitrage,” *Canadian Tax Journal*, vol. 51, no. 3 (2003), pp. 1100-1101.

³¹ In the United States, legislation passed in 2004

³² A.H. Rosenzweig, “Harnessing the costs of international tax arbitrage,” *Berkeley Electronic Press Legal Series*, paper no. 1575, 2006.



Not surprisingly, the most complex arbitrage transactions involve global banks which have the funds necessary to structure some of these deals. In some structured deals, a cross-border loan or investment is made on terms that are profitable after tax, but can be neutral or negative before tax, adjusting for risk. Again, the tax benefits are carefully factored into the pricing so that each party is benefiting from the deal, post tax. In such deals, the lender will have "tax capacity" or taxable profits and it seeks out a deal where it obtains a tax relief (in the form of a credit, deduction or even a deduction and exemption) from another country which it can use to offset its domestic tax bill.

These examples of tax arbitrage have prompted some responses from tax authorities and policymakers, most notably in the United States. Nevertheless, many economists and tax analysts question the extent of the problem, while some even defend tax arbitrage as inevitable in the context of the increasing mobility of capital and the distinct tax national policies determined independently. What is often ignored, however, is that the practice of tax arbitrage produces a number of negative consequences. Clearly, it may result in reduced tax revenues for all jurisdictions involved. Beyond this, however, there is also an economic cost. Tax arbitrage can distort economic decision-making by firms and encourage international transactions that are tax favourable but not necessarily economically efficient.

4.4. Tax Avoidance Strategy 3: Private Equity Funds

Private equity firms are groups of investors that are typically organized as a limited partnership. They use private equity funds to acquire existing publicly-traded companies and then take those companies private. These acquisitions normally require significant debt-financing, often using or leveraging the assets of the acquired company as collateral for the borrowed capital – a strategy known as leveraged buyout.

Managers of private equity funds derive their compensation from an annual management fee plus typically 20% of the profits earned by the companies they control. The latter arrangement is referred to as "carried interest". In most countries, the management fees are taxed as regular income, but the carried interest is taxed as capital gains at a far lower rate (see Box 4.4). In other words, rather than being taxed as managers of the firm, they are taxed as investors in a company.³³

³³ B. Badertscher, S.P. Katz, and S.O. Rego, "The impact of private equity ownership on corporate tax avoidance," *Harvard Business School Working Paper 10-004*, 2009

Box 4.4. Carried Interest: Regressive Taxation

Warren Buffett is one of the richest men in the world and CEO of the holding company Berkshire Hathaway. Buffet benefits from carried interest, but he doesn't think it's fair. That's because in one year he was taxed at an effective rate of 17.7% on \$46 million in income, while his receptionist was taxed at about 30% on her employment income. And that's just the tip of the carried interest iceberg. Buffet's pay pales in comparison to other hedge fund managers. In 2009, the top spot went to David Tepper who made \$4 billion.

Source: G. Weiss, "Tax Haven," *Portfolio.com*, April 27, 2010.

<http://www.portfolio.com/views/2010/04/27/private-equity-funds-and-hedge-funds-lower-taxes-via-carried-interest/>

It is estimated that in the U.S. alone, private equity funds control nearly \$1 trillion in assets. Consequently, some observers have argued that the revenue lost by taxing carried interest as capital gains could amount to several billion dollars a year.³⁴

Many of the largest private equity funds make use of tax havens to further reduce the tax liabilities of their investors. This is routinely done by creating an offshore "feeder" or "blocker" corporation. Under tax rules in the United States, for instance, foreign investors in a private equity fund are normally considered to be "passive investors" and are not required to file an American tax return unless they play an active role in a business. However, because the partners in a private equity fund are considered to be the managers of the fund, foreign investors would be assessed taxes in the U.S. To avoid this, the fund can create a so-called blocker corporation in a tax haven designed specifically for foreign investors. The blocker corporation is essentially a front that passes funds through to the equity fund. However, in this way foreign investors will be considered to be "passive investors" in a corporation, not active managers of an equity fund, and they will not be subject to U.S. taxes.

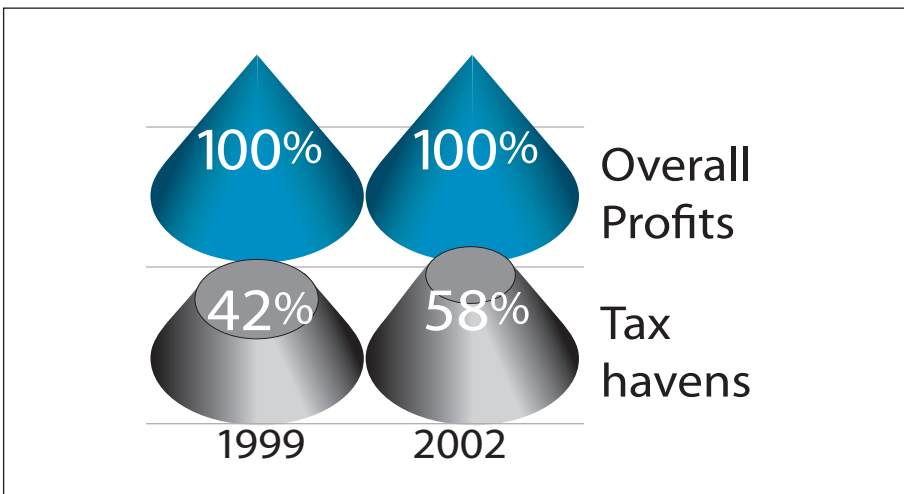
4.5. The Bottom Line: What is the Price of Tax Avoidance and Evasion?

How much does tax avoidance and tax evasion cost governments? The answer is very difficult to determine. Current figures reporting the scale of tax avoidance and losses vary greatly because the very nature of tax avoidance and evasion means there is little if any statistical documentation. What is clear is that the sheer scale of tax avoidance by wealthy individuals and multinational enterprises has become so prevalent that it is increasingly difficult to quantify.

³⁴ A. Aron-Dine, "An analysis of the 'carried interest' controversy," *Center on Budget and Policy Priorities Working Paper*, August 1 2007.

Globally, at least half of all corporate transactions and trade passes through tax havens, even though these jurisdictions account for just 3% of the world's GDP.³⁵ Economist Martin Sullivan estimates that, between 1999 and 2002, the share of worldwide profits earned in tax havens rose from 42% to 58%, far exceeding the share of economic activity occurring in these countries (Figure 1).³⁶

Figure 1. Share of worldwide profits earned in tax havens compared to the overall profits, 1999 and 2002



As shown in the introduction, the tax revenue lost because of tax avoidance is disputed. The OECD estimates that by 2007 wealth held offshore amounted to between US\$5 trillion and US\$7 trillion. Approximately US\$1.4 trillion of this total was estimated to be held in the Cayman Islands alone.³⁷ On the other hand, as highlighted in Chapter 1 already, the Tax Justice Network argues the value of offshore assets is far higher. It estimates that the world's High Net Worth Individuals (HNWIs) held \$11.5 trillion of assets offshore in 2005.³⁸

In the absence of any solid statistical evidence, we are forced to rely on imprecise measures of tax avoidance. Oxfam, for instance, has examined the potential impact that

³⁵ J. Christensen and R. Murphy, "The social irresponsibility of corporate tax avoidance: Taking CSR to the bottom line," *Development*, 47 (3), 2004, p. 39.

³⁶ M. Sullivan, "Data Show Dramatic Shift of Profits to Tax Havens," *Tax Notes*, 13 September 2004, pp.1190–1200.

³⁷ J. Ramos, "Places in the sun," *The Economist*, Feb. 22, 2007.

³⁸ Tax Justice Network, "Briefing Paper: The price of offshore," March 2005. Available on-line at: http://www.taxjustice.net/cms/upload/pdf/Briefing_Paper_-_The_Price_of_Offshore_14_MAR_2005.pdf Accessed June 7, 2011.

transfer pricing manipulation and offshore wealth holdings cost developing countries. They put the figure at about \$US 50 billion in lost tax revenues in 1998 alone. That represents “an amount equivalent to six times the estimated annual costs of achieving universal primary education, and almost three times the cost of universal primary health coverage”.³⁹

The Oxfam calculation is based upon multiplying the total foreign direct investment (FDI) stock in developing countries in 1998 with a 20% estimate for the return on this investment. The authors assume an average 35% tax rate which leaves a \$US 35 billion tax gap from what was collected in 1998. Added to this is an estimated \$US 15 billion revenue loss as a result of financial assets hidden abroad.

The Oxfam study usefully exposed the sheer magnitude of the tax avoidance problem. Nevertheless, the figure is likely overstated. The problem with the Oxfam estimate is that the assumption of a 35% effective tax rate, based on the average statutory rate of a number of developing countries, is far too high. It ignores the existence of regular deductions as well as various tax incentives (such as investment credits, tax holidays, export processing zones, etc.) that developing countries use to attract FDI. Taken together, these policies reduce the effective tax rate significantly.

Furthermore, the return on FDI is not an entirely accurate base on which to calculate taxable income. If FDI is financed by debt, for instance, adjustment must be made to take into account interest deducted from the taxable base.⁴⁰

Other estimates of losses due to transfer pricing have focused on abnormally priced transactions recorded in import and export data. One study of U.S. data found that more than one in 10 imports were undervalued by \$US 202 billion in 2005, and that just over 5% of exports were overvalued by \$US 50 billion. Using a similar method, Christian Aid calculated that transfer pricing cost developing countries \$US 160 billion in 2008.⁴²

These estimates provide a more reliable picture of the impact of income shifting, but should be read with some caution. As with the FDI study undertaken by Oxfam, the estimated tax revenue losses are based upon statutory tax rates rather than effective tax rates. Moreover, one critical weakness in these studies has been the failure to take into account pricing abnormalities in the other direction. The research has largely ignored overpriced imports and underpriced exports.⁴³

³⁹ Oxfam, *Tax Havens: Releasing the Hidden Billions for Poverty Eradication* (London: Oxfam GB, 2000).

⁴⁰ C. Fuest and N. Riedel, *Tax evasion, tax avoidance and tax expenditures in developing countries: A review of the literature*, Report prepared for the UK Department for International Development (June 19, 2009), pp. 28-29.

⁴¹ S. Pak, *Closing the Floodgates: Collecting Tax o Pay for Development*. Paper Commissioned by the Norwegian Ministry of Foreign Affairs and the Tax Justice Network. 2007.

⁴² Christian Aid, *Death and taxes: The true toll of tax dodging*. May 2008.

⁴³ Fues and Riedel, *op. cit.*, p. 34.



This is not to say that revenue losses as a result of transfer pricing are insignificant. On the contrary, even if the actual losses for developing countries are even one-tenth that estimated, that still amounts to about \$16 billion annually - or close to the entire annual GDP of Uganda. Whatever the real figure may be, the key point is that tax avoidance and evasion is wrong and is imposing real costs on countries and their citizens.

There are other costs arising from tax avoidance that are even more difficult to quantify. Some have argued, for instance, that tax havens and offshore financial centres played a major role in contributing to the devastating economic crisis of 2008. With their lax regulatory environment and lack of transparency, tax havens encouraged the kind of flagrant abuse and outright fraud in the financial system that brought the global economy to its knees. Tax havens formed the basis of a global shadow banking system that allowed companies to devise ever more complex and arcane financial instruments, such as derivatives, collateralized debt instruments, structured investment vehicles and credit default swaps far away from any effective regulatory oversight.

While most of these innovations were born of Wall Street imaginations, few found their home in New York. Seventy-five percent of the world's hedge funds are based in four Caribbean tax havens: the Cayman Islands, Bermuda, the British Virgin Islands, and the Bahamas. The two subprime mortgage-backed Bear Stearns funds that collapsed in 2007, precipitating the credit crisis, were incorporated in the Caymans. Jersey and Guernsey, offshore financial centres in the Channel Islands, specialize in private equity.⁴⁴

In addition, OFCs have allowed many companies to conceal the true nature of their financial health, leading to a cover-up of their losses. In other cases, tax havens have facilitated or provided convenient cover for the operation of scams such as the Allen Stanford fraud that led to the collapse of the Bank of Antigua in 2009.

Taken together, the real price of tax avoidance and evasion by wealthy individuals and corporations is not only measured by a drain in revenues and capital flight. It has also contributed to an increasingly shaky global financial system which is failing to deliver decent jobs, quality public services, or sustainable growth.

CHAPTER 5

MULTINATIONAL CORPORATION TAX AVOIDANCE

by Kimberly A. Clausing

International corporate tax reform is long overdue. Throughout the world, income shifting (or transfer pricing) concerns have been steadily increasing and, as shown in Chapter 4, government revenues are lost through extensive use of low tax jurisdictions. The following chapter indicates that, for the United States alone, income shifting reduced U.S. government revenue between \$57 and \$90 billion in 2008, as much as 30% of total U.S. corporate tax revenues. Enforcement, administrative, and compliance burdens are also fueled by the mind-numbing complexity of international tax rules. Multinational firms frequently rate transfer-pricing as their most important tax concern, and governments are often engaged in lengthy and costly transfer-pricing disputes.

5.1. Introduction

In an environment of mounting fiscal pressures, many governments are seeking increased revenues. In today's global economy, governments also face pressures of policy competition, since economic activity and the associated income is influenced by tax policy differences among countries. In this context, understanding how corporate taxation affects the economic decisions of multinational corporations is essential. Global firms respond to international tax incentives in ways that influence both the real location of their economic activities and their financial decisions regarding where to book profits. Tax-induced distortions to international financial decisions are often referred to as "income shifting" or "transfer pricing", as illustrated in the previous chapter.

This chapter will focus in particular on the techniques employed by multinational firms to reduce their worldwide tax burdens, the consequences of these actions for government revenues, and possible policy responses to these challenging issues. The following analysis indicates that high-tax countries are presently losing large amounts of tax revenue due to multinational corporation income shifting. Further, the present systems of taxing multinational firms are inadequate for addressing income shifting, suggesting a need for corporate tax reforms.

5.2. Taxing Multinational Corporations in industrialized countries

5.2.1. The Economic Policy Context

A number of OECD countries, including the United States, face dire fiscal situations over the coming decades. There are fundamental mismatches between steady streams of government spending obligations and far smaller projected revenues. Even with difficult



spending cuts, policy-makers will need to make tough choices regarding the nature and structure of tax systems.

Many observers feel that corporate tax reform is a good place to start. In the United States, there are many unsatisfying features of the corporate income tax, and the U.S. tax system is an outlier in comparison with peer countries. First, the U.S. corporate tax rate has remained constant while those in other countries have fallen; the U.S. rate is now more than one standard deviation higher than the average OECD country corporate tax rate. Second, the United States has narrowed the corporate tax base in recent decades, while foreign governments have generally accompanied lower rates with a wider corporate tax base. Third, the United States is one of the only major countries to retain a worldwide (or credit) system of taxing multinational firms; many other countries use an exemption (territorial) system, exempting foreign income in at least some instances.

While corporate tax revenues are a significant slice of total revenues in the United States (between 7% and 15% over the previous 5 years), revenues are smaller as a share of GDP than those in most OECD countries, despite a relatively high corporate tax rate. The corporate tax system is responsible for many distortionary effects, including a substantial tax bias toward debt finance. Further, in a global economy, corporate tax incentives influence the location of economic activity as well as a host of financial decisions that affect firm financial statements and government tax revenues.

Indeed, one of the key challenges in the area of corporate tax reform is how to handle income earned abroad. For many U.S. firms, income earned abroad represents a sizeable (and growing) share of their total profits. Whether and how that income gets taxed has bedeviled tax policy experts for at least fifty years. For instance, some hold that attempting to tax foreign income diminishes the competitiveness of domestic firms in a way that ultimately harms the domestic economy; yet others are concerned that exempting foreign income from taxation would provide a tax bias in favor of foreign activities relative to domestic activities. In the United States, both President Obama and many Congressional leaders have expressed serious interest in reforming the taxation of U.S. corporations. However, there remains no consensus on the best reform. Though there is general agreement among experts that rates could be lower if the tax base were broadened, the specifics of such changes raise political difficulties and policy tradeoffs.

Fiscal situations are similarly dire in other countries. In the European Union countries, large budgetary pressures have been coupled with increased attention to tax competitiveness among countries, as many countries have sought to shift tax burdens away from mobile sources of income, such as corporate income, toward consumption. For example, the Netherlands has announced a reduced corporate tax rate that will be coupled with increases in value-added taxation. The UK plans to lower the corporate tax rate in several steps, to 23% by 2014, funded by an increase in the VAT from 17.5% to 20%. There have been similar policy changes across the region, as detailed in a recent *Tax Notes International* news analysis.⁴⁵

⁴⁵ See entry on *European Union* in the *May 9, 2011 Tax Notes International*.

Many OECD countries have changed their corporate tax systems in recent years, and they continue to seek ways to make their tax systems more compatible with their revenue needs and the pressures of globalization. Throughout the world, there is stress on the corporate tax system due to income shifting across countries. In the European Union, policy-makers are actively considering a common consolidated corporate tax base (CCCTB). The European Commission published its proposal in March 2011; companies would file a single tax return for all operations in the EU, and a formula would be used to apportion the tax base to the member states. While they envision applying the CCCTB on an optional basis, the change would provide a step forward in responding to tax policy pressures among highly integrated economies.

5.2.2. Systems for Taxing Multinational Firms

Countries vary in how they chose to tax the foreign income of multinational firms. The current U.S. system of taxing multinational firms is a *worldwide* (credit) system: it taxes the worldwide income of U.S. resident multinational firms, allowing a credit for taxes paid to foreign governments. Many other countries use *exemption* (territorial) systems that exempt foreign income from taxation, though some of these countries have strict anti-avoidance provisions that nonetheless tax income earned in certain low-tax foreign jurisdictions.

In addition, countries presently employ tax systems that are based on *separate accounting*: multinational firms keep track of income and expenses separately in each country in which they operate. *Formulary apportionment* differs from separate accounting in that global income would be allocated by formula to tax jurisdictions. While formulary apportionment is presently used in several sub-national contexts (in U.S. states, Canadian provinces, and German Länder, e.g.), it is not presently used for allocating international income.

How does the current system work ?

Table (a) will give a simple example of how the U.S. worldwide system works. Consider a U.S. based multinational firm that has affiliates in two foreign countries, Country A (which has a tax rate of 10%) and Country B (which has a tax rate of 40%). The U.S. corporate tax rate is 35%. Assume the firm earns \$100 in each foreign country (ignoring foreign currencies for simplicity), and it earns \$200 in the United States. Assume for now that all foreign income is immediately repatriated to the United States.

Since the U.S. based firm is taxed on worldwide income, it would owe U.S. tax on its foreign income, although it would receive a tax credit for taxes paid to foreign governments. However, the foreign tax credit is limited to the U.S. tax liability. Thus, since Country B's tax rate is higher than that in the United States, the firm would not receive a rebate for the \$5 "extra" tax that it paid to the high tax government. However, it could use this excess credit to offset tax due on its Country A income (which would



be \$35 - \$10, or \$25), reducing the U.S. tax liability on the Country A income to \$20. This process is known as 'cross-crediting'. Note that the firm accounts separately for income and expenses in each country.

Table a. Worldwide (Tax Credit) System

| | Country A (10%) | Country B (40%) | U.S. (35%) | World Total |
|-------------------------------|--------------------|--------------------|---------------|-------------|
| Receipts | 200 | 200 | 400 | 800 |
| Expenses | 100 | 100 | 200 | 400 |
| Income | 100 | 100 | 200 | 400 |
| Local Tax | 10 | 40 | 70 | 120 |
| U.S. Tax on Foreign Income | 25 | 0 | n.a. | 25 |
| - above, with cross-crediting | 20 | 0 | n.a. | 20 |
| U.S. Tax w/o Repatriation | 0 | 0 | n.a. | 0 |

This example is made more complicated by a number of features. Of these, perhaps the most important is deferral, which enables firms to delay U.S. taxation on foreign income until that income is repatriated. Thus, if the firm in the above example did not repatriate the low-tax country income, the income would grow tax-free abroad until it was repatriated. This feature creates a substantial incentive to earn income in low-tax countries.⁴⁶

How do firms engage in income shifting?

In fact, multinational firms are often adept at shifting income among their affiliates in order to earn more income in low-tax countries. Income shifting is made easier by the substantial economic linkages among affiliates. For example, about 40% of all U.S. international trade occurs amongst affiliates of multinational firms. In the above example, if the affiliate in Country A undertakes transactions with the affiliate in Country B and the United States parent firm, it can overprice transactions sold to these affiliated firms in order to simultaneously make the low-tax affiliate appear more profitable and the high-tax affiliate and U.S. parent less so, thus reducing worldwide tax liabilities.⁴⁷

Table (b) shows one possible outcome of such income shifting, where Country B expenses, U.S. expenses, and Country A receipts are all artificially high. In the case where

⁴⁶ Some provisions of U.S. tax law limit the use of deferral, such as subpart F. Also, the American Jobs Creation Act of 2004 provided a purportedly one-time tax holiday for repatriating funds from low-tax countries, spurring large repatriations in 2005.

⁴⁷ In theory, firms should be limited in their ability to engage in tax-motivated transfer pricing by fear of detection. Governments generally require firms to price intrafirm transactions as if they were occurring at arm's length. Still, there is universal agreement that this requirement leaves substantial room for tax incentives to affect pricing. Clausing (2003) provides direct evidence.

Country A income is not immediately repatriated, this reduces current worldwide tax burdens substantially. Current worldwide local taxes are \$92.50 in Table (b), but \$120 in Table (a).

Table b. Worldwide (Tax Credit) System with Income Shifting

| | Country A | Country B | U.S. | World Total |
|-------------------------------|-----------|-----------|--------------|--------------|
| Receipts | 300 | 200 | 400 | 900 |
| Expenses | 100 | 150 | 250 | 500 |
| Income | 200 | 50 | 150 | 400 |
| Local Tax | 20 | 20 | 52.50 | 92.50 |
| U.S. Tax on Foreign Income | 50 | 0 | n.a. | 50 |
| - above, with cross-crediting | 47.50 | 0 | n.a. | 47.50 |
| U.S. Tax w/o Repatriation | 0 | 0 | n.a. | 0 |

There are also several other ways to shift income among affiliated firms, such as altering the structure of affiliate finance to incur more interest deductions in high-tax locations and more interest receipts in low-tax locations. In addition, the location of intellectual property holdings is influenced by income shifting incentives.

What are other tax system options ?

While the U.S. government employs a worldwide tax credit system, many other countries exempt foreign income. Over the past quarter century, of OECD countries, roughly one-third use a worldwide (credit) system, one-third use an exemption system (also referred to as a territorial system), and one-third use a hybrid system with characteristics of both systems. In recent years, more countries have moved from having a worldwide system to having an exemption or hybrid system. In a strict exemption system, current world tax liabilities on foreign income would be zero, even if the foreign income were repatriated immediately. This further strengthens the incentive for earning income in low-tax countries. The tax obligation becomes just the local tax row of the above Tables, and firms are free to repatriate income without incurring consequent tax obligations at home. This strengthens the incentive to shift income abroad since there is no concern of amassing excessively large foreign earnings that are difficult to repatriate for tax reasons.

A formulary apportionment system would differ from both of these systems in that it would not rely on separate accounting. Instead, a multinational firm's global income would be assigned to countries based on the fraction of their worldwide activity that occurred in each country, by formula. For example, if one quarter of the firm's economic activity occurred in both Country A and Country B, and one-half in the United States, then one-half of the world income would be assigned to the United States, and taxed accordingly.



Recently, the European Union has considered allocating the European corporate tax base by formula, and researchers are devoting more attention to this alternative. Some of the recent papers that have focused on formulary apportionment as an alternative to separate accounting include Hines (2010), De Waegenaere and Sansing (2007), Fuest et al (2007), and Devereux and Loretz (2008a, 2008b).

Indeed, due to the practical difficulties in employing separate accounting across highly integrated sub-national jurisdictions, formulary apportionment is the system that U.S. states use to assign national income across states. Formulas differ by state, but a common formula is the so-called “Massachusetts formula”, which bases tax liabilities on a weighted average of the share of a firm’s assets, payroll, and sales in a particular jurisdiction. If applied internationally, the tax paid by a multinational firm in a particular country would be given by a similar formula. The details of such a system are described in more detail in paragraph 5.2.3.

5.2.3. Multinational Corporation Response to Tax Incentives

Multinational firms undertake both financial and real responses to the taxation of corporate income. Financial responses to corporate taxation include the aforementioned efforts to shift income to more lightly taxed locations. For instance, multinational firms may alter the transfer prices assigned to international trade with affiliates, alter the structure of affiliate finance, or change the location of royalties or intangibles. Real responses to international tax incentives include locating more assets, employment, and economic activity in low-tax countries. While both financial and real types of responsiveness are likely to affect government revenues, they have distinct policy implications.

To some extent, the real responses of multinational firms to tax rate differences across countries are not particularly troubling. Multinational firms operate throughout the world in order to best serve international markets, and firms that are expanding rapidly abroad are also frequently the same firms that expand rapidly at home. By best arranging their international operations to make use of comparative advantage, they are able to better serve their markets and grow their business. Indeed, the economic literature frequently finds that domestic and foreign operations are complementary, such that a domestic firm’s foreign operations can enhance the scale and success of their domestic operations. Desai, Foley, and Hines (2009) provide some useful evidence of such mechanisms.

That said, given the extent of global operations, financial responses to tax differences among countries are likely less indicative of true comparative advantage across countries than of opportunities for tax avoidance. Further, to the extent that undertaking real operations in low-tax countries is necessary in order to facilitate tax avoidance behavior, these incentives will also distort the location of real economic activities. Evidence provided below indicates that tax-motivated income shifting is likely to have a far larger impact on government revenues than real responses to taxation. Systematic analyses of this

question, such as that of Clausing (2009), also find larger revenue effects of financial responses to taxation.

The prior economic literature has made substantial progress in understanding the nature of these real and financial tax responses. There is a long and varied list of research papers that have examined the tax responsiveness of foreign direct investment with respect to the tax rate, and a somewhat smaller but still considerable set of papers on the tax responsiveness of taxable income with respect to the corporate income tax rate.

De Mooij and Ederveen (2008) provide a very informative overview. They build their analysis around a decomposition of different types of tax responses that firms can take to corporate income taxation: changes in legal form, changes in financial structure, changes in profit shifting behavior, and changes in investment. Together, these types of responses imply a total response of the tax base to corporate tax rates. They take the consensus view of the literature to be that a percentage point increase in the tax rate would reduce the tax base by 3.1%. They note that the consensus estimate of the entire literature is quite close to the aggregate results estimated by Clausing (2007). Among the margins, de Mooij and Ederveen note that the income (profit) shifting margin has the largest effect size. They also note a large investment response. Responses for organizational form and financial structure are smaller, but still statistically significant.

Box 5.1. Literature on income shifting and elasticities

De Mooij (2005) surveys the literature on income shifting, concluding that studies yield a typical semi-elasticity of -2, implying that a one percentage point increase in the tax rate will reduce reported income by 2%. Regarding foreign direct investment, all surveys, including de Mooij and Ederveen (2003, 2008), Hines (1997, 1999), Devereux and Griffith (2002) and Devereux (2006) present consensus views that there are large tax effects on foreign investment flows. The literature varies a great deal in approach, country coverage, time period covered, tax variables utilized, and control variables. Thus, empirical specifications as well as data vary substantially. Still, the overall median value of the elasticities found in the most recent survey, de Mooij and Ederveen, is -2.9, implying that a 1 percentage point increase in a tax measure reduces foreign capital by 2.9 percent. On average, elasticities from exemption country investors are about 1.0 higher (in absolute value terms) than those from credit countries.

It is important to note that these elasticities need to be converted into tax base effects by accounting for the fact that some capital ownership is not foreign-owned, and de Mooij and Ederveen also take into account the share of the normal returns in the corporate tax base. When these factors are taken into account, the implied elasticity of the tax base resulting from the foreign direct investment tax response is about -1.0.



5.2.4. The Changing International Tax and Regulatory Environment

There have been many important changes in the international tax and regulatory environment in recent years. Over the period of the Clausing (2009) study, 1982 to 2004, the average OECD country statutory corporate tax rate fell from 42% to 29%, and corporate tax rates have continued to fall steadily in more recent years. By 2011, the average OECD country statutory corporate tax rate was 23.5%.

Over this period, the average effective tax rates have also decreased by similar magnitudes. The standard deviation of both tax rates across the sample also fell during this time period, by approximately one third. In addition to changes in tax rates, there were other important changes in tax policy by both the U.S. and foreign governments. For example, in 1997, the U.S. government introduced “check-the-box” regulations that greatly simplified the use of aggressive tax planning techniques.⁴⁸

Multinational firms have also become far more adept at utilizing indirect financing structures in order to minimize their worldwide tax burdens. For example, Mintz and Weichenrieder (2010) demonstrate how indirect financing structures avoid taxation by maximizing interest deductions. For example, conduit affiliated entities operating in low-tax countries can loan money to operating affiliates in third countries, that deduct their interest payments to the conduit affiliates. A second interest deduction can be taken if the parent finances the investment in the conduit affiliate with debt. The interested reader is referred to Mintz and Weichenrieder (2010) for more detailed information on indirect financing structures.

The estimates of revenue loss due to income shifting behavior that are presented below have also increased in recent years. One important reason for this has been the dramatic upward trend in corporate profits (abstracting from cyclical considerations). In the case of multinational firms, profits of affiliates abroad have been increasing particularly rapidly.

5.2.5. Illustrative Data on Multinational Corporation Response to Tax Incentives

The U.S. Bureau of Economic Analysis (BEA) does annual surveys of U.S. based multinational firms and their affiliated firms abroad. Even a quick consideration of these data indicates a large discrepancy between the physical operations of U.S. multinational firm affiliates abroad and the locations in which they report their income. For example, Figure 1 shows the top ten locations of U.S. multinational firm affiliate employment in 2008; the accompanying Table 1 indicates the effective tax rates of these countries.⁴⁹ Effective tax rates are calculated as foreign income taxes paid by all affiliates in a given

⁴⁸ This development is discussed in more detail in Altshuler and Grubert (2005).

⁴⁹ 2008 is used since it is the most recent year with publicly available (albeit preliminary) data. Other recent years display similar patterns.

country relative to their net income (adding back in foreign tax payments). The top employment countries are the usual suspects: large economies with big markets. Effective tax rates are not particularly low for this set of countries.

Figure 1. Top Employment Locations of Majority-Owned Foreign Affiliates of U.S. Multinational Firms, 2008 (share of foreign total)

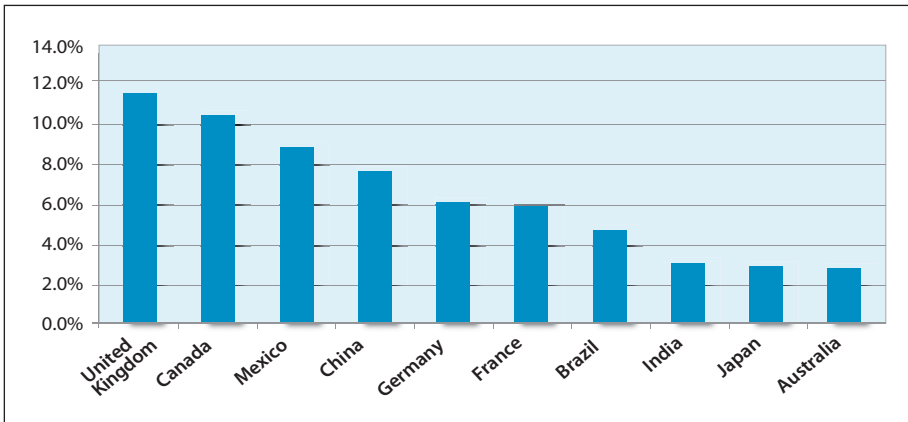


Table 1. Effective Tax Rates of Countries in Figure 1, 2008

| Country | Tax Rate |
|----------------|----------|
| United Kingdom | 44.7% |
| Canada | 13.2% |
| Mexico | 24.7% |
| China | 16.4% |
| Germany | 17.8% |
| France | 21.2% |
| Brazil | 23.5% |
| India | 19.8% |
| Japan | 36.7% |
| Australia | 20.1% |

In contrast, Figure 2 shows the top ten locations of U.S. multinational firm affiliate gross profits (net income with the addition of foreign income taxes). The comparison with Figure 1 is startling. As Table 2 indicates, six of the top seven profit countries have effective tax rates of 4% or lower: the Netherlands, Luxembourg, Ireland, Bermuda, Switzerland, and Singapore. While some of these are medium sized economies, some are very small: Luxembourg has under 500,000 people and Bermuda has 64,000. The combined population of these six countries, 34 million, is less than that of California, yet they account for 46% of all foreign profits.

Figure 2. Top Income Locations of Majority-Owned Foreign Affiliates of U.S. Multinational Firms, 2008 (share of foreign total)

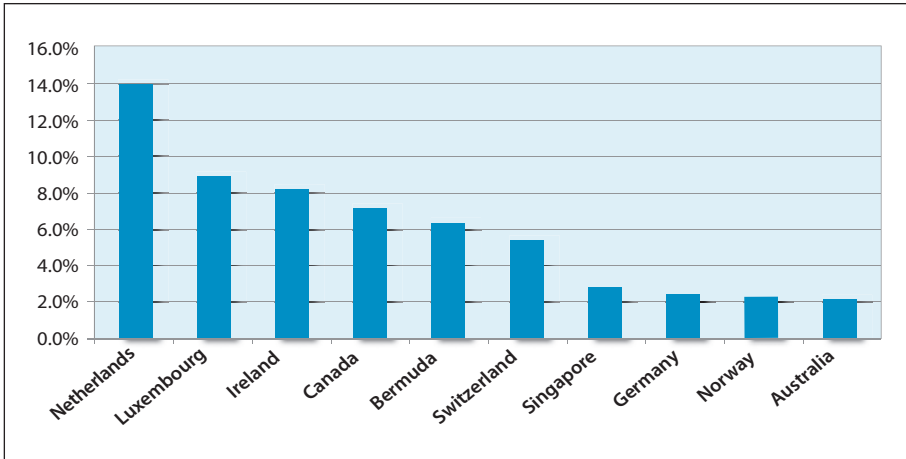


Table 2: Effective Tax Rates of Countries in Figure 2, 2008

| Country | Tax Rate |
|-------------|----------|
| Netherlands | 2.1% |
| Luxembourg | 0.4% |
| Ireland | 4.0% |
| Canada | 13.2% |
| Bermuda | 0.6% |
| Switzerland | 3.4% |
| Singapore | 3.4% |
| Germany | 17.8% |
| Norway | 38.4% |
| Australia | 20.1% |

Some have critiqued this particular data series. The data include “income from equity investments”⁴², some of which are counted more than once if there are tiers of ownership within the same country. Unfortunately, with existing data, it is not possible to account for this double-counting accurately. Still, one can use an alternative data series, also from the Bureau of Economic Analysis (BEA), on direct investment earnings. This data series excludes all income from equity investments.⁵⁰ While eliminating the

⁵⁰ In addition to these differences, there are other technical differences between the series that may be important in size, but they are difficult to separate. Direct investment earning data cover non majority-owned affiliates, and the data are pro-rated by the ownership share of U.S. parents. Direct investment earnings data are also after-tax.

possibility of double counting, this series is also incomplete, since income from investments is excluded. Firm decisions regarding where such income is earned are no doubt influenced by tax incentives; these data would not show such income. Nonetheless, Figure 3 and Table 3 show a similar pattern as Figure 2 and Table 2. The same six countries with low effective tax rates are in the top eight countries: Netherlands, Luxembourg, Ireland, Bermuda, Switzerland, and Singapore. Together, they account for 40% of all foreign direct investment earnings. Thus, while the adjustment for double-counting can make some difference, it is unlikely to be the dominant feature of these patterns.

Figure 3. Top Direct Investment Earning Locations of Majority-Owned Foreign Affiliates of U.S. Multinational Firms, 2008 (share of foreign total)

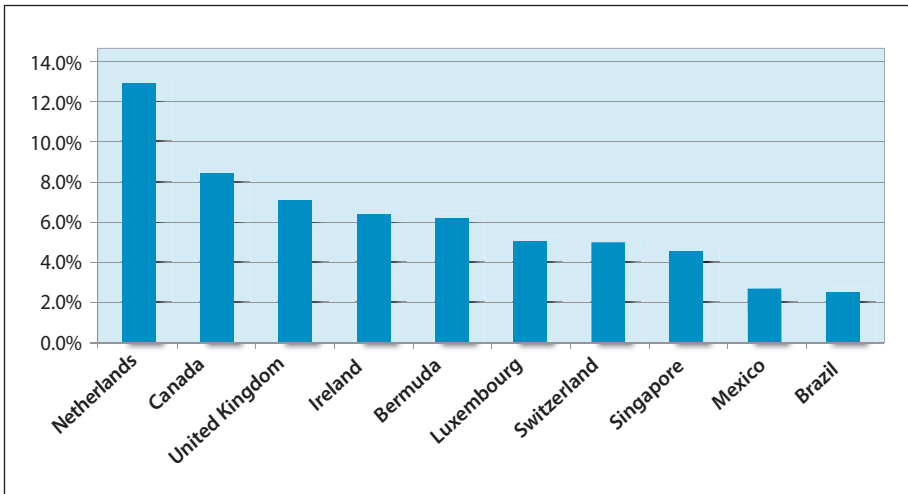


Table 3. Effective Tax Rates of Countries in Figure 3, 2008

| Country | Tax Rate |
|----------------|----------|
| Netherlands | 2.1% |
| Canada | 13.2% |
| United Kingdom | 44.7% |
| Ireland | 4.0% |
| Bermuda | 0.6% |
| Luxembourg | 0.4% |
| Switzerland | 3.4% |
| Singapore | 3.4% |
| Mexico | 24.7% |
| Brazil | 23.5% |



These pictures show compelling visual evidence of the importance of income shifting behavior. While tax considerations are no doubt important in determining multinational firms' real decisions about the locations of investments and jobs, tax considerations are clearly a much more dominant influence for multinational firm decisions regarding where to book income.

5.3. Conclusion

As shown by this and the previous chapters, international corporate tax reform is long overdue. Throughout the world, income shifting (or transfer pricing) concerns have been steadily increasing as government revenues are lost to low tax jurisdictions. The above analysis indicates that, for the United States alone, income shifting reduces U.S. government revenue between \$57 and \$90 billion in 2008, as much as 30% of total U.S. corporate tax revenues.

Enforcement, administrative, and compliance burdens are also fueled by the mind-numbing complexity of international tax rules. Multinational firms frequently rate transfer-pricing as their most important tax concern, and governments are often engaged in lengthy and costly transfer-pricing disputes.

CHAPTER 6

MULTINATIONAL FIRM TAX AVOIDANCE AND GOVERNMENT REVENUE – A FOCUS ON THE U.S.

by Kimberly A. Clausing

In the United States, the tax system is particularly ripe for reform, since the United States raises less revenue as a share of GDP than peer OECD countries yet also has a higher corporate tax rate. Both income shifting and an exceptionally narrow tax base have contributed to this problem, as the author demonstrates in this contribution.

It is important to note that the estimates of U.S government revenue loss due to income shifting are indicative of the size of a policy problem. However, it is unlikely that the entirety of these revenue losses would be recouped through policy changes. Even formulary approaches that eliminate income shifting incentives would create their own incentives to shift formula factors toward low tax countries. While the public finance literature has persuasively and consistently shown that real responses to tax incentives are smaller than financial responses to tax incentives, real responses are still important.

This chapter shows that there are several policy alternatives that would be improvements relative to the status quo. The most transformative approach would be to adopt a formulary approach to the taxation of international income. However, more minor policy innovations are also worthy of full consideration, such as traditional rate-lowering, base-broadening reforms, proposals to end deferral of domestic taxation on international income, and minor modifications of the tax treatment of foreign income.

6.1. Effects on Revenue in Other Countries

More broadly, income shifting behavior likely reduces revenue in many countries, particularly in countries with an above-average tax rate. The European Commission did an impact assessment of their proposed common consolidated corporate tax base, and they found that the average tax base within the EU would be broadened under the proposal, noting that there would be increases in tax bases in Germany, Spain, France, Greece, Italy, the United Kingdom, and in many Central and Eastern European member states. Of course, low tax rate member states (such as Ireland, the Netherlands, and Luxembourg) are likely to see decreases in their tax base.⁵¹

The Commission cautions that revenue effects are difficult to determine absent an understanding of any induced policy response to a common consolidated corporate

⁵¹ See coverage of the EU Commission proposal in Stewart (2011).



tax base. Still, while these tax base changes need not result solely from changes in income shifting incentives, they are indicative of the sorts of revenue effects that income shifting generates.

6.2. Policy Options

6.2.1. Current Proposals in the United States

There are several existing proposals for reforming corporate taxation in the United States. For example, the National Commission for Fiscal Responsibility and Reform (chaired by Simpson and Bowles) issued a December 2010 report that suggests lowering the corporate tax rate to between 23 and 29%, moving to an exemption system for the active income of multinational firms, and eliminating some tax base narrowing features of current law, such as the domestic production deduction. An alternative plan was put forward in November 2010 by the Bipartisan Policy Center's Debt Reduction Task Force (chaired by Domenici and Rivlin); their plan would cut the top corporate tax rate to 27 percent while also raising the tax rate on dividends and capital gains to 27 percent. The plan would eliminate some corporate deductions and credits, and it would retain a worldwide system like our current system.

A bipartisan tax reform proposal bill by Ron Wyden and Judd Gregg was also introduced in 2010. This bill would cut the corporate tax rate to 25% but widen the corporate tax base substantially. In addition, the bill would move toward a more comprehensive version of the current worldwide system of taxation, by limiting both deferral of foreign income and cross-crediting. The bill would reinstitute per-country foreign tax credits.

A final approach is that of Auerbach (2010), in a paper for the Center for American Progress and the Hamilton Project. The core components of this proposal would be immediate deductions for all investments (in lieu of depreciation allowances) and a revamping of the current approach to taxing foreign income that would ignore all transactions except those occurring exclusively in the United States. This system would not tax foreign income, but it would also disallow deductions for foreign expenses or interest. This proposal is discussed in Avi-Yonah (2010) as a "pure territorial" (exemption) system. Auerbach and Avi-Yonah disagree about the effects of the proposal on income-shifting incentives.

6.2.2. Traditional Corporate Tax Reform

A traditional approach to corporate tax reform could simply combine a package of tax-base broadening measures and a lower corporate tax rate, with the balance of the two determined by revenue needs. Lowering U.S. corporate tax rates would reduce income shifting incentives; this provides an additional justification for lowering the corporate

tax rate in an environment where our corporate tax rate is far higher than that in many peer countries. However, in today's fiscal climate, it remains essential to note that the United States also has a far narrower tax base than many of its trading partners due to a plethora of special credits and deductions. Thus, a lowering of the corporate tax rate should ideally be accompanied by the elimination of many of these base-narrowing corporate tax provisions.

Of course, some argue that the corporate tax itself is misplaced and distortionary. In this context, several points should be recalled. First, the corporate tax has an important backstop function for the individual income tax, particularly in an environment where dividends and capital gains are tax preferred. Second, recall that investments financed by debt with generous depreciation rules may actually receive a net subsidy from the corporate tax. Third, and related, part of the corporate tax is undoubtedly a tax on pure economic rents rather than corporate capital per se.

Fourth, the incidence of the corporate tax is a very complicated question. Here one might usefully consider a political economy point, first heard from Larry Summers in 2007. It is indeed possible that corporate stock holders and managers who resist the corporate tax are not really acting in their own interests because they don't understand corporate tax incidence, since corporate taxes will ultimately be borne by their workers. But it seems far more plausible that they have calculated their interests correctly.

6.2.3. Formulary Approaches

Avi-Yonah and Clausing (2008) discuss a system of formulary apportionment for taxing the income of multinational firms. Instead of requiring multinational firms to separately account for their income and expenses in each country, a formulary apportionment system would allocate worldwide income to individual countries by formula. The formula could take any number of forms, but it would be intended to reflect the distribution of the firm's real economic activities, as measured by some combination of sales, payroll, and capital stocks. The firm would then pay U.S. taxes on the share of its worldwide income that is allocated to the United States by the formula.

Box 6.1. Formula

One common formula would equally weight asset, sales, and payroll shares in the United States. So tax payments in the United States would be given by the following formula.

$$Tax_{US} = t_{US} \Pi_w \left[\frac{1}{3} \left(\frac{A_{US}}{A_w} + \frac{S_{US}}{S_w} + \frac{P_{US}}{P_w} \right) \right]$$

where the subscript US indicates the United States, the subscript w indicates the world, t_{US} is the tax rate, Π_w is world profits, A is assets, S_w is Sales, and P is payroll.



Formulary apportionment is used by U.S. states to allocate national income across states.⁵² The state system was motivated by the perception that highly integrated state economies make it impractical to separately account for income and expenses by state.

In an increasingly global economy, moving to such a system internationally could prove similarly practical for assigning world income. There would be no need to allocate income or expenses, to worry about subpart F and the foreign tax credit (because there would be no deferral and no U.S. taxation of foreign-source income), or to cope with cumbersome transfer pricing regimes.

A formulary apportionment system would also remove the incentive to undertake financial responses to tax differences among countries. The incentive to shift income to low-tax countries would be eliminated, as firms' tax liabilities would be independent of where income was booked. Firms' tax liabilities would depend instead on the allocation of formula factors across countries, and thus sales, payroll, and employment would be discouraged in high-tax countries, but these measures are likely to be far less responsive to tax differences among countries.

As summarized by Slemrod and Bakija (2008) and Auerbach and Slemrod (1997), there is a vast amount of empirical research on taxation that suggests a hierarchy of behavioral responses. Taxpayers are most responsive when the timing of transactions affects taxation; taxpayers are also responsive in undertaking financial or accounting responses to taxation; real economic decisions concerning employment or investment are far less responsive to taxation. As demonstrated in the above analysis, there is a similar pattern of tax response for U.S. multinational firms and their affiliates.

Some authors, such as Altshuler and Grubert (2008) and Hines (2010), fear that formulary apportionment could introduce its own distortions. For example, both studies emphasize that formula apportionment could lead to tax incentives for mergers or divestitures. For example, in high-tax countries, firms would have an incentive to sell low-margin affiliated product lines in order to lower the formula factor weights in such countries. Also, in low-tax countries, firms would have an incentive to acquire companies in order to increase factor weights. However, it remains an empirical question whether the tax incentives created by formula weights would be sufficient to induce significant tax-motivated reorganization activity. The organization of ownership is a substantial real behavioral response, and thus it is likely to be less sensitive to taxation than accounting or financial manipulations aimed at shifting income.

The European Union has recently worked on developing a common consolidated corporate tax base, using a formulary approach to allocate European income, without applying the formula to income beyond the "water's edge" of Europe. In that context, several

⁵² It is also used by sub-national governments in both Canada and Germany.

recent studies have considered the efficiency consequences of formulary apportionment. Eggert and Haufler (2006) provide an overview of the literature, noting that it provides no unequivocal lessons regarding the desirability of formulary apportionment, as it may depend on details of implementation. Gerard (2007) argues that the common consolidated corporate tax base is a worthy change, if the formula focuses on criteria that are not easy to manipulate, if consolidation is made compulsory, and if a credit system is adopted vis-à-vis the rest of the world. Devereux and Loretz (2008a) find that formulary apportionment may improve both tax distortions affecting the international allocation of capital (or capital export neutrality) and the tax distortions influencing the international ownership patterns of capital (which they term market neutrality), although improvements to the later are larger.

In considering ideal formula weights, Eicher and Runkel (2008) suggest that formulary apportionment with a sales factor would best mitigate fiscal externalities due to tax competition. Pethig and Wagener (2007) also analyze corporate tax competition under formulary apportionment, finding that tax competition will lead to lower tax rates as the tax base is more elastic. In their model, the asset elasticity exceeds the employment elasticity, which in turn exceeds the sales elasticity.

Like other high-tax countries, if the United States were to adopt formulary apportionment, there would be gains in revenue as a result.⁵³ Under the current system, high-tax countries have disproportionately low shares of the worldwide income of multinational firms compared to their shares of world employment, assets, or sales, so they are likely to gain tax revenue under formulary apportionment. Low-tax countries are likely to lose revenue for a similar reason. Devereux and Loretz (2008b) study the effects of formula apportionment on corporate tax revenues in the European Union, under the assumption that the formula would allocate European Union income only, applying a water's edge principle. Devereux and Loretz find that the countries that gain revenue are those with high factor shares relative to their income shares, generally high-tax countries. Yet, revenue gains or losses are sensitive to assumptions regarding whether the formulary system is optional or mandatory as well as how loss consolidation is handled. Fuest et al (2007) also consider this question, and they find that loss consolidation has a negative impact on the overall EU tax-base, but their results may be sensitive to their use of a database of German firms over a period when these firms were experiencing large losses. In general, they find that tax revenues increase for high-tax countries relative to low-tax countries.

Formulary apportionment could result in double taxation (or double non-taxation) if other countries do not adopt similar schemes. However, since the European Union is already considering a move to formulary apportionment, that might facilitate broader

⁵³ *Of course, the move to formulary apportionment could be made revenue neutral by reducing the corporate income tax rate.*



international cooperation. Further, non-adopting countries would be likely to lose revenue to formulary countries, since multinational firms operating in both types of countries would have an incentive to shift reported income to formulary countries, because their tax liability in such countries would no longer depend on the income reported there. The consequent loss of tax revenue in the non-adopting countries would give them a strong incentive to adopt.⁵⁴

In addition to addressing income shifting concerns, formulary apportionment would also address competitiveness concerns. Taxation would not depend on the residence of the parent firm or its legal form (e.g., branch or subsidiary). Thus, it would remove the incentive for corporate inversions as well as any competitive disadvantage associated with being a U.S.-based multinational firm.

Another alternative worthy of consideration is a formulary profit-split, such as that proposed by Avi-Yonah, Clausing, and Durst (2009). Under a formulary profit-split, the U.S. tax base for multinational corporations would also be calculated based on a fraction of their worldwide income. This fraction would be the sum of (1) a fixed return on their expenses in the United States and (2) the share of their worldwide sales that occur in the United States. This system is similar in significant respects to the current “residual profit split” method of the U.S. transfer pricing regulations and the OECD Guidelines.

Altshuler and Grubert (2010) suggest that such a method may prove less distortionary than either a strict formulary system or the current separate accounting system. They focus on the potential for both separate accounting and formulary approaches to distort the decisions regarding whether or not to perform activities within the firm and whether or not to organize firms across national borders. In their simulations, they find that a profit-split method can result in less distortion to the location of capital.

Two prominent alternative options for reforming the taxation of multinational corporate income are considered next: (1) adopting an exemption system and (2) eliminating deferral of U.S. taxation of foreign income under the current system. When comparing these reforms, one should consider several important, yet at times conflicting, tax policy goals. In addition to raising revenue, the tax system should attempt to promote an efficient worldwide allocation of capital, and it should attempt to not distort ownership patterns or discourage multinational firm headquarters activities in the home country. Formulary apportionment does well on many of these criteria: it would likely raise revenue, and it eliminates the tax consequences of residence and legal form, thus reducing any

⁵⁴ *The transition to formulary apportionment would require careful attention to a number of details, discussed further in Avi-Yonah and Clausing (2008). Care would be required to define the unitary business, determine the appropriate apportionment formula, insulate against possible behavioral responses to the chosen formula weights, create common accounting standards (or reconcile differences between standards), and handle international tax treaty issues.*

tax disincentive associated with basing operations in the United States. However, a formulary system would need to be carefully designed to minimize distortionary tax responses of firms to the factors in the formulas, and tax-induced firm reorganization.

6.2.4. Exemption of Foreign Income

In the United States, multinational firms frequently advocate the adoption of an exemption tax system, although they are at times particular about the details of such proposals (if, e.g., they would disallow deductions for foreign expenses). The rationale for exemption systems is frequently centered around ensuring the competitiveness of multinational firms, since firms based in worldwide countries may face a tax disadvantage when competing with firms based in exemption countries.

If the U.S. adopted an exemption system, U.S. firms would not be disadvantaged relative to firms based in other countries. Still, the allocation of capital would be further skewed in favor of low-tax locations. In addition, an exemption system would increase income shifting incentives and erode the U.S. tax base. Observers frequently note that one benefit of a worldwide (credit) system is that it somewhat dampens income shifting incentives. U.S. multinational firms already shift a great deal of income abroad; exempting foreign income from taxation would exacerbate this already large incentive. It would be difficult to avoid more aggressive use of transfer price manipulation and other income shifting techniques.

A recent analysis, Markle (2010, p.28), examines the income shifting behavior of multinational firms in territorial (exemption) and worldwide systems. He finds that “territorial multinationals shift more income than do worldwide multinationals with the same tax incentives and opportunities. The difference is both statistically and economically significant.”

6.2.5. Ending Deferral

Presently, US tax on foreign income is deferred until that income is repatriated. Ending deferral of the U.S. taxation of foreign income under the current system would substantially reduce incentives to shift income toward low-tax countries. Such proposals stand in contrast to exemption system proposals, which would worsen income shifting incentives.

Ending deferral would likely increase U.S. government revenues. Yet, one concern is that ending deferral would disadvantage U.S. based multinational firms compared to those based in other countries, and this could distort ownership patterns and the location of headquarters activities. It may induce corporate inversions, whereby the residence of corporations would be relocated overseas, although anti-inversion provisions could be included to combat this problem.



Multinational firms are likely to oppose such proposals vociferously. In general, though, competitiveness concerns would be lessened by a revenue-neutral version of the proposal, if the corporate tax rate were lowered at the same time. If the repeal of deferral were coupled with a lower corporate tax rate, that would reduce opposition.

6.2.6. More Incremental Approaches

Absent more comprehensive corporate tax reform, there are still several more incremental options that are worthy of full consideration. In the United States, policy-makers could consider restricting or repealing “check the box”, limiting the use of foreign tax credits, expanding the definition of subpart F income, better enforcing transfer pricing rules, and creating more uniformity between how corporate and non-corporate income is taxed. While many of the incremental proposals require technical modifications to existing rules and regulations that are too detailed for a thorough discussion here, a few examples will prove illustrative.

In the fiscal 2011 budget, the Obama administration proposed to clarify the definition and valuation of intangible property. A related measure would treat excessive returns resulting from the transfer of intellectual property to low-tax controlled foreign corporations as subpart F income, thus not permitting deferral of US taxation on foreign income in these instances.⁵⁵ Prior Obama Administration international tax proposals have included restricting the ability to treat some foreign entities as “disregarded entities” under check-the-box regulations, changing expense allocation to reduce the ability of multinational firms to claim U.S. income deductions for expenses resulting in indefinitely deferred foreign income, and reducing the ability of multinational firms to use cross-crediting. Many of these proposals are clear attempts to reduce the ease of income shifting by multinational firms.

Yet all of these proposals have met with fierce opposition from the multinational corporations themselves. Based on competitiveness concerns, multinational corporations argue that the U.S. tax laws should in fact be moving in the opposite direction: taxing foreign income more lightly, permitting deductions in the U.S. for expenses that generate foreign income, lowering the corporate tax rate, and reducing the remaining constraints of Subpart F. Thus, there is a fundamental tension between the concerns of multinational firms and efforts to reduce the revenue losses associated with income shifting.

A final incremental proposal is that of Altshuler, Harris, and Toder (2010); they suggest shifting more capital taxation to the individual level, away from the corporate level. They argue that such a change would prove less distortionary to the location

⁵⁵ For a full discussion of this proposal, see the testimony of Stephen Shay on July 22, 2010, available at: http://waysandmeans.house.gov/media/pdf/111/2010Jul22_Shay_Testimony.pdf.

and income shifting decisions of multinational firms, while also increasing the progressivity of the tax system. They suggest taxing capital gains and dividends as ordinary income, with a maximum rate of 28%, and simultaneously lowering the corporate rate to a similar level.

In this context, it is important to recall that the structure of corporate and individual taxation, where debt-financed investments may even be subsidized at the corporate level, causes some investors to face marginal tax rates on corporate income that are lower than their tax rates on ordinary income. Indeed, proposals such as that of Altshuler, Harris, and Toder (2010) may reduce the distortions associated with the disparate treatment of debt and equity financed investments, in addition to providing other advantages.

6.3. Conclusion

In the United States, the tax system is particularly ripe for reform, since the United States raises less revenue as a share of GDP than peer OECD countries yet also has a higher corporate tax rate. Both income shifting and an exceptionally narrow tax base have contributed to this problem.

There are several policy alternatives that would be improvements relative to the status quo. The most transformative approach would be to adopt a formulary approach to the taxation of international income. However, more minor policy innovations are also worthy of full consideration, such as traditional rate-lowering, base-broadening reforms, proposals to end deferral of domestic taxation on international income, and minor modifications of the tax treatment of foreign income.

CHAPTER 7

SPOTLIGHT ON THE OECD

by Pierre Habbard and Kirstine Drew

The Organisation for Economic Cooperation and Development (OECD) plays a leading role in international tax cooperation and in shaping the tax policy agenda of its member countries. It is indeed a major actor in international initiatives aimed at combating tax evasion and avoidance and strengthening the tax systems of developing countries.

This chapter provides a snap-shot of selected OECD-led or supported instruments and initiatives for strengthening international cooperation on tax, curbing tax evasion and avoidance by MNEs and building the capacity of tax administrations in developing countries. It then turns to a discussion of the tax policy reform agenda, the need to address taxation in the context of the stability of the financial sector and for the OECD to support the Financial Transactions Tax (FTT). It also sets out the trade union agenda.

7.1. Introduction

The Organisation for Economic Cooperation and Development (OECD)⁵⁶ plays a leading role in international tax cooperation. In addition to developing its own standards and principles, it is a major actor in international initiatives aimed at combating tax evasion and avoidance and strengthening the tax systems of developing countries. The OECD also plays a significant role in shaping the tax policy reform agenda of OECD member countries. Its faith in the benefits to growth and employment of reducing taxes on corporations and incomes, while increasing taxation on consumption and property – an agenda which by its own admission “*reduces progressivity*” and increases inequality – underpins its policy recommendations to member states.

This dual role of the OECD in international cooperation and country-specific tax policy reform requires a mixed advocacy response by trade unions. At the international level, the Trade Union Advisory Committee to the OECD (TUAC), together with its Global Union partners, supports strengthening the Global Forum and building greater transparency, in particular as regards the financial reporting of multinational enterprises (MNEs). Shifting the focus of the OECD’s recommendations on tax policy reform away from prioritising private sector growth and competitiveness to supporting shared growth across society, however, requires concerted action not only at the OECD, but at member state level.

⁵⁶ The OECD work is led by the OECD Centre for Tax Policy and Analysis.

7.2. Strengthening international cooperation

7.2.1. The Global Forum on Transparency and Exchange of Information for Tax Purposes

The OECD plays a leading role in the Global Forum on Transparency and Exchange of Information for Tax Purposes (the "Global Forum"), the main multilateral framework for government cooperation on tax evasion and tax avoidance. The Global Forum has 101 member jurisdictions, including all G20 countries. Created in 2000, the Global Forum came to prominence in 2008 with the advent of the global financial crisis, which put tax transparency and tax evasion and avoidance high on the political agenda. Tax transparency has remained on the G20 agenda ever since the first G20 Summit held in Washington D.C., November 2008.

The Global Forum leads the implementation of the "*standard of transparency and exchange of information*", which was developed by the OECD in 2004.⁵⁷ The purpose of the standard is to provide a model agreement to be reproduced in bilateral and multilateral tax treaties and to set rules and tax rights for effective exchange of information between tax authorities "*on request*" on judicial tax matters and when the information is "*foreseeably*" relevant to the enforcement of tax obligations. It aims to ensure that information, including bank and fiduciary information, is available for use by the tax authorities and that the appropriate mechanisms are in place to support such an exchange.

All members of the Global Forum have made a commitment to implement the standard, which has also been endorsed by the G20 and by the UN Committee of Experts on International Cooperation in Tax Matters (which accordingly aligned the UN Model Tax Convention with the standard).

The Global Forum regularly publishes a 'progress report', which groups member jurisdictions into three categories: (i) those that have "*substantially implemented*" the internationally agreed tax standard; (ii) those that have "*committed to*", but have "*not yet substantially implemented*" the internationally agreed tax standard (the 'grey list'); and (iii) those that have not committed to the internationally agreed tax standard (the 'black list'). At the time of writing⁵⁸, Montserrat, Nauru and Niue together with Guatemala and Uruguay have been placed on 'grey list'. As all jurisdictions surveyed by the Global Forum have committed to implementing the internationally agreed tax standard, then no jurisdiction has been placed on the 'black list'⁵⁹.

⁵⁷ *The standard was developed on the basis of the 2002 Model Agreement on Information Exchange on Tax Matters as well as Article 26 of the OECD Model Tax Convention.*

⁵⁸ *The information is based on the list that was last updated 6 July 2011.*

⁵⁹ *Progress Report on the Jurisdictions surveyed by the OECD Global Forum in Implementing the Internationally Agreed Tax Standard , Progress made as at 6 July, 2011, <<http://www.oecd.org/dataoecd/50/0/43606256.pdf>>.*

7.2.2. The Convention on Mutual Administrative Assistance in Tax Matters

The 1998 Convention on Mutual Administrative Assistance in Tax Matters was jointly established by the OECD and the Council of Europe with the aim of promoting *"international co-operation for a better operation of national tax laws, while respecting the fundamental rights of taxpayers... in particular with a view to combating tax avoidance and evasion"*.⁶⁰

The Convention was amended in 2010 following the call from the G20 Summit to make it easier for developing countries to benefit from enhanced international cooperation on tax and for a multilateral approach to the exchange of information. A protocol amending the Convention was opened for signature at the OECD's Ministerial Council Meeting in May 2010. The protocol has the effect of aligning the Convention with the Global Forum's standard on information exchange for tax purposes. It additionally provides for the option of automatic exchange of information, which can be established through an administrative agreement between willing competent authorities. Whereas the Convention was originally only open to members of the OECD or the Council of Europe, it is now open to all countries.

Box 7.1. International cooperation: trade union agenda

TUAC contends that the approach of the OECD and the Global Forum to information exchange between tax authorities is too limited in that it relies on requests for information rather than automatic exchange. Transparency and disclosure of beneficial ownership – access to the real identity of bank accounts, owners of shares, bonds and other securities – also remain problematic for many OECD jurisdictions, including the US. While, in principle, TUAC welcomes the publication of the OECD 'grey' and 'black' lists, in practice there are very real question marks over an approach that results in so few financial centres being on the 'grey list' and none at all on the 'black list'. Jurisdictions need only sign twelve bilateral agreements that meet the standard to avoid being placed on the 'grey' list – tax havens and offshore financial centres (OFCs) can easily reach this threshold by signing agreements between themselves – and they can stay off the 'black list' on the basis of a mere commitment. Furthermore, TUAC notes that the progress report's classification of China as having "substantially implemented the internationally agreed tax standard" excludes its "Special Administrative Regions". This means that Hong Kong and Macau, both members of the Global Forum, should appear separately on the 'grey list'.

TUAC is calling on the OECD to strengthen the Global Forum and other initiatives on tax evasion and avoidance and specifically to:

1. Global Forum: ensure that Global Forum membership includes all financial centres;
2. 'Grey list': ensure that the Global Forum assesses individual member jurisdictions' compliance with the international standard so that they are listed separately on the 'grey list';
3. Information exchange: require the implementation of automatic exchange of information between national tax authorities, with due regard to minimum confidentiality requirements; and provide for mandatory disclosure of the beneficial ownership of all assets (bonds, equity and alternative assets).

⁶⁰ *Convention on Mutual Administrative Assistance in Tax Matters*, http://www.oecd.org/document/57/0,3746,en_2649_33767_2489998_1_1_1_1,00.html.

7.3. Targeting multinational enterprises

7.3.1. Transfer pricing

The OECD has also developed rules directed at multinational enterprises (MNEs) as part of its effort to crack down on international tax evasion and tax avoidance. As described by Robinson and Clausing in Chapters 4 and 5, MNEs use a range of techniques to reduce their global tax burden, including income shifting through transfer pricing.

Transfer pricing refers to the pricing of transactions that occur in the context of international trade between enterprises, which belong to the same corporate group – e.g., transactions made between a subsidiary and the parent company or between subsidiaries of the same parent company. Unlike transactions between two independent enterprises, which would involve the negotiation of a fair market price (the ‘arms-length’ price), associated enterprises can distort prices so as to minimise their profits in high tax jurisdictions and maximise their profits in low tax jurisdictions (including tax havens), thereby reducing their global tax bill.

Such transfer ‘mispricing’⁶¹ has obvious and significant adverse consequences for national tax collection authorities. According to the Tax Justice Network, intra-MNE trade is estimated to account for as much as 60-70% of all international trade. Clausing (cf. Annex 1) cites the loss to the U.S. Government as being in the region of \$57-\$90 billion in 2008; worldwide the annual loss in tax revenue is estimated to be several hundred billion dollars.⁶²

The 1995 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, revised most recently in 2010, is the OECD’s leading international instrument for preventing the loss of tax revenue from transfer pricing. It provides guidance on the ‘arm’s length’ principle as the basis of valuing cross-border transactions, for tax purposes, between associated enterprises.

The OECD also includes recommendations on tax compliance, including transfer pricing, in its Guidelines for Multinational Enterprises.⁶³ The OECD MNE Guidelines are a leading instrument for responsible business conduct in the global context. Updated in 2011, they cover a broad range of issues ranging from human rights, to employment, disclosure and tax.⁶⁴ While not legally binding, they are not voluntary either, setting

⁶¹ *Transfer pricing is perfectly legal – it is transfer mis-pricing that is abusive or illegal.*

⁶² *The Tax Justice Network quotes Global Financial Integrity as the source of this estimate: http://www.taxjustice.net/cms/front_content.php?client=1&lang=1&parent=91&subid=91&idcat=139&idart=25*

⁶³ *The Guidelines have been signed by 42 governments representing the most industrialised countries of the world, with the notable exceptions of China, India, Indonesia and Russia. The full text in English and French can be found at: http://www.oecd.org/document/28/0,3746,en_2649_34889_2397532_1_1_1_1,00.html.*

⁶⁴ *The Guidelines comprise the following chapters: I. Concepts and Principles; II. General Policies; III. Disclosure; IV. Human Rights, V. Employment and Industrial Relations, VI. Environment, VII. Anti-corruption, VIII. Consumer Interests; IX. Science and Technology; X. Competition; and XI. Taxation.*



out governments' expectations of how businesses should behave. Uniquely, they require signatory governments to establish a complaints mechanism – a National Contact Point (NCP) – for the purposes of resolving issues arising under the Guidelines. Trade unions can submit cases to these government-backed NCPs concerning breaches of the Guidelines by any MNE that is headquartered in a country that has signed the Guidelines. To date trade unions have submitted 131 cases under the Guidelines.

The Tax Chapter of the Guidelines requires MNEs to *"contribute to the public finances of host countries by making timely payment of their tax liabilities"* and to *"comply with both the letter and the spirit of the tax laws and regulations of the countries in which they operate"*.⁶⁵ The recommendations pay particular attention to the importance of *"providing to the relevant authorities, timely information"* and conforming to the 'arm's length' principle in transfer pricing practices. The commentaries further explain that MNEs should not structure their transactions *"in a way that will have tax results that are inconsistent with the underlying economic consequences of the transaction..."*.⁶⁶ And they expand on the importance of providing timely and complete information in the context of requests from another country, such as a tax treaty partner, in recognition of the fact that developing countries face considerable asymmetry in their access to information from MNEs.

7.3.2. Corporate governance

The OECD MNE Guidelines also recommend that the corporate board takes a more active role in assessing tax risks. They instruct MNEs to *"treat tax governance and tax compliance as important elements of their oversight and broader risk management systems"* stating that *"corporate boards should adopt tax risks management strategies to ensure that the financial, regulatory and reputational risks associated with taxation are fully identified and evaluated"*. The commentaries provide further guidance on the need to put in place internal tax control systems and to inform corporate boards about all potentially material tax risks.

⁶⁵ Paragraph 1, Chapter XI, Taxation.

⁶⁶ Commentary to Paragraph 1 of Chapter XI, Taxation.

Box 7.2. Targeting multinationals: trade union agenda⁶⁷

The OECD has been criticised by tax justice campaigners for relying on the overly complex ‘arm’s length’ principle as a response to the substantial problem of abusive transfer pricing. According to Richard Murphy, tax consultant for the UK Trades Union Congress (TUC), the appropriate solution lies in increasing the transparency of the financial reporting of MNEs and specifically country-by-country reporting which would entail an MNE reporting: the names of the countries in which it operates; the names under which it trades in each; and its financial performance in each country.⁶⁸ A number of governments support country-by-country reporting, including most recently The Netherlands, with the Dutch Parliament adopting a motion in July 2011, urging the government to work towards ensuring that “country-by-country reporting becoming an international standard”.⁶⁹

The OECD Guidelines for Multinational Enterprises provide trade unions with the opportunity to file cases against MNEs for failures in tax compliance, including as regards their transfer pricing practices. In April 2011, five NGOs⁷⁰ filed a complaint with the Swiss and Canadian NCPs concerning the practices of a Zambian subsidiary of Glencore International AG (Switzerland) and First Quantum Minerals Ltd. (Canada). Using information provided in a published report,⁷¹ the complainants alleged that the subsidiary distorted copper selling prices in favour of Glencore in violation of the ‘arm’s length’ principle. They alleged that this reduced the subsidiary’s net income by several hundred millions dollars, thereby substantially reducing the tax collected by the Zambian authorities.

TUAC is calling on the OECD to:

1. promote transparency in financial reporting: undertake an in-depth study of the different options for increasing transparency in the financial reporting of MNEs building on the experience of existing transparency initiatives; undertake an assessment of the costs and benefits of developing a country-by-country reporting standard; identify the next steps for developing such a standard;

TUAC encourages trade unions to:

2. use the OECD Guidelines for Multinational Enterprises: considering filing cases under the OECD MNE Guidelines, which provide the means to hold an MNE to account in its home country for tax compliance failures abroad, including for transfer pricing abuses.

⁶⁷ This summary is based on the case database managed by OECD Watch:

http://oecdwatch.org/cases/Case_208.

⁶⁸ The concept of country-by-country reported was developed by Richard Murphy and this description is based on a Tax Justice Network briefing on country-by-country reporting: <http://www.taxjustice.net/cms/upload/pdf/Country-by-country_reporting_-_080322.pdf>

⁶⁹ The Dutch Government supports Country-by-Country Reporting: <<http://taxjustice.blogspot.com/2011/07/netherlands-in-support-of-country-by.html>> SHERPA (France), the Center for Trade Policy and Development (Zambia), the Berne Declaration (Switzerland), l’Entraide Missionnaire (Canada) and Mining Watch (Canada).

⁷⁰ SHERPA (France), the Center for Trade Policy and Development (Zambia), the Berne Declaration (Switzerland), l’Entraide Missionnaire (Canada) and Mining Watch (Canada).

⁷¹ The report was published by the international accounting firms Grant Thornton and Econ Pöyry.



7.4. Capacity-building in developing countries

The OECD is also working to strengthen the capacity of tax administrations in developing countries in view of the dual role of tax as a revenue generating tool, which would help reduce countries' reliance on aid, and a tool for public accountability.

In 2010, the OECD's development and tax committees established a multi-stakeholder '*Informal Task Force on Tax and Development*' comprising representatives from OECD and non-OECD governments, as well as business, trade unions and NGOs. The Task Force was charged with developing recommendations on: capacity-building for tax administrations in developing countries; transparency in financial reporting by multinational enterprises; transfer pricing; and the exchange of information regarding tax evasion. Its sub-group on '*Transparency in Reporting Financial Data by Multinational Corporations*' published a report⁶³ which identifies a number of future priorities for future work, including in the areas of country-by-country reporting, discretionary tax administration and the disclosure of statutory accounts.

The OECD is a member of the International Tax Dialogue (ITD),⁷² alongside the European Commission, the International Monetary Fund (IMF), the World Bank, the Department for International Development (DFID, UK) and the Inter-American Development Bank (IADB), which was set up in 2005 in response to the Monterrey Financing for Development, which called for enhanced international dialogue on tax matters. The ITD aims to stimulate and support discussion of tax matters among national tax officials, regional tax organisations, and international organisations.

The OECD also engages in regional cooperation on tax holding regular meetings and consultations with the Inter-American Center of Tax Administrations (CIAT), the Centre for Meetings and Studies of Directors of Tax Administrations (CREDAF), the Intra-European Organisation of Tax Administrations (IOTA), the Study Group on Asian Tax Administration and Research (SGATAR), and the African Tax Administration Forum (ATAF).

Box 7.3. Tax and Development: Trade Union Agenda

TUAC strongly supports the priority given by the OECD to tax policy and development. Efforts to create an effective international architecture for combating tax avoidance and evasion are as critical as support for strengthening developing country tax administrations.

In addition to undertaking in-depth studies to support the development of a standard for country-by-country reporting by MNEs, TUAC is calling on the OECD to:

1. support regional initiatives: support regional initiatives such as the African Tax Administration Forum (ATAF);
2. involve the UN: more strongly involve the UN Committee of Experts on International Cooperation in Tax Matters and other UN agencies in its work.

⁷² The International Tax Dialogue <http://www.itdweb.org>

7.5. Tax cuts to boost private sector growth

Over recent years, the OECD has pushed an extensive agenda of transforming tax systems to help promote private sector growth and competitiveness. The 2009 edition of the OECD's flagship publication, 'Going for Growth', explicitly assigns tax systems the goals of avoiding distorting business choices so as to increase GDP growth.⁷³ The OECD's recommended policy mix is not neutral from the perspective of working families. It advocates tax reforms that are targeted at increasing and broadening consumption-related taxation, such as VAT and property taxes. At the same time, it calls for reductions in corporate and personal income taxation, as well as employer social security contributions.

The OECD contends that "[T]axing consumption and property appears to have significantly less adverse effects on GDP than taxing income", while corporate income taxes "have a particularly negative impact on GDP per capita" and on the "growth of the most dynamic and innovative firms". The OECD also sees value in taxing capital income (interest, dividends and capital gains) at lower rates than labour income.

The OECD's recommendations to member states essentially represent a tax cutting agenda as shown by the following examples:⁷⁴

- *Reduce personal income tax*: Austria, Australia, Finland, Italy, Norway, Poland, Denmark, Sweden, and the US;
- *Reduce personal income tax targeted at lower income households, lone parents or second earners*: Canada, Netherlands, the UK, Germany, Ireland, Netherlands and the Slovak Republic;
- *Reduce tax on labour income in general or low-income earners in particular financed by reductions in public spending*: Belgium, the Czech Republic, Greece and Turkey;
- *Reduce employer social security contributions*: Germany, Hungary, Poland, and the Slovak Republic;
- *Reduce corporate income tax*: Japan;
- *Reduce capital income taxation*: Canada;
- *Raise property taxes*: Denmark, Finland, Japan and Sweden;
- *Raise, introduce or broaden consumption-related taxation, such as VAT*: Mexico, Netherlands and the US.

The rationale underlying these recommendations is to "shift the tax structure from mobile income taxes to less mobile taxes, such as consumption",⁷⁵ in the context of

⁷³ See "Economic Policy Reforms: Going for Growth 2009"

http://www.oecd.org/document/33/0,3343,en_2649_34117_41935009_1_1_1_1,00.html.

⁷⁴ See "Economic Policy Reforms: Going for Growth 2011: Country Notes"

http://www.oecd.org/document/31/0,3746,en_2649_37443_47449183_1_1_1_1_37443,00.html.

⁷⁵ OECD quotes in this paragraphs are taken from "Taxation and Economic Growth" - OECD Economic Department Paper No.62, July 2008, [http://www.oecd.org/officialdocuments/displaydocumentpdf/?cote=eco/wkp\(2008\)28&doclanguage=en](http://www.oecd.org/officialdocuments/displaydocumentpdf/?cote=eco/wkp(2008)28&doclanguage=en).

increasing trade, investment and financial cross-border liberalisation. Mobile tax bases are those most affected by globalisation and should be reduced so as to limit the risk of tax arbitrage. Corporate income tax is particularly mobile as MNEs can relocate to more tax-friendly jurisdictions. Top personal income tax rates are also subject to international competition and arbitrage as countries compete for highly-skilled workers. In contrast, the taxation of lower-skilled workers and of consumption, the OECD argues, is less affected by globalisation *"because these tax bases are less mobile"*. Property tax *"is seen as the least affected by globalisation"*.

7.6. Tax systems and financial stability

Another reason for the shift from income and capital to consumption taxation is the concern over the *"debt bias"* effect of tax systems. *"Double taxation [through corporate income tax then dividend tax] can create a bias towards financing investment with debt rather than equity"*. Not only does such bias *"discriminate against firms that have less access to debt financing"*, it can actually fuel excessive leveraging in the economy.

The links between tax systems and financial stability is the focus of new work at the OECD. The combination of Offshore Financial Centres (OFCs), financial 'innovation' leading to poorly regulated investment vehicles and products – derivatives, hedge funds – and the above tax bias toward debt has accelerated tax arbitrage and tax evasion strategies worldwide. MNEs have ample opportunity to practice *"double-dip"* strategies whereby the interest payments on a single debt are deducted twice from the company's accounting in two separate jurisdictions. It is also understood that the phenomenal growth in debt securitisation by global banks in the run up to the 2008 crisis, has gone far beyond the mere theoretical justification of *"spreading"* credit default risks across markets and asset classes. The real motivation was tax evasion. In sum, when tax systems are not calibrated to the size of the financial sector, they can artificially reduce the cost of financing of transactions and investments that otherwise would not be viable, which in turn can lead to mispricing of assets and hence of risks... as happened in 2008.

As a result of its increased focus on the role of taxation in contributing to financial stability, the OECD appears to have softened its position on the taxation of financial transactions. Historically the OECD has been against any such 'Tobin Tax', in part, due to the negative impact on liquidity, but also, perhaps, as a result of its faith in open, transparent and efficient markets. In a recent paper, however,⁷⁶ the OECD's chief financial expert, Adrian Blundell-Wignall, saw value in establishing a Financial Transactions Tax (FTT) on derivatives over-the-counter trading, *"the incidence of which would fall mainly on [global systemically important financial institutions] and regulatory arbitrage and gambling activities, as opposed to longer term hedging by end users"*.

7.7. Tax reforms and inequality

There is in fact *prima facie* traction in the argument for reducing taxes on labour income to promote growth and employment. However, the net positive impact is not as clear as the OECD tax experts would like. The OECD Employment Outlook 2008 suggested that the long-term impact of cuts in employer social security contributions on employment levels were limited.⁷⁷ Employers have either reported an increase in profits resulting from the tax cuts or (where trade unions are effective) an increase in wages for the existing workforce – but no job creation as such. The OECD insistence on cutting employer social security contributions is likely to become of increasing concern over time, as such reductions lead to significant losses of revenue and thereby the potential destabilisation of social security financing.

More fundamentally, the shift from direct to indirect taxation raises questions about inequality. The OECD concedes that its reform package would “*reduce progressivity*” and “*increase inequality, particularly at the lower end of the wage distribution as consumption taxes are less progressive than personal income taxes*”. Accordingly governments face “*a trade-off between tax policies that enhance GDP per capita and equity*”. To deal with this trade-off, the OECD considers that “*it is better to use the benefit system [i.e. social safety nets] to deal with distributional concerns*”⁷⁸ rather than using the tax system. However, the prospects for social safety nets being expanded to compensate for increasing regressivity of tax systems appear rather dim in the near future given that the OECD itself is advocating cuts in employer social security contributions and that governments are facing huge fiscal consolidation challenges, unemployment rates are close to 10% across OECD countries, under-employment rates are at 20% and levels of poverty and social deprivation are rising.

The OECD has paid much attention to tax evasion and tax arbitrage, the need to increase the tax base in the real economy and to the harmful effects of the many tax expenditures. In contrast, and despite recent work, the OECD perhaps has yet to grasp the full implications of the multiple tax exemptions that benefit the financial sector. Tax bases have been shrinking in the past decade because the current tax systems were designed for the real economy (corporate income tax, personal income tax, VAT, property, etc.) and not for the ever growing complexity and size of the financial sector. Across OECD economies, banking and other financial services are usually exempted from VAT. Yet it is these sectors that have experienced the most growth over the past decade, which would have potentially generated the most revenue growth. The tax dimension of derivatives markets has yet to be tackled seriously by regulators. The sign of a rethink on the issue of taxing financial transactions is welcome, but the OECD now has to follow this up with a shift in policy.

⁷⁷ *Employment Outlook, OECD (2009), page 73.*

⁷⁸ “*Taxation and Economic Growth*” - OECD Economic Department paper No.62, July 2008, [http://www.oecd.org/officialdocuments/displaydocumentpdf/?cote=eco/wkp\(2008\)28&doclanguage=en](http://www.oecd.org/officialdocuments/displaydocumentpdf/?cote=eco/wkp(2008)28&doclanguage=en). Tax Policy Reform and Fiscal Consolidation - OECD Policy Brief, December 2010 <http://www.oecd.org/dataoecd/28/12/46600079.pdf>.

Box 7.4. Tax policy reform: trade union agenda

The labour movement considers that taxation should first and foremost serve a social cohesion and revenue redistributive function within society. TUAC considers that the OECD must urgently learn the lessons of the crisis and in particular the importance of addressing inequality, now widely acknowledged to have been a major contributor to the crisis. It must re-focus its tax policy reform agenda to make it a progressive agenda that shifts the focus of tax policy back to distributive justice objectives. In addition, TUAC considers there to be compelling arguments in favour of a financial transaction tax (FTT).⁷⁹

Overall, TUAC is calling on the OECD to:

1. address inequality: ensure a balanced approach to tax reform aimed at growth and reducing inequality – the OECD's reliance on social safety nets to tackle rising inequality is illusory, given its own policies and the post-crisis fiscal consolidation pressures on government;
2. prioritise tax and financial market stability: step up its policy analysis on the links between taxation systems and financial market stability and throw its weight behind the international campaign on the FTT, which is supported by a number of OECD member governments.

Box 7.5. Financial Crisis and Taxes A European Perspective [by Mechthild Schrooten]

The international financial crisis of 2008/9 severely struck the 17 member states of the Eurozone: real GDP crashed down, unemployment increased tremendously, many banks and financial institutions came under pressure. One important reason for the financial crisis is to be found in the overstretching neo-classical economics. In nearly all member states, far-reaching deregulation programs, especially in the financial sector, produced specific market failures, which in turn were responsible for the emergence of the most severe economic crisis since the Great Depression. As such, the international financial crisis and its consequences have renewed the debate about the role of the government, taxes, tax avoidance and tax evasion, as well as about the general responsibilities of the public sector.

For many years, economists and politicians agreed on slimming down the governmental sector and reducing the so called fiscal burden. In times of globalization and of the ongoing European integration, low tax rates for enterprises were considered as a means for gaining comparative advantage⁸⁰ in the European Union the national government has the authority to regulate taxation – especially direct taxation. Thus, in the Eurozone many countries decided on large tax cuts so as to become attractive to foreign investors. The legal framework of the EU supported a cutthroat competition among member states, as the case of Ireland shows - before the crisis, Ireland was a tax haven for international investors and financial intermediaries; today the country is confronted with tremendous financial and fiscal problems because the state had to bail out many banks and to counteract the crisis in the real economic sphere. .../.

⁷⁹ "The Parameters of a Financial Transaction Tax and the OECD Global Public Good Resource Gap, 2010 – 2020", TUAC Policy Paper, February 2010, http://www.tuac.org/en/public/e-docs/00/00/06/7C/document_doc.phtml.

⁸⁰ Tax policy has far reaching consequences for international investment decisions. About one third of foreign profits reported by U.S. corporations 2003 came from just three small countries (The Netherlands, Ireland and Bermuda). Cited from Faulhaber, Lilian V (2009): *Sovereignty, Integration, and Tax Avoidance in the European Union: Striking the Proper Balance*. Available at <http://www.law.harvard.edu/faculty/faculty-workshops/new-folder/faulhaber.pdf> (last visit 24 June 2011)

During the last decade, tax cuts resulted in pressure on public finances all over the world. Often, governments ran into fiscal deficits. During the same period, the reported governmental deficits were often used as arguments for sizing down the public sectors as whole. In the case of Europe, this was accompanied by institutional changes on the supra-national level: the European Court of Justice (ECJ) limited the ability of single member states to police tax avoidance (Faulhaber 2009). Thus, fiscal weakening was a basic tenet of European policy.

However, in a time of crisis, it became clear that the provision of public goods and governmental intervention programs were crucial for the survival of the system. As know from development economics, public services and infrastructure are key factors for economic development, growth, stability and sustainability. When studying fiscal policies, it is important to distinguish between different types of governmental revenues. Typically, taxes are levied from regular payments and official economic activities, whereas the shadow economy is free from taxes. Basically, within the EU, each national government has authority over fiscal policy and tax regulation, while only those outside the Eurozone have influence on their national currencies. The 17 members of the Eurozone do not have such separate influence as they must act collectively on currency matters.

Extraordinary strong regulation of economic activities might provide incentives to act on the shadow economy. At the same time, weak regulation makes speculative attacks against the monetary system more likely, and this is precisely the dilemma currently facing the members of the Eurozone.



CHAPTER 8

STRATEGIES FOR CHANGE

by David Robinson

The chapter summarizes key attempts to challenge transfer pricing and other avoidance strategies. While Chapter 6 focuses on policy options and current proposal for corporate tax reform within the U.S. and Chapter 7 on the OECD, this chapter provides a final critical overview of the various international efforts. The section also highlights the trade union perspective on possible strategies for change, i.e. the need for a new compact: fair and reasonable taxation paid into public revenues by MNCs for the provision of effective quality public services in all communities.

8.1. Regulating Transfer Pricing

As described previously, transfer pricing refers to the price that a company charges a related affiliate or branch for a product, service, loan or the use of intangibles such as intellectual property rights or royalties. It is therefore a normal and routine business practice for multinational corporations and conglomerates. In many cases, however, multinational companies take advantage of intra-firm transactions to reduce or shift income and profits from a high- to a low-tax jurisdiction, thereby avoiding tax bills (Box 8.1). Companies can do this by artificially inflating the costs of products or services they charge a branch, subsidiary, division or affiliate located in a state with lower taxes (Box 8.2).

Box 8.1. Busted in China: FDI and Vanishing Profits

The rapid expansion of the Chinese economy in recent years has attracted huge inflows of foreign capital and investment. In 1980, total FDI was just US\$57 million, but had reached US\$35.8 billion by 1995 and rose to US\$ 92.4 billion in 2008. At the same time, however, more than half of all foreign corporations operating in China have reported net operating losses and paid no taxes. Under normal business conditions, the inability to make a profit should have prompted a mass exodus from China. In fact, many companies are simply using transfer pricing to avoid paying taxes in China. A survey by the National Bureau of Statistics found that nearly two-thirds of those companies claiming to be losing money had artificially inflated their losses through transfer pricing. In one year alone, according to the study, transfer pricing resulted in a loss to the Chinese treasury of \$US4.39 billion in taxes. China is not the only developing or emerging country to suffer from transfer pricing. The United Nations Conference on Trade and Development reports that 84% of developing countries estimate foreign-based companies are shifting income to parent companies to avoid tax liabilities.

Sources: P. Sikha and H. Willmott, "The dark side of transfer pricing: Its role in tax avoidance and wealth retentiveness." *Critical Perspectives on Accounting*. No. 21 (2010), pp. 342-356. United Nations Conference on Trade and Development, *Transfer Pricing* (Geneva and New York: 1999), p. 31

Box 8.2. How much is that bucket in the window ?

In a study of U.S. customs data, Pak and Zdanowicz found some unusually high prices for some imported items and extraordinarily under-valued exports. These included plastic buckets from the Czech Republic priced at \$972.98 each. As high as that was, it was almost a bargain compared to a \$8,500 ballpoint pen from Trinidad or a \$3,500 smoke detector from Germany.

Meanwhile, there were bargain basement prices to be had for exported goods. Fork-lifts destined for Jamaica were sold at the low price of \$384.14 each, while missile and rocket launchers to Israel were available at just \$52.03 apiece.

Source: S.J. Pak and J. S. Zdanowicz. "An estimate of 2001 lost U.S. federal income tax revenues due to over-invoiced imports and under-invoiced exports." Working Paper. Penn State University, 2002

Concerns about the use of transfer pricing to avoid tax payments are not new, and stretch as far back as the late 19th Century. In the United States, the first legal disputes over how corporations were using related entities to manipulate transaction prices emerged in 1836.⁸¹ By the 1920s, growing concerns over transfer pricing prompted the U.S. Congress to enact a series of laws intended to prevent companies from artificially shifting income to other firms they controlled. This culminated in the passage of the Revenue Act of 1928 which included provisions to ensure that intra-firm transactions were conducted as if different entities of the same company were at arm's length from each other. This "arm's length principle" was incorporated into the first tax treaty the U.S. signed with France in 1932 and would subsequently become the international norm to regulate transfer pricing.⁸²

Internationally, the League of Nations took up the case of transfer pricing in 1933, commissioning a report on how it was being dealt with by various governments around the world and to consider the international dimensions of the problem. Later in the same year, the League adopted the first international model treaty on transfer pricing, the Draft Convention Adopted for the Allocation of Business Income for the Purposes of Taxation.⁸³ The Convention provided that the profits of a firm could only be taxed in another jurisdiction if it had a "permanent establishment" in another state. In such cases, the profits subject to taxation would be determined by the "prices or remunerations entered in the books at the value which would prevail between independent persons dealing at arm's length."⁸⁴

⁸¹ See *Delamter Est.*, 1 Whart. 362 (Pa. 1836).

⁸² M. Oates and J. O'Brien, "The Arm's-Length Standard: Why it matters," *International Tax Journal* (July-August, 2009), pp. 12-13.

⁸³ M.B. Carroll, "Allocation of Business Income: The Draft Convention of the League of Nations," *Columbia Law Review*, Vol. 34, No. 3 (Mar., 1934), pp. 473-498.

⁸⁴ Cited in C.J. Taylor, "Twilight of the Neanderthals, or are bilateral double taxation treaty networks sustainable?" *Melbourne University Law Review*, vol, 34 (2010), p. 286.



As a consequence of these early developments, most industrialized countries have adopted some version of the “arm’s-length principle” to regulate transfer pricing. It is the standard set out in U.S. Internal Revenue Code of 1986 (and subsequent amendments), the OECD Guidelines for transfer pricing, most bilateral tax treaties, and in the model treaties issued by the United Nations. The arm’s-length principle is perhaps most definitively defined in Article 9, paragraph 1 of the OECD Model Tax Convention:

“[When] conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.”

The arm’s-length principle is based on the standard that a transaction between related entities should be priced at a similar level as a comparable transaction between independent entities. In its simplest form, the arm’s-length principle implies that if Company A sells widgets to independent Company B at a price of X per unit, Company A should charge roughly the same X per unit price for any widgets sold to a branch, subsidiary or other related unit. If an internal transaction is not valued at what Company A would have charged Company B, then tax authorities may determine that Company A has engaged in tax-avoidance pricing practices.

Tax authorities generally employ two main methods when applying the arm’s-length principle: transactional methods and profits-based methods. The former are the most widely used and have a number of variations, but are generally based on comparing the price of an intra-firm transaction to prevailing market prices, often adjusting for other costs associated with a purchase (e.g. customs duties) and sometimes allowing for a reasonable cost mark-up. Profits-based methods, by contrast, focus not on the costs of an internal transaction but rather the profits obtained. The profit is then compared to what would normally have been achieved in the same or comparable transaction with an independent company.⁸⁵

Despite the widespread use of the arm’s-length principle to limit tax avoidance through transfer pricing, a growing number of critics have pointed to a number of limitations. Transactional methods to assess pricing were developed when global trade and intra-firm transactions were dominated primarily by visible exchanges of physical products – either raw materials or manufactured goods. In today’s global economy, however, the trade in services and in less visible and intangible items such as intellectual property (IP) is becoming more prominent. Multinational companies may use these transactions in intangibles to transfer income from high-tax to low-tax jurisdictions. For instance, a multinational enterprise may attribute research and development

⁸⁵ See *United Nations Conference on Trade and Development, Transfer Pricing (Geneva and New York: 1999)*, pp. 8-11.

costs to a higher-tax country which then reduces its net revenues in that jurisdiction for tax purposes. Subsequently, the company's branch in a lower-tax jurisdiction may also impose royalty fees on a parent or affiliated company in the higher-tax country.

Transactional methods cannot adequately deal with this form of transfer pricing. For the arm's length principle to apply, comparability is essential in order for tax authorities to determine whether a price or a profit is reasonable and reliable. However, finding comparable pricing for royalty fees or IP licences, for example, is often difficult if not impossible. A patent, design or trademark is normally unique and its value largely subjective.⁸⁶ This opens up giant loopholes for knowledge-based enterprise such as pharmaceutical corporations and high tech industries to use intangible transactions to shift income and avoid taxes (see Box 8.3).

Box 8.3. The Luck of the Irish or Tax Shenanigans ?

The difficulty in determining a comparable price for transactions in knowledge-based industries has led to flagrant tax avoidance in recent years. Between 2007 and 2009, Pfizer Inc. reported a net loss of US\$ 5.2 billion in the United States where its corporate headquarters are located. Over the same period, Pfizer's Irish subsidiary reported a pre-tax profit of \$US 20.4 billion.

Meanwhile, Oracle's Irish branch, which had no recorded employees, paid zero income taxes while mysteriously generating one quarter of the company's global profit.

Not to be out done, Google Inc. has legally evaded an estimated \$US 3.1 billion in taxes by shifting income through offshore subsidiaries, including Google Ireland Limited.

Source: R. Wu, "Transfer Pricing: Current Problems and Solutions," CMC Senior Theses (2010), Paper 87

A related flaw in the arm's-length system is that it ignores the reality of the modern multinational enterprise. Under the prevailing approach, tax authorities base their assessment of an intra-firm transaction on the principle that it can be compared with the same transaction between independent firms. However, the relationship and activities between entities within the same corporate structure are in many ways structurally different than between independent firms. Multinational enterprises have arisen precisely because there are some transactions that either do not occur or do not occur in an economically efficient way between independent firms. As a result of organizational advantages, companies that are integrated across borders are able to generate additional profit over what would occur between unaffiliated firms. As a result, it is difficult if not impossible to find a relevant comparator for many transactions within a multinational entity. Within an increasingly integrated economy, it is exceedingly difficult to try to attribute revenues and profits to national markets.⁸⁷

⁸⁷ Michael Durst, "It's not just academic: the OECD should re-evaluate transfer pricing laws," *Tax Analysts* (January 18, 2010).



8.2. Formulary Apportionment⁸⁸

In practice, the arm's length principle has proven to be very hard to implement and it has permitted ongoing abuse of transfer pricing by multinational enterprises. This has led some economists and policymakers to propose a different approach to taxing international corporate income and limiting tax avoidance. They advocate a "formulary apportionment" system, sometimes referred to as "unitary taxation".⁸⁹ This would involve calculating a multinational company's domestic tax obligations as a fraction of its worldwide income equal to the share of certain factors (such as sales, employment, assets) within that jurisdiction. Most proposals for formulary apportionment suggest that sales revenues would be the most relevant and simplest factor to apply. In this case, for example, if Acme Inc. earns worldwide net revenues of \$US 1 billion, and sells 25% of its products or services in Country A, it would pay taxes to Country A based on net revenues of \$US 250 million.

As highlighted previously in this report, the benefit of such a system is that the method for assessing taxes is worldwide. This would, supporters argue, reflect the truly globally-integrated nature of modern businesses. Moreover, under formulary apportionment based on sales, firms would have no incentive to artificially shift income to lower-tax jurisdictions, because their tax liabilities would be assessed based on total income and the share of sales in each jurisdiction. Proponents say this would be simpler to administer and determine compared with the methods used under the arm's-length principle.⁹⁰

Formulary apportionment, however, has been widely criticized and resisted. The OECD, for example, investigated the merits of formulary apportionment and concluded that it would not be a better replacement for the arm's-length principle. According to the OECD, it is an arbitrary and unrealistic method of assessing tax liabilities.⁹¹

Critics say that basing corporate income tax liability on the share of sales (or other factors) in a particular country is arbitrary. It does not reflect the specific profit or loss of each entity. For example, a profitable multinational may incur a loss in a particular territory, but will nevertheless have taxable profit apportioned to that territory. Similarly, a multinational group which has an overall total net loss but which makes profits in a particular territory will be apportioned no taxable profits in that territory.

However, it is not clear that formulary apportionment is any less arbitrary than the current arm's-length principle. As shown above, with the difficulty of applying arm's-length standards

⁸⁸ See Chapter 6 and, particularly, paragraph 6.2.3, explaining formulary apportionment in details

⁸⁹ Formulary apportionment has been little used in practice, although the U.S. states and Canadian provinces use it to allocate corporate tax revenues amongst themselves. The European Union is also studying the feasibility of such a system.

⁹⁰ K.A. Clausing and R.S. Avi-Yonah, *Reforming Corporate Taxation in a Global Economy: A proposal to adopt formulary apportionment* (Washington: The Brookings Institution, 2007)

⁹¹ John Neighbour, "Transfer pricing: keeping it at arm's-length," *OECD Observer* (230), January 2002

to intangibles it has become possible for multinational companies to shift income arbitrarily and to pay no taxes at all. As one observer notes with respect to the current arm's-length principle:

The underlying problem is that the national tax authorities are trying to place an exact figure on a concept that does not exist, namely the "true" profit that arises in each national taxing jurisdiction. In the real world, the profit allocated to each country by a multinational enterprise commonly is an artefact of whose size is determined largely by precedent and the debating skills of lawyers and accountants.⁹²

Under formulary apportionment, there would at least be a consistent method to assigning profits to a particular jurisdiction based upon the worldwide performance of a multinational enterprise.

This would require, nevertheless, that most if not all countries adopt the same approach. In the absence of this, firms would be potentially subjected to double taxation – taxed on the arm's-length principle in some jurisdictions, and taxed again on the basis of formulary apportionment in others. For this reason, an international agreement would likely have to be reached.

The OECD suggests such an agreement is unrealistic, but this is more a reflection of the current lack of political will and leadership, rather than a fundamental flaw in approach. Formulary apportionment is used successfully at the sub-national level among the states and provinces in the United States and Canada respectively. As the global economy becomes increasingly integrated, it is imperative that nations better coordinate their tax collection efforts in order to ensure a fair, transparent and enforceable corporate tax regime:

A fundamental tension underlying the whole international tax system is that MNEs operate on a global basis, whereas tax authorities operate on a national basis. The reality of the contemporary world is that separate national governments are not in a position to adequately monitor intra-firm transactions. When tax administrators everywhere do their best to get a "fair" share from an MNE's global income, the absence of effective international coordination is bound to give rise to over-taxation or under-taxation of the MNE's income.⁹³

Despite its limitations, therefore, a shift toward formulary apportionment, with the appropriate international leadership and coordination, holds much promise. It would remove many of the complexities and loopholes in the current system. It could not only limit tax avoidance through transfer pricing, but also could remove the attraction of tax havens by allocating taxable profits to locations where substantive business activities occur. Such a system would therefore significantly increase corporate tax revenues.

⁹² R. Vernon, *In the Hurricane's Eye: The Troubled Prospects of Multinational Enterprises*, (Cambridge, MA: Harvard University Press, 1998), pp. 40-41.

⁹³ Jinyan Li, *International Taxation in the Age of Electronic Commerce: A Comparative Study* (Toronto: Canadian Tax Foundation, 2003), p. 556.



8.3. Unions' perspective

The 2008 worldwide financial crisis followed by the all out assault on the livelihoods and rights of working people presents international trade unions with the opportunity to aggressively seek a re-balancing of the social compact. Increasingly globalized corporations are eschewing their social responsibility to contribute their fair share of taxes, resulting in significant loss of revenues to support public goods and services.

Tax avoidance schemes such as these, detailed in earlier chapters of this report, while mostly legal, shift the burden of taxation from the largest corporations to individuals and small and medium sized businesses. In the United States alone, high tech and pharmaceutical companies have parked \$1.5 trillion offshore in 2011 in order to avoid paying US corporate taxes (Kocieniewski, David, "Companies Push For A Tax Break On Foreign Cash," NY Times, June 20, 2011). The businesses are lobbying U.S. Congress for a tax holiday, which would allow them to repatriate the profits, and pay just a fraction of the US taxes they owe.

Box 8.4. General Electric: What value to Americans?

General Electric's relationship to the U.S. tax collection system has a long history, which dates back in the 80s at the time of the Reagan administration, when President Reagan's administration discovered the loopholes of the company in tax payments and required it to pay a far higher effective rate (32.5%) than what G.E. used to pay. In the late 1990s, G.E. and other financial services firms won a change in tax law that would allow multinationals to avoid taxes on some kinds of banking and insurance income. The change meant that if G.E. financed the sale of a jet engine or generator in Ireland, for instance, the company would no longer have to pay U.S. tax on the interest income as long as the profit remained offshore. This tax break allowed G.E. to avoid taxes on lending income from abroad, and permitted the company to amass tax credits. As the company expanded abroad, the portion of its profit booked in low-tax countries like Ireland and Singapore grew very fast up to now. As a result of this ever growing expansion, over the last three years, 46% of the company's revenue was in the U.S., but just 18% of its profit.

G.E. claims that the disparity between U.S. revenue and U.S. profit is the result of ordinary business factors, while saying that the nation's workers benefit when the company profits overseas, as winning in markets outside the U.S. increases U.S. exports and jobs. It is undisputable that G.E. spends heavily on lobbying and tax minimization. In 2004, the company succeeded in being involved in the rewriting of a portion of the corporate tax code, which was signed into law as the American Jobs Creation Act by President George W. Bush, containing more than \$13 billion a year in tax breaks for corporations, many very beneficial to G.E. According to its 2007 regulatory filing, the company saved more than \$1 billion in U.S. taxes because of this law in the three years after it was enacted.

.../.

While G.E.'s declining tax rates have bolstered profit and helped the company continue paying dividends to shareholders during the economic downturn, some tax experts question what taxpayers are getting in return. Since 2005, the company has eliminated a fifth of its work force in the United States while increasing overseas employment. In that time, G.E.'s accumulated offshore profit have risen to \$92 billion from \$15 billion. As many tax experts claim, though, the U.S. tax system should encourage job creation and investment in America and end the tax incentives for exporting jobs and dodging responsibility for the cost of securing the country. As the Obama administration and leaders in Congress consider proposals to revamp the corporate tax code, G.E. is well prepared to defend its interests anyway.

Source: "How the biggest U.S. company beats the taxman", NY Times, 26 March 2011

International unions must challenge the lack of enforcement of existing rules and the lack of transparency that easily allow companies to shift profits to low tax havens. It is critical that as global trade unions, we demand that companies respect and follow an international framework governing the taxation of multinationals, rather than accepting policies that allow companies to pit country versus country, workplace versus workplace.

However, our unions should not expect that successfully fighting for funding for education and public services is sufficient. In education we need to provide a clear direction for what we expect children in our education system to learn and accomplish, then fund and build structures to make that happen. Similarly, in the fight for public goods and services, our unions must be engaged at every level to insure that our public resources are deployed and delivered in a smart and effective manner, using the lens of four key criteria: Quality, Equity, Shared Accountability and Collaboration.

Quality public goods and services rely at the core on human resources, well prepared and supported in their work. Equity is not simply equal shares of public resources but providing the resources that insure opportunity for all. Shared Accountability acknowledges that no one institution or sector can be singled out for blame and respects that the best outcomes result when we are mutually accountable. Collaboration requires a common process and the trust that enables it to work.

Consider the opportunities for us to find ways for collaborative initiatives that enable a partnership between business and government to advantage each party while adding value to both. Some consideration for in-lieu services could become a form of revenue enhancement that would take advantage of the size of multi-nationals purchasing power and match it with the needs of government. Discounts enabled in joint-purchasing and development serve the same purpose as tax revenues to a point, and some consideration of an entrepreneurial effort on the part of the partnership could generate real gains.



Equity consideration of shared development costs is another area that could be substituted for a portion of taxes that are currently avoided. A transparent fiscal environment that enabled governments to clearly see the pricing and profit potential of a joint venture could provide incentives to both government and business to increase production and profit while potentially growing the resources for both entities.

Without transparency and collaboration these kinds of initiatives fall by the way, and opportunities for nations to leverage their development of infrastructure in ways that enhances the GDP of the nation. We can see gains through more productive business ventures that pay a fair and reasonable amount in return for the benefits to the corporate balance sheet gained by the state's investments in roads, telecommunications, housing, and water systems. More importantly, the greatest potential contributor to future national and international growth, the citizens of the nation, will see improved opportunity for their personal development when partners in government and commerce find common national ground.

As we think about demands for changes in the way that MNCs conduct their business, we should invite them to invest in the nations in which they do business. We have found a multi-trillion dollar need in the United States for economic and social infrastructure over the next five years to meet critical infrastructure needs. We have suggested that our nation's public pension plans explore pledging a portion of their assets, in a prudent manner, to create a national pool of resources to help finance the rehabilitation and new construction of the nation's infrastructure assets. These investments should be undertaken at the risk-adjusted market rate of return. Examples could include a smart electric grid, expanded access to high-speed and wireless communications, high-speed rail and clean energy sources.

A collaborative effort with an equity interest included would be one way to engage multinational corporations in preserving and improving the host nation's infrastructure, and could be a consideration on taxes owed, favouring those who step up and stand with governments to make these needed improvements that can benefit all.

As we go forward we need to be focused on the immense capital that changes hands within multinational corporations, and find ways that enhance both the interest of the nations in which they operate and provide a way for the corporations to mutually benefit. It is not acceptable for these companies to accumulate capital and use it as leverage to avoid taxation, playing one nation against another in a race to the bottom. We need to find ways to propel all paying their fair share, in becoming transparent, and in sharing their size and resources to help nations meet their needs and their citizens to find meaningful and gainful employment.

8.4. Conclusion

Finding effective and fair ways of taxing multinational companies is a necessary but complex challenge. Trade unions and non-governmental organizations have an important role to play in this by pressing for badly needed reforms to tax policy and practice so that loopholes can be closed and tax avoidance limited.

Many measures need to be taken to ensure that corporations and their stockholders pay their fair share of tax on their worldwide profits. An important first step would be to make the tax returns of corporations more transparent so that the public could see precisely how much tax firms were paying - or alternatively not paying. In this respect, agreement is needed at the international level to define and implement minimum standards of financial transparency and disclosure. This should include greater scrutiny of intra-firm trading and the location of revenues and profits.

Beyond this, more robust tax rules are needed to deal with the problem of transfer pricing, tax arbitrage and other avoidance strategies. It is painfully clear that the current international tax regime has failed. Attempts to regulate transfer pricing, either through bilateral tax treaties or the OECD Guidelines, have fallen well short of their goals, largely because they are built on faulty or outdated assumptions. There remain large loopholes that corporations can manipulate to their advantage.

The arm's-length principle for assessing tax liabilities may have worked in the days when multinational companies were structured more clearly and when intra-firm transactions were dominated by finished goods. However, as multinationals evolve into far more complex organisms, and intra-firm transactions are dominated by intangibles, it has become increasingly difficult to apply the old rules. Formulary apportionment, although not without its limitations, does seem to offer a positive step toward a simpler and fairer corporate tax regime.



CONCLUSIONS by Bob Harris

Here are some conclusions drawn from the chapters:

- Tax arbitrage from global corporations clearly results in reduced tax revenues for all jurisdictions involved. Beyond this, however, there is also a general economic cost. Tax arbitrage can distort economic decision-making by firms and encourage international transactions that are tax favourable but not necessarily economically efficient.
- Tax-induced distortions to international financial decisions are often referred to as “income shifting” or “transfer pricing”. Multinational firms frequently rate transfer-pricing as their most important tax concern, and governments often engage in lengthy and costly transfer-pricing disputes.
- A fundamental tension underlying the whole international tax system is that global corporations operate on a global basis, whereas tax authorities operate on a national basis. The reality of the contemporary world is that separate national governments are not in a position to adequately monitor intra-firm transactions. When tax administrators everywhere do their best to get a “fair” share from the global income of a Multinational Enterprise (MNE), the absence of effective international coordination is bound to give rise to under-taxation (or sometimes over-taxation) of the MNE’s income in a given jurisdiction.
- Countries presently employ tax systems that are based on *separate accounting*: multinational firms keep track of income and expenses separately in each country in which they operate. *Formulary apportionment* differs from separate accounting in that global income would be allocated by formula to tax jurisdictions. While formulary apportionment is presently used in several sub-national contexts (in U.S. states, Canadian provinces, and German Lander,) and a similar approach is under consideration in the European Union, it is not presently used for allocating international taxable income.
- Corporations use public services provided by the state. They benefit from a state’s transportation infrastructure—the roads, railways, airports, and harbours used to receive materials and to move products to market. Corporations also benefit from public safety operations, including police, fire, and medical emergency services. The state judicial system protects their contractual, intellectual property, and other legal rights. Corporations also depend on the public school systems to produce an educated workforce — an especially important role in the information society of the 21st Century. High-quality school systems also help attract qualified employees.

- Corporate tax itself is not inherently distortionary. In this context, several points should be recalled. First, corporate tax has an important backstop function for individual income tax, particularly in an environment where dividends and capital gains are tax preferred. Second, investments financed by debt with generous depreciation rules may actually receive a net subsidy from the corporate tax. Third, part of the corporate tax is a tax on pure economic rents rather than corporate capital per se.
- Political debate over statutory corporate tax rates may not address major issues which underpin the tax minimization and avoidance industries. Reduction in statutory corporate tax rates could actually improve compliance if combine with broadening of the tax base.
- Tax bases have been shrinking in the past decade because the current tax systems were designed for the real economy (corporate income tax, personal income tax, VAT, property, etc.) and not for the ever growing complexity and size of the financial sector. Across OECD economies, banking and other financial services are usually exempted from VAT. Yet it is these sectors that have experienced the most growth over the past decade, which would have potentially generated the most revenue growth. Moreover, the tax dimension of derivatives markets has yet to be tackled seriously by regulators.
- The phenomenal growth in debt securitisation by global banks in the run up to the 2008 crisis, went far beyond the mere theoretical justification of “spreading” credit default risks across markets and asset classes. The real motivation was tax evasion. In sum, when tax systems are not calibrated to the size of the financial sector, they can artificially reduce the cost of financing of transactions and investments that otherwise would not be viable, which in turn can lead to mispricing of assets and hence of risks... as happened in 2008.
- The combination of Offshore Financial Centres (OFCs), financial ‘innovation’ leading to poorly regulated investment vehicles and products – derivatives, hedge funds – and the tax bias toward debt has accelerated tax arbitrage and tax evasion strategies worldwide. MNEs have ample opportunity to practice “double-dip” strategies whereby the interest payments on a single debt are deducted twice from the company’s accounting in two separate jurisdictions.
- The OECD MNE Guidelines, recently updated and approved by the OECD’s 2011 Ministerial Council, recommend that corporate boards takes more active roles in assessing tax risks. They require MNEs to “*treat tax governance and tax compliance as important elements of their oversight and broader*



risk management systems” stating that “corporate boards should adopt tax risks management strategies to ensure that the financial, regulatory and reputational risks associated with taxation are fully identified and evaluated”. The commentaries to the Guidelines provide further guidance on the need to put in place internal tax control systems and to inform corporate boards about all potentially material tax risks.

Time for a paradigm shift

This study shows that it is time for a paradigm shift. The time has come for democratic societies, and the global corporations themselves, to rethink the relationship between major economic actors – particularly the global corporations - and communities.

During some three decades, the prevailing paradigm legitimized the notion that tax minimization and avoidance was 'okay'. It was and still is considered a good thing to do. It is often a principal focus of corporate leadership, and the thinking that this activity is legitimate permeates these great corporations to the middle management levels, and across their vast worldwide operations. An entire industry of accountants and lawyers maintains the paradigm.

This study comes to a very simple conclusion:

global corporations should pay fair and reasonable taxes to ensure quality public services and our collective future economic prosperity.

Simple and straightforward as this proposition may be, it inevitably provokes fierce opposition. Corporate leadership backed by the tax avoidance industry of accountant and lawyers, further backed by bankers and lobbyists, generally oppose proposals that would increase taxes paid by corporations. They are capable of marshalling an array of arguments to maintain the prevailing approach to taxes. Perversely, they often succeed in conveying a sense of moral outrage at the thought that any more taxation should be paid. Their success in rallying support through the media and broader public opinion has been striking. Their impact on political processes in democracies has been highly effective.

It is unlikely that a spirit of “business as usual”, or “politics as usual”, will significantly change things. That is why a paradigm shift is necessary.

Our conclusions suggest some of the conceptual underpinnings for such a paradigm shift, and propose the basis for some practical strategies for change.

A key conceptual issue is that the prevailing system is fundamentally out of balance.⁹⁴ Inequities that existed at the national level are greatly exacerbated at the global level. Global corporations can generate massive revenues from supply lines and markets stretching across the planet, yet use that same global reach to avoid contributing resources for the well-being of the communities where they operate. Little attention is paid to the impact of this imbalance. Yet it is real, and the disequilibrium is becoming more accentuated.

History shows that such disequilibrium cannot continue indefinitely. Sooner or later, something gives. Historical examples of systemic failure abound. The end of the Soviet Union and the centrally planned economies dominated by privileged elites was a classic recent example, one that coincided with the rise of the Thatcher/Reagan advocacy for small government and low taxation in the market economies. The lesson drawn and often expounded by the advocates for that line of thinking was that the role of government should be reduced to the minimum, and that market forces left untrammelled would work for the greater good. Yet a quite different lesson might be drawn from the collapse of centrally planned economic systems at the end of the 1980s. That lesson is that any system dominated by elites for their own benefit, and therefore based upon growing inequity, will ultimately over-reach and fail. **That** is the real risk which underlies the current imbalance in the global economic system.

The same lesson can be drawn from the fall of dictatorships. For long periods, dictatorships may seem to be impregnable. But sooner or later, the oppressed find a way to rise up and overthrow them. The Arab Spring of 2011 is the contemporary example. The historian, Barbara Tuchmann, described the common threads running through the collapse of political and economic systems. In "The March of Folly"⁹⁵ Tuchmann cited the example of the American Revolution, yes, the revolution that was sparked by an uprising against unjust taxes! Tuchmann's analysis did not dwell on the unjust taxation issue as such – that was taken as a given. Rather, she emphasized that the potential for overthrow of an unjust system emerges when those who dominate the system assume that they can carry on with "business as usual", when hubris prevails over reason. Through this and other historical examples, she points out that, invariably, there are warnings that are ignored. So it was in the recent global economic crisis of 2008. There were abundant warnings, from scholars based on analysis, but also from the trade union movement based on the reality confronting their memberships. These warnings stated clearly that the boom carried the seeds of bust. Yet the warnings were ignored.

⁹⁴ See Ron Blackwell (2009) *The Economic Crisis: "How Did We Get Here?"*, AFL-CIO, for a discussion of imbalances in the global economy .

⁹⁵ Barbara Tuchmann *The March of Folly*, Random House, 1984



**Systems that get too far out of balance ultimately fail.
Nobody knows when or how, but invariably they do.**

The rational response to systemic imbalances is to put measures in place to redress those imbalances. This is the conceptual basis for a paradigm shift which would change the current legitimacy of the tax minimization and avoidance industry.

It is worth considering for a moment the emotional arguments which generally underpin the no-tax industry. There is the notion that all taxation is by definition unjust - a notion that tends to drive the current "tea-party" movement in the United States and the rejection of all proposals to raise taxation in any form. As indicated above, the real lesson of the Boston tea-party was not that taxation was inherently unjust in itself, but that taxation without representation was wrong. Tea-party extremists would do well to revisit their American history!

Allied to this notion, and astutely played politically by the Thatcher/Reagan movement, is the notion that government is by nature inefficient, that the private sector can do a better job in providing services to communities. Hence the no-tax increase movement is accompanied by a drive to reduce public budgets. Combined, these two notions – of minimal taxation and small government – lead to very significant imbalances in societies. When extrapolated to the global level, those imbalances become so much greater. They account fundamentally for failure to mobilize the resources needed to achieve such relatively modest targets as those set by the international community as the Millennium Development Goals for the year 2015. As a recent study by a World Bank research economist points out, inequity becomes systemically threatening.⁹⁶

**A paradigm shift on taxation would replace the minimal tax/minimal government approach with one based on a new compact.
That compact would consist essentially of recognition of the legitimacy and necessity for fair and reasonable taxation on the one hand, and the provision of quality public services, efficient and ethical public services, on the other.**

Both sides of this compact require the democratic participation of citizens – for the determination of fair and reasonable rates and procedures for taxation, and for public services that are genuinely responsive to citizens. Democratic societies are held together by shared values that set the parameters for robust debate and political contest. Values of justice, fairness and equity must be incorporated in these parameters and be part of the debate. The re-affirmation of such values is an essential element of the process of paradigm shift. Those values should become once again the reference point for democratic debate, rather than the legitimisation of no tax/small government as a slogan based on misplaced feelings of entitlement, embedded as they are in the protection of special interests.

⁹⁶ Branko Milanovic, *The Haves and the Have Nots: A Brief and Idiosyncratic History of Global Inequality*, Basic Books, January 2011

In the course of political debate, it is all too facile to rebut a rational case for rebalancing the system with extravagant rhetoric – to label fair taxation on wealthier individuals as “class warfare”, for example. The debate on corporate tax has also tended to take on such overtones, and to label any proposal that challenges the current paradigm as being “anti-business”. The fact of the matter is that perpetuation and accentuation of the current imbalances places at risk the systemic survival of business as we know it. The proposal to move to a new paradigm of fair and reasonable taxation allied with a new compact for quality public services in all communities is not a threat to business nor to the principles of market economy. The threat actually comes from within – from the imbalances in the present system.

Corporations have to be part of this new, more balanced paradigm, and global corporations should lead the way.

This study has evoked some of the arguments often advanced against taxation of enterprises. One of these is that shareholders may be taxed twice, once through taxation on the profits shown on company balance sheets, and then again as individuals paying taxes on revenue earned from dividends. The reality is often just the opposite. Taxation regulations on companies can often be manipulated in such a way that the companies minimize their corporate taxes, while shareholders minimize their personal taxes. So this argument is specious, to say the least.

The invalid double-tax argument does however highlight a more real difficulty with corporate taxation, which is the problem of collection. As the report shows, that is the essential problem with taxation of global corporations in today's globalised economy. The array of means available to global corporations for tax minimization and avoidance has been shown in this report to be extensive. A priori, putting an end to just one of these means, abusive transfer-mispricing, would be sufficient to generate the resources needed for quality public services in OECD countries, and for achievement of the Millennium Development Goals in the developing countries.

A first step in the needed paradigm shift would be a global consensus among OECD governments to apply with the necessary rigour the OECD guidelines on transfer pricing, and indeed all the OECD guidelines on corporate taxation and the revised OECD MNCs' guidelines. While such a global consensus with, (why not?), the cooperation of the corporations themselves, would be an important step forward, the underlying dilemma remains the disconnect between global corporations functioning in a global economy, and national jurisdictions each endeavouring to apply their own rules and procedures. It is fairly natural that global economic players will continue to exploit this disconnect in their favour.

So, as both Kim Clausing and David Robinson suggest, it is time to look at a new system which would reflect the reality of global actors in a global economy. They call such a



system “formulary apportionment”, along the lines of procedures already in place in the States of the US, the provinces of Canada and the Länder of Germany (and under consideration within the EU), which simply means that global corporations would pay taxes apportioned to each of the countries in which they operate, according to an internationally agreed formula. That formula might be based on sales or net results. Sounds simple, but the negotiation of an international agreement by a sufficient “critical mass” of governments would be difficult, to say the least. Yet, ultimately, some such system could be perceived by global corporations as being in their own interest, because of the simplicity and clarity it would provide, thereby enabling them to move their focus away from the tax avoidance game and to place it rather on their principal roles in the world economy.

Strategies for change

No paradigm shift will occur easily. Resistance to change will always be great. Change requires anticipation of consequences, and readiness to alter course so as to mitigate those consequences. Historically, some political institutions have succeeded in negotiating change and have survived. But there are probably more examples in history of failure to adapt.

In today’s democracies with market economies, the best hope for paradigm shift lies with the advocacy and mobilization of representative organizations and movements of civil society. Trade unions continue to be among the most significant representative organizations, but must demonstrate more than ever their relevance in the global economies of the 21st century. Allied with civil society, they are among the most potent agents for change. Trade unions and civil society organizations have in recent times developed all-important linkages between global and local action. New technologies help them to do so. They have the capacity to influence public debate and political governance at local, national and global levels.

As we complete this report, we are aware that more needs to be done to quantify the resources that tax minimization and avoidance by global corporation deny to communities around the world. The public has a right to know how much we are talking about, and this is fertile ground for further research. The report presents a case for zooming in on the global corporations as economic players who could, with a shift in the paradigm of tax minimization and avoidance, make a real contribution to better lives for people around the world. To do so would be a mark of real corporate social responsibility. Global corporations should themselves break out of stereotypes that they may not like, but are the direct consequence of the current paradigm. The World Economic Forum and its Global Agenda Councils provide one set of platforms for sensible and forward-looking debate on these issues. Global corporations should engage with global unions and civil society as partners in new thinking, leading to new and serious commitments to build better communities and better lives.

ANNEX 1

ESTIMATING THE REVENUE CONSEQUENCES
OF INCOME SHIFTING BEHAVIOR

by Kim A. Clausing

The following analysis estimates the consequences, in terms of revenue, of income shifting behavior. It comes directly from Clausing (2011), which extends her analysis of 2009. The earlier analysis began by using regression analysis to relate profit rates (gross income to sales ratios) to tax rates, to determine that statistical relationship between tax rate differences and reported profits. The results from the regression are used to estimate how the distribution of profits would differ absent tax rate differences among countries. Then some fraction of the lower foreign profits is attributed to the United States tax base.

The present analysis (Clausing, 2011) begins with a similar method; one difference is that the regression analysis employs a different specification, calculating semi-elasticities between gross profits and tax rate differences between the U.S. and foreign countries. This is in line with much of the prior literature on tax base elasticities, and in fact a similar elasticity is employed as those found in the meta-analyses of de Mooij and Ederveen (2003, 2008) and de Mooij (2005). Also, some of the data have been revised, and the new estimates are based on the full sample.

This tax response elasticity is then used to calculate what profits would be in the countries of operations of U.S. affiliates absent differences in tax rates between foreign countries and the United States. The United States has a statutory tax rate of 35%. In cases of high-tax rate countries with effective tax rates above the U.S. rate (e.g., in 2008, Denmark, Argentina, and Peru), foreign profits would be higher in the counterfactual, but in many cases, foreign profits would be lower. Once these profit adjustments are made, a fraction (32.4% in 2008) of the hypothetically lower foreign profits (on aggregate) are attributed to the U.S. tax base. Of course, this fraction itself is just a plausible benchmark, based on the fraction of intrafirm transactions that occur between affiliates abroad and the parent firm in the United States, relative to all intrafirm transactions that occur with affiliated firms. Thus, in 2008, foreign affiliates of U.S. parent multinational firms undertook 32.4% of their affiliated transactions with the United States; the remaining 67.6% were with other affiliated firms abroad.

Finally, this number is scaled up, under the assumption that foreign multinational firms also engage in income shifting out of the United States. While the data do not allow a separate estimate of their profit shifting behavior, I assume that it would increase the revenue costs of income shifting by approximately 35%. This is based on the ratio

of the sales of majority-owned affiliates of foreign based multinational firms in the United States to the sales of U.S. parent multinational firms worldwide. While this is a highly arbitrary scaling, it is also a conservative estimate. Sources of underestimation and overestimation are discussed below.

Table 1 summarizes these estimates, updating my prior analysis to 2008. Column 2 shows the total income earned abroad by foreign affiliates of U.S. firms. Column 3 shows the estimated U.S. tax base increase if income shifting incentives were eliminated. Column 4 shows the reduction in U.S. corporate income tax revenues due to income shifting, assuming that marginal revenues are taxed at the statutory tax rate, 35%.⁹⁷ Column 5 shows actual corporate tax revenues in the corresponding year. Column 6 shows the ratio of reduced revenue to total revenues. Note that the 2004 numbers do not correspond exactly to the numbers from the prior study, due to changes in the regression specification as well as the fact that additional years in the regression analysis affect the estimates.

Table 1. Updated Estimates of Reduced Revenue due to Income Shifting

| Year | 2. Gross Income in Foreign Affiliates (billions) | 3. Estimated Increased U.S. Tax Base without Income Shifting (billions) | 4. Reduction in Revenue due to Income Shifting (billions) | 5. Actual Corporate Tax Revenue (billions) | 6. Ratio of Reduced Revenue to Actual (col.4/5) |
|------|--------------------------------------------------|-------------------------------------------------------------------------|-----------------------------------------------------------|--------------------------------------------|-------------------------------------------------|
| 2004 | 529 | 145 | -\$50.8 | \$189 | 26.9% |
| 2005 | 697 | 177 | -\$62.0 | \$278 | 22.3% |
| 2006 | 781 | 198 | -\$69.2 | \$354 | 19.5% |
| 2007 | 891 | 218 | -\$76.4 | \$370 | 20.6% |
| 2008 | 1,016 | 256 | -\$89.6 | \$304 | 29.5% |

The steady upward trend of estimated revenue is not a reflection of increasing tax responsiveness in terms of the elasticity of the tax base with respect to a given tax rate difference, since that is assumed to be constant over this period. Instead, it is due to two other factors. First, and most important, the total amount of foreign profits is increasing dramatically over recent years. Gross income of all foreign affiliates was \$529 billion in 2004, and it grew steadily to \$1.02 trillion by 2008. Second, the average foreign effective tax rate fell by about one percentage point, also contributing to income shifting incentives.

⁹⁷ The argument for using the statutory rate is that the new profits would be marginal profits and taxed accordingly. However, if one holds that a lower rate is appropriate, one can easily adjust the estimates in kind.

Finally, Table 2 shows an alternative revenue reduction estimate, based on the Bureau of Economic Analysis (BEA) Direct Investment Earnings series. This data series generates smaller estimates, avoids double-counting, but also eliminates some types of income shifting. Column 2 indicates total direct investment earnings abroad over the period 2004-2008; data from the BEA are adjusted to add back in foreign taxes paid and to account for the BEA's adjustment of the data by the US parent equity ownership percentage. Column 3 shows the estimated increase in the U.S. tax base, again employing the methodology as in Table 6. The resulting revenue reduction estimates of Column 4 are lower than those in the prior table; this is due to the combined effects of the elimination of double-counting and the omission of some types of income. Unfortunately, with available data, one cannot separate these two effects

Table 2. Alternative Estimates of Reduced Revenue, Based on Direct Investment Earnings

| Year | 2. Direct Investment Earnings Abroad (billions) | 3. Estimated Increased U.S. Tax Base without Income Shifting (billions) | 4. Reduction in Revenue due to Income Shifting (billions) | 5. Actual Corporate Tax Revenue (billions) | 6. Ratio of Reduced Revenue to Actual (col.4/5) |
|------|-------------------------------------------------|-------------------------------------------------------------------------|-----------------------------------------------------------|--------------------------------------------|-------------------------------------------------|
| 2004 | 440 | 101 | -\$35.5 | \$189 | 18.8% |
| 2005 | 542 | 113 | -\$39.5 | \$278 | 14.2% |
| 2006 | 610 | 128 | -\$44.9 | \$354 | 12.7% |
| 2007 | 693 | 139 | -\$48.8 | \$370 | 13.2% |
| 2008 | 767 | 151 | -\$52.8 | \$304 | 17.4% |

Sources of Uncertainty

There are several assumptions embedded in this analysis; thus, these estimates should be treated as a careful educated guess about the magnitude of income shifting. While the analysis is subject to uncertainty, I have taken care to choose the best plausible assumptions and to avoid sources of bias. Below, I enumerate the sources of uncertainty and discuss their possible effects on the estimates.

1. The analysis begins with a regression of gross profits on effective tax rate differences between the foreign country and the United States. This yields a semi-elasticity of (-) 3.3 for the entire period (1982-2008); this elasticity is consistent with studies reviewed in de Mooij and Ederveen (2003, 2008) and de Mooij (2005). While the elasticity is higher than the median elasticity of reviewed studies, study elasticities have been increasing over time. In the present analysis, the elasticity would be higher if it were estimated on data from only the recent period or if



it were estimated based on foreign tax rates rather than tax rate differences. Also, if I had employed profit to sales ratios (as in Clausing, 2009) instead of gross profit rates, the resulting revenue loss estimates would have been larger.

2. The analysis assumes that, absent income shifting incentives, lower foreign profits would be earned, and a fraction of those profits would be earned instead in the United States. That fraction is calculated each year as the ratio of foreign affiliate sales to parent firms in the United States relative to foreign affiliate sales to both parents and affiliated firms in other countries. In 2008, this fraction is 32.4%; in 2004, this fraction is 37%. There is no particularly good reason to think that exactly 32% of the lower foreign profits would be earned in the United States in 2008. However, when one considers the potential to shift income, one notes that the terms and nature of intrafirm transactions provide the essential method for shifting income. Thus, the assumption here is that income would be shifted across destinations in proportion to these intrafirm transactions.
3. The final estimate is scaled up to account for the income shifting of foreign multinational firms, by about 35% in most years. This is based on the ratio of the sales of majority-owned affiliates of foreign-based multinational firms in the United States to the sales of U.S. parent multinational firms worldwide. This is a highly arbitrary, albeit quite conservative, scaling. An alternative method of scaling would employ the ratio of the sales of majority-owned affiliates of foreign-based multinational firms in the United States to the sales of majority-owned foreign affiliates of U.S. based multinational firms. This would suggest scaling the number up by about 66% instead of about 35%, since U.S. parents have larger sales than foreign affiliates of U.S. parent firms. For example, in 2008, majority owned affiliates of foreign-based multinational firms in the United States had \$3.5 trillion in sales, U.S. parent firms had \$8.7 trillion in sales overall, and majority-owned foreign affiliates of U.S. parents had \$5.2 trillion in sales.
4. There is some double-counting in the BEA foreign income data of Table 1. The data include "income from equity investments", some of which are counted more than once if there are tiers of ownership within the same country. Unfortunately, with existing data, it is not possible to account for this double-counting accurately. Still, one can use an alternative data series, also from the Bureau of Economic Analysis, on direct investment earnings. This data series excludes all income from equity investments.⁹⁸ Unfortunately, this series is also incomplete, since income from investments is left out. Nonetheless, Table 2 reports alternative estimates on the revenue effects of income shifting that are based on this income series.

⁹⁸ In addition to these differences, there are other technical differences between the series that may be important, discussed above in footnote 97.

5. This analysis would not capture methods of tax avoidance that might reduce worldwide taxable income. For example, Mintz and Weichenrieder (2010) demonstrate how indirect financing structures avoid taxation by maximizing interest deductions. For example, conduit affiliated entities operating in low-tax countries can loan money to operating affiliates in third countries, that deduct their interest payments to the conduit affiliates. A second interest deduction can be taken if the parent finances the investment in the conduit affiliate with debt.

In summary, items 1, 3, and 5 suggest that the estimates of Table 1 in Chapter 4 may be underestimates of the true size of the revenue costs of income shifting. Item 2 has no clear direction of bias. Item 4 suggests that the estimates of Table 1 may be an overestimate of the revenue costs of income shifting. However, an alternative estimate is also provided in Table 2 in Chapter 4, using a data series that likely provides an underestimate since it does not include all sources of income.



ANNEX 2

CORPORATE INCOME TAX IN THE U.S.

by David Brunori

This annex brings the example of the United States to show where corporate taxation fits in the overall framework for taxing MNCs, i.e. the rationale for Corporate Income Tax (CIT). The author illustrates the problems with and the solutions for strengthening tax, and how they apply specifically to the case of the US. Finally, he presents three policy changes that could strengthen the tax system, allowing this way states to rescue state corporate income tax from near irrelevancy and to make it a more significant source of income at that level.

Introduction: the situation in the U.S.

Forty-three states in the United States tax corporate net income, including such traditionally anti-income tax jurisdictions as Tennessee, New Hampshire, and Florida. In 2009, corporate tax accounted for about \$40 billion in tax revenue for the states, according to the U.S. Census Bureau.⁹⁹ Only Ohio, South Dakota, Texas, Michigan, Nevada, Washington, and Wyoming do not impose any taxes on corporate income.¹⁰⁰

Corporate income tax is a revenue source that is vastly underutilized by state governments. Under use is a direct result of political decisions that reduce corporate tax burdens. These political decisions have in turn resulted in the corporate income tax being among the most complicated components of state revenue systems. The way the tax is imposed, the legal, economic, and political constraints, and the vast planning opportunities challenge policymakers, tax administrators, and the attorneys and accountants that represent corporations. Those policies make raising revenue from the taxation of corporate profits difficult.

Corporate income taxes make up a surprisingly small portion of state revenues. The relative importance of the state corporate income tax has steadily declined for decades. From its high of about 9.5 percent in 1977, state corporate income tax dropped to about 5 percent of total state tax revenue in 2009. And the tax accounts for less than 2 percent of total state revenue (tax and non-tax revenue).

⁹⁹ All data on corporate income tax revenue are for 2009 and are from the U.S. Census Bureau, "Federal, State, and Local Governments: 2010 State Government Finance Data," <http://www.census.gov/govs/www/state10.html> (accessed May 1, 2011).

¹⁰⁰ Ohio, Washington, Texas, and Michigan impose variants of business activity or gross receipts taxes on corporations

But it is the intentional creation of planning opportunities that have led to the decline in the importance of the tax. Those planning opportunities have also increased both the administrative and compliance costs of the tax. Commentators and scholars have long noted the difference in administrative and compliance costs for the corporate income tax relative to other levies (Brunori 2002; Pomp 1998). The reason for this cost/benefit imbalance is that corporations generally have the resources to take advantage of the available planning opportunities. Corporations are able to employ highly trained and skilled lawyers, accountants, and economists. Maintaining this expertise significantly raises corporations' compliance costs.

The private sector's highly trained, well-paid attorneys and accountants also significantly raise the costs of administering the corporate income tax for the states. To meet the corporate legal/accounting resources, the states must hire, train, and retain equally qualified tax professionals. Although the state corporate income tax raises very little revenue compared with other levies, it consumes a disproportionate amount of planning and litigation resources.

The ability to plan around or otherwise avoid corporate taxes is the single greatest cause of the decline in the tax. Even in states with long traditions of progressive taxation, which would seem most likely to rely on the tax, the revenue gained from corporate taxes is minimal. For example, Oregon, historically one of the most progressive states in terms of taxation, has no sales tax and a history of relatively high personal income taxes. Despite this progressive tradition, the state raised only 3.4 percent of its tax revenue from corporate levies in 2009. Oregon raised more than twice the amount from decidedly regressive excise taxes (\$744 million) than it did from corporate income tax (\$258 million). Montana, another state with a progressive tax history, raised only \$164 million from corporate income taxes in 2009, compared with over \$529 million from excise taxes.

The three states most dependent on corporate income taxes in 2009 were Alaska, New Hampshire, and Delaware; in these states, the tax accounts for 12.7 percent, 23 percent, and 7.4 percent of total state tax revenue, respectively. It should be noted, however, that these three states do not impose state-wide sales tax. Alaska and New Hampshire also do not tax personal income.

Historical Trends of the State Corporate Income Tax in the U.S.

Although U.S. states have imposed taxes on various business activities since the late 1700s, today's corporate net income tax can be traced to Wisconsin's Income Tax Law of 1911. The tax proved successful in progressive Wisconsin, and its success quickly led five other states to adopt the corporate income tax. By 1930, 17 more states had adopted the tax; by 1940, an additional 17 states had begun taxing corporate income.



The relatively rapid spread of state corporate taxation is attributable to several political and economic factors. Progressive and populist political leaders with a sceptical view of corporations controlled many states in the early part of the 20th century. The opportunity to raise revenue from corporations fit naturally with their political philosophies. These same leaders fought successfully to implement progressive personal income taxes at the federal and state levels.

The growth of the corporate tax in the mid-1900s also reflected a developing movement in most states to diversify their tax systems. Throughout the 19th century, state governments financed their operations mainly through excise and some form of property taxes. These financing systems, however, did not raise enough revenue to meet growing public service demands. The early and mid-20th century saw the adoption of personal income taxes as well as sales and use taxes throughout the country. The tax on corporate income was part of the expansion to diversify the overall tax base. These fundamental changes to how states collect revenue have persisted into the start of this century.

Like other levies, the state corporate income tax was developed for a far different economy. The tax was designed at a time when most corporations manufactured tangible personal property. It was also designed to function in an environment in which interstate tax competition was not nearly as intense as it is today. Although that economy no longer dominates, the tax has largely remained the same.¹⁰¹

Why Tax Corporate Income ?

There are several rationales for taxing corporate income. The most obvious, although among the least discussed in academia, is that taxing corporate income has the potential to be a significant revenue source for the states. Apart from the economic or tax policy justifications for the tax, the political reality is that states need revenue and corporate profits can be a source for additional revenue.

There are two aspects to this “political” rationale to taxing corporate income. First, there are inherent limitations on virtually all other taxes (see Brunori 2005 and sources cited therein). There is intense political opposition to personal income tax on the part of state legislators and governors. Despite recent increases in top personal income tax rates in several states, there remains a decided bias against raising additional personal income tax revenue. For most of the past three decades, states have looked to raising personal income taxes as a last resort.

¹⁰¹ *Pomp (1998) points out that the states have been successful at modifying some aspects of how they tax corporate income to reflect the changing economy.*

That bias is unlikely to change. The state sales tax has been under siege for a quarter century. The base of the tax is shrinking as a part of the economy as most states are unable to tax most services, intangibles, or real estate. In addition, the inability to tax remote sales has stymied growth in sales tax revenue. Finally, the other sources of tax revenue, namely excise, license, and severance, are unlikely to grow significantly in the future. As states face continued budget difficulties, there are few viable revenue options available. But there is growth potential in the state corporate income tax.

The second aspect of this political rationale is that it is likely that the public would support higher tax burdens on corporate entities. Efforts to highlight the ineffectiveness of state corporate tax have resulted in movement toward strengthening the tax in the past. Periodically, a study will find that the largest corporations in a particular state pay little or no income taxes. Such reports have usually spurred public and private calls for increasing corporate tax burdens.

For many people, raising corporate income taxes is an attractive alternative to either higher personal income and consumption taxes or significant reductions in public services. Indeed recent polling data shows that the public is generally willing to increase corporate income taxes to fund government services such as education and health care (Public Policy Institute of California 2011; Tulchin Research 2010; and MSEA 2011).

It should be noted that these political rationales are not grounded in traditional tax policy. To be effective, they will need to be asserted through the argument that there are not a lot of options available for raising badly needed additional revenue.

A more progressive, albeit much harder, argument is that corporate income tax is necessary to limit the power of corporations. Indeed, this was among the earliest motivations for supporters of the corporate income tax (Avi-Yonah 2004). This justification for the corporate income tax relies on an emotional understanding of what constitutes fair distribution of liability to the state to meet budget demands, the nature of the liberal democratic state requires that the political, economic and corporate power of corporations should not go unchecked by a lack of allocation of that liability to them. If accountability to the people of those in positions of power is an ideal of the democratic state, the “excessive accumulations of private power” ought to be curbed via constitutional means by the government. Especially given the recent Supreme Court decision eliminating limits on corporate campaign spending in *Citizens United v. Federal Election Commission*, 130 S.Ct. 876 (2010) (holding that the rights of personhood under the First Amendment inure to corporations, and as such their political speech is protected from limitations on spending to endorse or denounce political candidates), the need to curb corporate political power in order to “affirm communal responsibilities, deepen citizenship, and demonstrate the fiscal virtues of a [democratic] citizenry” are arguably more important than ever.



There are, however, more traditional justifications for taxing corporate income. One widely noted rationale is that it compensates for deficiencies in the property tax (Brunori 2005, Brunori 2000). The property tax does not take into account that businesses require varying degrees of property inputs to produce the same level of profit. Consequently, capital-intensive operations (e.g., manufacturing companies) are taxed more heavily by the property tax than are labour-intensive companies, including knowledge-based enterprises such as high- technology companies. This inequity is compounded by the difficulties in assessing property taxes for intangible property. Instead of relying entirely on taxing business inputs, states, in the interest of greater equity, have included a corporate income tax in their mix of revenue sources.

A more common rationale for the corporate income tax is that it protects the much more significant (in terms of revenue) personal income tax. Without a levy on corporate income, taxpayers might have an incentive to shelter personal income in corporate holdings. For example, business owners seeking to avoid personal income tax would incorporate their operations; the corporation itself would then accumulate the dividends or salary that normally would be paid out to the individual (see generally Neal 2011). The shareholders could thus escape personal income taxation on these monies until they were paid out as dividends or the company was sold.

This rationale—that the corporate income tax helps protect the personal income tax— makes sense intuitively. However, the increasing number of corporate tax exemptions in recent years undermines its validity. Experienced tax practitioners and state administrators have long recognized that a corporate entity could be used to shelter personal income. The federal government has adopted rules to prevent the accumulation of corporate profits as a way to avoid personal income tax liability.¹⁰² Personal income tax revenue has grown dramatically in the past decades, a period when corporations increasingly avoided state taxation of income. It is difficult to see how the personal income tax could receive protection from a tax that has proved quite ineffectual in the past quarter-century. The corporate income tax is badly in need of reform if it is to become a viable source of income for the states.

An effective corporate income tax system may add to the tremendous success of the personal income tax. But the deficiencies in the state corporate tax system do not generally stem from individuals trying to shelter profits from personal income taxes but rather from corporations' attempts to escape entity-level taxation. Thus, based on the historical record, it is unclear whether the corporate income tax can be justified based on the need to protect the personal income tax.

The most compelling rationale for imposing tax on corporate profits is that such levies reimburse the states for the significant services provided to the business

¹⁰² See 26 U.S.C. sec. 531.

community (Brunori 1999a, 2002; McLure 2005a). Requiring corporations to pay for services provided by the community satisfies the benefits theory of taxation—that is, that tax liabilities are imposed to compensate for the benefits received.

Corporations use public services provided by the state as much as individuals and unincorporated businesses. They benefit from a state's transportation infrastructure—the roads, railways, airports, and harbors used to receive materials and to move products to market. Corporations also benefit from public safety operations, including police, fire, and medical emergency services. In addition, the state judicial system protects their contractual, intellectual property, and other legal rights. Corporations also depend on the state's school system to produce an educated workforce — an especially important role in this highly specialized age of electronic commerce. High-quality school systems also help attract qualified employees.

A corporation's success depends on the adequate provision of these services. In numerous cases, businesses have opposed state tax cuts (or, less frequently, advocated tax increases) to protect public services deemed vital to companies' operations (Brunori 1999b, 2004). Many studies have shown that corporations make decisions on where to expand (or relocate) largely based on the availability of adequate public services (Bartik 1991; Lynch 1996).

Finally, an important justification for the corporate tax is that it eases—to some extent—the regressivity of state tax systems. For example, a recent study found that almost every state's tax system takes more income from middle and low-income taxpayers than the wealthy (Davis 2009). It is not likely a coincidence that Out of the ten most regressive states, three impose no corporate income taxes.¹⁰³

It is widely believed that the corporate income tax generally has a progressive effect on a state's overall public finance system. While a broader segment of the population owns corporate stock than ever before, most of the corporate wealth remains in the hands of the wealthy. Along with the personal income tax, the corporate income tax offsets the regressive effects of the sales and use taxes as well as the excise taxes imposed by many states.

The idea that the corporate tax is progressive assumes that the burden of the tax fall primarily on shareholders. There is some dispute to this general view. Some public finance researchers have found that the corporate tax burden is borne by customers in the form of higher prices and by labour in the form of lower wages (see Felix 2009).

¹⁰³ *The ten most regressive states are Washington, Florida, South Dakota, Tennessee, Texas, Illinois, Arizona, Nevada, Pennsylvania, and Alabama (Davis 2009).*



Conclusion

Sullivan (2007) found that “from 1999 through 2006, they were 22 percent less efficient than the already porous federal corporate tax. That 22 percent shortfall translates into a revenue loss of \$14.5 billion for state governments in 2006.” Another study by the Multistate Tax Commission (2003) found that state corporate tax collection losses due to sheltering activity ranged from \$8 billion to \$12 billion annually. How can states rescue the state corporate income tax from near irrelevancy and make it a more significant source of income? Three policy changes could strengthen the tax.

First, the states could end the wasteful practice of offering tax incentives to corporations. Tax incentives have essentially gutted the corporate tax base, yet states have been unwilling and unable to stop offering incentives to corporations. The best way to reduce the use of corporate tax incentives is to better educate lawmakers about the incentives’ disadvantages. Various groups have made serious efforts to inform legislators and governors that tax incentives exemplify unsound tax policy. Organizations such as the Corporation for Enterprise Development, the Centre on Budget and Policy Priorities, and Good Jobs First have conducted studies illustrating the problems created by incentives. In addition, the mainstream media and trade publications such as *State Tax Notes* have increasingly highlighted the political and policy issues surrounding the use of targeted tax incentives. Public and political leaders who know why incentives are ineffective are more likely to question their use.

Second, states could require unitary-based combined reporting for all related corporations. Under this requirement, all related corporations would apportion their respective state tax returns as a single business. Combined reporting would severely limit corporations’ ability to avoid state corporate tax liability through tax planning techniques. It would also add billions of dollars to state revenue (Pomp 1998). Corporations, however, are generally opposed to combined reporting requirements and would likely challenge any attempt to mandate them.

Third, strengthening the corporate income tax depends on all the states working toward this goal. Reliance on different tax bases and the use of different apportionment formulas create opportunities for corporate tax avoidance in the states (Pomp 1998). The most effective way to strengthen the tax base is for the states to adhere to the principles set forth in the Multistate Tax Compact, which emphasizes uniformity among and cooperation between the states. Moreover, states imposing corporate income tax should work with the Multistate Tax Commission to develop uniform rules that will benefit the states as well as corporate taxpayers.

Uniformity in the tax base and apportionment formulas would reduce compliance and administrative costs. It would also remove the incentive to develop expensive tactics that take advantage of the myriad rules and regulations across states. Uniformity would

ease the problems of double taxation and, most important, limit the opportunity of corporations to avoid their obligations of paying for the government services they receive.¹⁰⁴

It is up to the state political leaders whether to pursue these courses of action. But to save the corporate income tax from irrelevancy, policymakers must find ways to strengthen and enforce the tax.

¹⁰⁴ *Sullivan (2010) makes a forceful argument that the states are incapable of accomplishing meaningful uniformity and that the U.S. Congress should impose uniformity on the state corporate tax system.*



ANNEX 3

A FOCUS ON PENSIONS

by Jewell Gould

Efficiency in the provision of quality public services goes hand in hand with the case for fair and reasonable taxation. One of the ways to introduce efficiency in government is to review how we are spending our resources and benefits for workers, health insurance and pensions, are among the more costly items. We have spent time in recent months looking at ways to protect benefits for our members while keeping an eye toward revenue enhancement and efficiency in spending for our country. Pensions for workers provide for retirement security and relieve the nations of the need to care for workers needs when the pension is sufficient for the well being of the worker and her family. We developed principles and recommendations, found in "Strengthening Retirement Security and Building a Better America"

(<http://www.aft.org/pdfs/press/StrengthRetireSecurity0411.pdf>).

These were offered to guide pensions and policymakers to build a foundation for retirement security for all American workers in the 21st century, but they have utility for workers in all nations. These include:

- Universal retirement coverage so every worker will be covered by retirement arrangements that provides consistent income replacing enough of his or her pre-retirement income to secure a reasonable standard of living throughout his or her entire retirement.
- Shared responsibility for retirement security should be the joint obligation of employers, employees and the government. Both employers and employees should contribute to fund retirement benefits while the government should ensure that low-income workers are able to participate fully. The lower future cost to the nation results in both a higher quality of life for workers and lowers the pressure on corporations to pay increased taxes to support the needs of the nation's retirees.
- Pension accruals should be portable when workers change jobs, and no withdrawals should be permitted before retirement except in cases of severe disability.

Governance issues include a requirement that states and other employers should pay their annual required contribution every year. All future changes to benefits should be reviewed for their impact on the plan's long-term financial health. Pensions should establish a reserve fund to assist in offsetting market volatility. Financial risks and costs

should be minimized through pooling assets in a trust, governed by one or more fiduciaries/trustees representing the plan's stakeholders. The trustee(s) should be empowered to develop and implement investment and funding policies, use trust assets to pay for their budgets, and hire and fire professionals as appropriate to manage the trust.

Public pension reforms are needed, and we should eliminate spiking at the end of a career, which artificially increases the pension benefit, double-dipping to responsibly limit the payment of both a pension and a salary to any employee who is rehired after retirement by the same employer, establish a maximum benefit ceiling on the employer-sponsored defined-benefit portion of an employee's pension to guard against excessive payouts, and prohibit pension fund senior staff and trustees from accepting employment from fund service providers for five years after leaving a fund.

Finally, voluntary savings can be an important component of retirement security and employers should encourage and facilitate voluntary tax-favoured savings.



Biographies of contributors

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Jim Baker is Co-ordinator of the Council of Global Unions (CGU). The CGU was formed in January of 2007 and is composed of Global Union Federations, which group trade unions by sector and occupation and the International Trade Union Confederation and the Trade Union Advisory Committee to the OECD (TUAC) which bring together national trade union centres. Prior to that, Baker was the Director of the Bureau for Workers' Activities (ACTRAV) at the International Labour Organisation (ILO). Before joining the ILO, he held the post of Director of Multinational Enterprises at the International Confederation of Free Trade Unions (ICFTU) in Brussels. Jim Baker held several positions in the American Federation of Labor - Congress of Industrial Organizations (AFL-CIO), including Executive Assistant to former President Lane Kirkland. He was European Representative of the AFL-CIO for nine years and served on the ILO Governing Body from 1986 to 1991. Prior to his service in Europe, he held various positions with the AFL-CIO on the West Coast, including being Regional Director covering the nine Western States. His original union was the United Automobile, Aerospace and Agricultural Implement Workers' International Union (UAW) when he was employed in California by the Ford Motor Company as a production worker.

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Laura Figazzolo works as a consultant for the Education International Research Institute (EIRI). During her work for the EIRI, she has dealt with issues related to the financing of education and the impact of the international financial crisis on public education. Prior to that, she worked on critical analyses of PISA for Education International, after cooperating for more than three years as a Research Professional Assistant for EI in



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Research Director for the American Federation of Teachers under four presidents, Jewell is currently responsible for the research supporting the economic, public finance, and collective bargaining programs for our union of professionals in education, government, and healthcare. He directs the activities of staff in AFT's Centers for Collective Bargaining, Center for Finance and Workforce Development as well as the AFT Library and Information Services Center. Directing the work of staff in the Center for Bargaining includes assisting AFT leadership and staff in the process of negotiations for collective bargaining agreements on wages, working conditions, and professional issues. He conducts fiscal analysis of employers of affiliates in education, public service and health care including state and local governments and health care providers. He also supervises, and provides training on public finance issues including state and local school funding, budgeting, contract cost out, and privatization of public services. He is responsible for the activities of staff related to the preparation of publications including wage and compensation surveys, preparation of resources for websites and databases for state legislative issues and collective bargaining. He serves as liaison to the AFT Archives professional staff conducting the archival program housed at the Reuther Library, Wayne State University, and provide supervision in the AFT local and national office records management aspect of the archives. He serves as the AFT point person on labor history.

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Pierre Habbard is a senior policy advisor to the Paris-based Trade Union Advisory Committee to the OECD (TUAC) covering the following policy areas: pension fund regulation, corporate governance, financial regulation and public governance. He is a French national born in 1972 who graduated from the Université Paris IX Dauphine and the London School of Economics and Political Science. The Trade Union Advisory Committee (TUAC, www.tuac.org) is an international trade union organisation which has consultative status with the OECD and its various committees. TUAC has 56 affiliated national trade union confederations based in OECD economies and is a member of the Council of Global Unions.

■ Harris, Bob

Bob Harris is a co-founder of Education International and served as Senior Consultant to the General Secretary of Education International (EI) until his recent retirement. A former secondary teacher in Adelaide Australia, he was Assistant General Secretary of the State Institute of Teachers, then the Australian Teachers' Federation, playing a key role in the establishment of the National Schools Commission in the 1970s, as well as the formation of a single national trade union centre. He became Coordinator for development of the World Confederation of Organizations of the Teaching Profession (WCOTP) in 1979, WCOTP Secretary General in 1988, and Executive Director of EI in 1993. Bob chaired the Working Group on Education, Training and Employment of the Trade Union Advisory Committee (TUAC) at the OECD from 1993 until 2011, was President of the Conference of NGOs at the United Nations, 1995-97, and President of the NGO Conference at UNESCO in 1982-88. He graduated in education and international relations from Adelaide and Australian National Universities, and studied at the Graduate Institute of International Relations in Geneva. He is a life member of the Australian Education Union.

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David Robinson is the associate executive director of the Canadian Association of University Teachers, representing more than 66,000 academic and general staff across the country. David is responsible for the Association's research, communications and advocacy work, and international relations. Prior to joining CAUT, he was the senior economist with the Vancouver office of the Canadian Centre for Policy Alternatives, Canada's leading progressive think-tank. He has also been a lecturer at Simon Fraser University in Burnaby, British Columbia, and Carleton University in Ottawa. He is the author of a number of articles, reviews, and reports on higher education and research policy, vocational education and training, and the impact of international trade and investment agreements on labour markets and public services. Currently, David also serves as a consultant on higher education, copyright and international trade issues to Education International, a global union federation representing more than 30 million teachers and education workers in 169 countries.

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Mechthild Schrooten is Professor of Economics, Monetary Policy and International Economics at the University of Applied Sciences Bremen, Germany. She is Director of International Studies on Global Management (ISGM), acting Head of the Research Program "Xtreme Events" and Board Member of the Institute for Finance and Service Management. In addition holds a positions as Research Professor at DIW Berlin, Germany. She studied mathematics, German literature, history at University of Marburg, Germany, the Jagiellonski University Krakow, Poland and the Free University Berlin, Germany. In 1990 she got her diploma in economics. Mechthild Schrooten holds a doctoral degree from the Free University Berlin.



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