Development, **2004**, **47**(3), (37–44)
© 2004 Society for International Development 1011-6370/04
www.sidint.org/development

Thematic Section

The Social Irresponsibility of Corporate Tax Avoidance: Taking CSR to the bottom line

JOHN CHRISTENSEN AND RICHARD MURPHY

ABSTRACT *Tax revenues are the lifeblood of democratic government and the social contract, but the majority of multinational businesses have been structured so as to enable tax avoidance in every jurisdiction in which they operate. John Christensen and Richard Murphy of the tax justice network argue that policy measures are required to redress the distortions that have arisen as globalized companies have left nationally based tax regimes floundering. Businesses should adopt corporate social responsibility standards on taxation, including requirements to publish all necessary accounting information and to refrain from the use of profits-laundering vehicles created without substantial economic purpose.*

KEYWORDS *tax havens; economic development; financial transparency; democracy*

'Taxes are what we pay for civilized society', Oliver Wendell Holmes[1]

Paying taxes is perhaps the most fundamental way in which private and corporate citizens engage with broader society. Tax revenues are the lifeblood of the social contract, vital to the development and maintenance of physical infrastructure and to the sustenance of the infrastructure of justice that underpins liberty and the market economy (Hutton, 2002: 75). It is therefore curious that tax minimization through elaborate and frequently aggressive tax-avoidance[2] strategies is regarded as one of the prime duties that directors are required to perform on behalf of their shareholders. It is more curious still that the debate about Corporate Social Responsibility (CSR), which has touched on virtually every other area of corporate engagement with broader society has scarcely begun to question companies in the area where their corporate citizenship is most tangible and most important – the payment of tax.

This is so despite the fact that a series of corporate scandals in recent years, involving such high-profile companies as Enron, WorldCom, Tyco, Yukos, Parmalat, the Big-Four global accounting firms, and major law firms, have drawn public attention to the growth of tax-avoidance mechanisms such as transfer-pricing, re-invoicing, offshore 'special purpose vehicles', corporate inversions, dubious charitable trusts and other vehicles for tax abuse.

In the case of Enron, which until December 2001 was widely heralded as the role model for the 21st century, a total of 881 offshore subsidiaries, of which 692 were

incorporated in the Cayman Islands, were used as part of an elaborate strategy to avoid taxes (Johnston, 2003). Data for the period 1996–2000 show that over a five-year trading period Enron generated pre-tax profits approaching US$1.8 billion, but paid no federal income taxes and was, in fact, a net recipient of tax rebates (http://www.ctj.org – accessed 13 November 2003). A 2,700-page report by a US Senate committee estimates that it will take ten years to examine forensically the schemes operated by the company, and it has emerged that Enron paid its advisers US$ 88 million in fees in order to avoid paying US$ 2 billion in US taxes (Sikka, 2004).

Enron's strategy of minimizing its asset base and avoiding taxes on a global basis made it popular with international investors; indeed, many of the practices used by Enron remain in use, particularly for tax-avoidance purposes. Studies conducted in the United States show that a large number of top companies, including famous brands such as Accenture, ExxonMobil, Hewlett-Packard, Deutsche Bank, Halliburton, Lufthansa, and Deutsche Telekom, have paid legions of accounting, banking and legal practitioners to concoct schemes devised solely to launder profits to tax havens in order to avoid paying their share of taxes in the jurisdictions where they make and market their goods and services. According to a US Senate report, KPMG, one of the Big-Four accounting firms, had a complex infrastructure for devising and marketing about 500 tax-related products, and acted in the knowledge that some of these products transgressed the line between avoidance and evasion (a line famously defined by Dennis Healey, a former UK Chancellor of the Exchequer as being 'the width of a prison wall') (http://www.irs.gov/newsroom/article/0,,id = 117990,00.html). In a series of internal e-mails released to the Senate enquiry, a senior US tax professional told colleagues that if regulators took action over their sales strategies, the possible penalties were much less than the potential profits. One e-mail noted: 'Our average deal would result in KPMG fees of $360,000 with a maximum penalty exposure of only $31,000' (Sikka, 2004).

Recent estimates suggest that the US federal authorities lose some US$ 170 billion annually to corporate tax avoidance (Sikka, 2003), and a further US$ 85 billion is lost to the Treasury as a result of tax shelter abuse by wealthy individuals.[3] It has been estimated that in 2001, 46 per cent of the estimated $233bn earned abroad by American-owned multinationals was held in foreign tax havens, an increase from 38 per cent in 1999 and 23 per cent in 1988. The reason for doing so was that this resulted in US tax being avoided on that income (Fine, 2004). Research conducted in the UK has revealed a similar pattern of tax avoidance among the leading companies on the FTSE100, and a randomly sampled study of multinational businesses operating in the extractive industries suggests an even higher incidence of tax abuse in developing countries.

Avoiding the issue

Judging from our informal studies of CSR statements published by a wide selection of multinational corporations, company directors do not regard tax payment as a part of the CSR agenda. Research conducted by PriceWaterhouseCoopers (PWC) has identified corporate governance as an important area of concern for institutional investors, with issues such as reduction of corruption, collusion, nepotism; inadequate disclosure and insufficient transparency of financial statements; inadequate enforcement of existing rules, and a lack of clear separation of company ownership and management, all being seen as key areas of institutional concern (PriceWaterhouseCoopers, 2003). Nonetheless, the seemingly related areas of compliance with taxation obligations, not using aggressive tax-avoidance techniques and transparency of reporting of tax-planning measures are not mentioned in the PWC report on good governance. Nor are they mentioned in the AA1000S Assurance Standard, launched in March 2003 by UK-based AccountAbility to promote corporate accountability for sustainable development.

Compelled by the profit logic, and by a legal principle that asserts that tax payers may organize their affairs in such a way as to pay the least tax possible under the law,[4] the majority of large businesses have been structured so as to enable tax avoidance in every jurisdiction in which they

operate. In the UK, for example, 52 per cent of the largest companies quoted on the London Stock Exchange have admitted to using 'novel tax planning ideas' – a euphemism for tax-avoidance schemes (Atkinson, 2001).

A typical defence of this practice was given by Mike Warburton, a partner in Grant Thornton (the global association responsible in part for auditing Parmalat) who said to the UK *Sunday Times* on 29 February 2004:

> The complexity of the tax system creates loopholes which people legitimately exploit. But the Inland Revenue has this strange concept of 'acceptable' and 'unacceptable' tax avoidance. There's almost a moral stance to this. It should be the case that if it's legal there should be no distinction.

We dispute this assertion. The CSR agenda is driven by demand for an ethical approach to doing business. It is not possible to be ethical in one area of business conduct and to act otherwise in another area, and companies that function in this way reveal a major disconnect in their core organizational values.

Perhaps the best documented example of corporate tax avoidance is provided by the media group News International, which operates through 800 subsidiaries, many registered in offshore tax havens. A trawl through the 101 subsidiaries of Murdoch's UK holding company, Newscorp Investments, covering an eleven-year period, shows that it generated profits of some £1.4 billion. At the present British corporation tax rate, it should have paid tax of over £350 million (Mitchell *et al.*, 2002: 5). In fact, it paid virtually no corporation tax in Britain.

Tax avoidance on this scale enables companies to become economic free-riders, enjoying the benefits of corporate citizenship without accepting the costs, while also causing harmful market distortions and transferring a larger share of the tax burden onto individual tax payers and consumers.

Taking a long-term time perspective reveals a dramatic shift in the distribution of the tax burden. In the US, for example, in 1953 families and individuals paid 59 per cent of federal revenues and corporations 41 per cent. According to the most recent Statistical Abstract of the United States, this ratio has now shifted to approximately 80:20 in favour of corporations. A similarly dramatic shift has occurred in the United Kingdom, where corporate tax revenues have fallen from 28.1 per cent of total Inland Revenue income in 1989 to 19.4 per cent in 2003 and now account for a mere 2.8 per cent of GDP. This is scarcely evidence of companies playing a significant role in financing education, health, transport infrastructure, defence expenditure, and all the other services that the business community requires of a dynamic market economy.

The global shadow economy

The scale of tax-avoidance activity has become so enormous that it can fairly be described as a shadow economy operating in the majority of globalized sectors, including and especially, the extractive industries, banking and finance, aviation, shipping, communications, pharmaceuticals, media, traded commodities and the weapons industry. Owing to the secretive nature of this type of activity, it is not possible to quantify accurately the scale of this shadow economy, but recent estimates give some idea of its possible scale:

- At least half of all world trade appears to pass through tax havens, even though these jurisdictions account for only about 3 per cent of global GDP.[5]
- The UK government estimates that 60 per cent of international trade consists of intra-company transactions, that is, firms trading with themselves and much of this is passed through tax havens that charge low or zero rates of tax on profits (*The Economist*, 2004). The transactions involved are frequently on paper only, the goods and services involved actually going nowhere near the territories in which they are supposedly transacted.
- The value of assets held offshore, either tax-free or subject to minimal tax, is estimated at US$ 11 trillion (€9.2 trillion), which is over one-third of global GDP.[6]
- In the mid-1970s, there were about 25 tax haven jurisdictions. In 2003, the International

Monetary Fund (IMF) identified more than 60 tax havens and offshore finance centers.

- Demand has been fuelled by the growth of the number of high net worth individuals and by the rapidly increasing number of companies operating on a multinational basis. In the case of the latter, according to UNCTAD data in the early 1990s there were about 37,000 international companies with 175,000 overseas subsidiaries. By 2003, there were about 64,000 companies with 870,000 subsidiaries (*The Economist*, 2004).
- The volume of funds that pass through tax havens annually is estimated at some US$7 trillion, approximately equivalent to the value of global trade in goods and services. This sum is greater than the value of goods and services traded through the havens, the difference being transactions of a purely financial nature (Oxfam, 2000).
- Offshore companies are being formed at the rate of about 150,000 per year, and are now numbered in the millions (http://www.finor.com/en/tax_havens_history.htm, accessed 12 March 2003). This figure does not include the huge number of trusts and foundations that have been established offshore over the past 70 or 80 years.

In summary, the offshore economy cannot be described as a minimal or transitory phenomenon. Despite the virtual absence of references to tax havens or offshore finance centres in mainstream economic analysis, their activities represent a significant and deeply embedded part of globalized capitalism (Hampton, 1996). Tax havens have been described by a former Director of Fiscal Affairs at the International Monetary Fund as 'fiscal termites' (Tanzi, 2000), and their role has been 'the cornerstone of the process of globalization' (Palan *et al*, 1996: 180), enabling multinational companies to remove themselves either partially or wholly from nationally based tax and regulatory regimes.

While the tax-avoidance industry is clearly damaging to the interests of developed countries, it is almost certain that harmful tax practices are an even greater problem for economies in transition and developing countries.[7] In the absence of powerful and sophisticated tax authorities like the US Inland Revenue Service, it is relatively easy for multinational companies and local political elites to erode the potential tax base.

According to one leading development NGO, the revenue losses to developing countries from the effects of tax competition and from non-payment of tax on flight capital amounts to at least US$ 50 billion annually (Oxfam, 2000: 2). This is a conservative estimate that does not include losses due to tax evasion and transfer-pricing. It does, however, include the tax loss on failing to tax capital gains, the granting of tax holidays, inward investment tax incentives and other techniques, most of which have been introduced under pressure from large corporations that threaten to withhold inward investment unless tax incentives are given. The resulting impact on developing countries and the transition economies is immense, compelling many of these countries to borrow on the financial markets to fund revenue and capital expenditure that would otherwise be less expensively funded from tax revenues.

Capital market liberalization and fiscal competition

The rapid growth of the offshore economy since the 1960s can be traced to technological change in telecommunications and to liberalization of the global capital markets. In combination, these changes have generated forces in the economic globalization process that undermine the ability of national governments to effectively enforce their tax regimes and which threaten the effectiveness of national democracies. It is almost certain that the promoters of such change intended the first of these outcomes.

Capital mobility enables multinational corporations to choose between different jurisdictions according to the preferential tax terms and other benefits on offer (Boskin and Gale, 1987). The result of this process of tax competition is that countries, particularly developing countries, have eroded their potential tax base, resulting either in a transfer of the tax burden to labour and consumption, which in both cases is socially regressive, or in a net reduction in the revenues

available to the state to invest in social and physical infrastructure.

Yet, at best the benefits to developing countries of tax competition are questionable. A study published in 2003 by consulting firm McKinseys concluded that fiscal inducements offered by four major developing countries – China, Brazil, Mexico and India – had negative and unintended consequences. 'Without materially affecting the volume of investment in most cases,' said McKinsey, 'popular incentives such as tax holidays, subsidized financing or free land, serve only to detract value from those investments that would likely be made in any case.' Which begs the question, why do governments persist with offering fiscal inducements when the evidence suggests that good social and physical infrastructure, an educated workforce, and stable social and economic conditions are a more important incentive for investors? The answer lies with the fact that governments feel compelled to offer tax incentives in order to attract inwards investment. Extensive research has demonstrated that fiscal inducements in the form of subsidies and tax incentives are crucial determinants of investment location decisions (Hines, 1999), but only because countries compete with one another in what is widely known as a 'race to the bottom.' In general it can be assumed that governments would prefer to refrain from offering tax incentives if there was agreement to avoid this process of undercutting one another by granting such incentives (Avi-Yonah, 2000). The existence of such a race to the bottom is not, however, in dispute. In 1996, the average corporation tax rate in an OECD country was 37.5 per cent. By 2003 it was 30.8 per cent. The trend in less developed countries has been even more severe.

Distorting global markets

However, concerns about tax competition and fiscal degradation lie deeper than the loss of state tax revenues that legitimately belong to the people. The ability of transnational corporations to structure their affairs through paper subsidiaries in tax havens provides them with a significant tax advantage over their nationally or locally based competitors. Local businesses, no matter whether they are technically more efficient or more innovative than their transnational rivals, will be competing on an uneven field. In practice, of course, this differential tax treatment favours the large business over the small one, the international business over the national one, and the long-established business over the start-up. It follows, simply because most businesses in the developing world are smaller and newer than those in the developed world and typically more domestically focused, that this in-built bias in the tax system now favours developed world multinational businesses over their domestic competitors in the developing world.

As a result of the transnational companies' ability to exploit the uneven global fiscal topography, investment decisions are being taken on the basis of whatever tax and regulatory concessions can be extracted from competing governments, which effectively negates the Ricardian doctrine of comparative advantage that lies at the very heart of the liberal global trade model (Gray, 1998: 82).

In addition to these profound market distortions, aggressive tax avoidance by transnational companies undermines the integrity and equity of existing tax structures; increases the administrative burden of revenue collection; and perhaps most importantly, increases income disparities within and between nation states (Christensen and Hampton, 2000).

Far from acting as a legitimate disciplinary agent on high-tax, high-spend governments, the type of harmful tax practices that have been identified are symptomatic of an almost wholesale withdrawal of wealthy elites and multinational companies from their economic and social obligations (Lasch, 1995). Furthermore, the aggressive manner in which they exert their considerable political influence is in itself profoundly unethical and on occasions criminal. As Senator Joseph Lieberman commented to the Senate Committee on Governmental Affairs on 18 November 2003, we are faced with 'ranks of lawyers, accountants, and financial consultants who have abused the law and their own professional ethics simply for the sake of huge sums of money'.

Countering harmful tax practices

The only way to counter harmful tax practices effectively is through global initiatives (Hampton and Christensen, 2003). A multilateral framework is therefore required that will balance the need for sovereign states to protect their tax revenues from aggressive tax avoidance with a respect for the right of democratic governments to determine a tax rate appropriate to their circumstances. At the same time, measures are required that will empower countries, especially developing countries, to stem their tax losses and to resist pressure from transnational corporations to degrade their tax regimes. The United Nations General Assembly signalled a move in this direction in December 2003 when it decided to move towards the creation of an intergovernmental organization to re-orient the international tax policy framework. This is a welcome step by the only global agency likely to have both the authority and credibility to achieve the desired outcome.

Alongside such statutory measures, however, new guidelines are needed to overcome the ethos of tax minimization. A major step towards reversing the general trend towards corporate tax avoidance would be the adoption into tax law of what are commonly called General Anti-Avoidance Rules (GAAR). These provide tax authorities with the power to consider whether the main purpose, or one of the main purposes, of any transaction is the avoidance or reduction of a tax liability and, if this is the case, to allow the authorities to assess the person who has undertaken it to additional tax to counteract the avoidance or reduction of liability that they sought to achieve.

There are clear advantages to such provisions. Firstly, tax authorities would have a measure that allows them to enforce both the letter and the spirit of the law. This latter point is important since, as the earlier quote from Mike Warburton of Grant Thornton indicates, persistent and aggressive tax avoiders normally seek to exploit the loopholes that any legal construction makes inevitable. A GAAR prevents this by letting such behaviour be attacked without a perpetual round of amending legislation, much of which creates further loopholes. Paradoxically, the very ambiguity of a GAAR produces clearer and simpler tax legislation.

Secondly, if a GAAR effectively outlaws transactions whose sole or principal purpose is to avoid tax, such transactions shift from the legal activity of tax avoidance into the illegal activity of tax evasion. The entire *modus operandi* of tax planners in seeking tax advantage on behalf of their clients irrespective of the actual economics of the transactions they propose would disappear, leaving them potentially liable to prosecution for aiding and abetting tax evasion.

International Accounting Standards

Agreement is needed at a global level to define minimum standards of transparency and disclosure by companies and to enable the development of wider networks of cooperation extending beyond the OECD to all developing countries and transition economies. This is possible because the International Accounting Standards Board (ref http://www.iasb.org/) has issued standards endorsed by the European Union for use by all 25 member states from 2005. These are already in use in over 30 states and there is a broad agreement between the International Accounting Standards Board and the US Federal Accounting Standards Board to seek convergence of standards to create global regulation. This would provide an opportunity to seek worldwide improvements in reporting that advance both the CSR and anti-tax-avoidance agendas. A proposal for just such a standard, which would require the disclosure of all inter-group trading and the location in which all revenues, profits and taxes are earned or paid by all multinational companies has been made by one of the authors of this paper. (Murphy, 2004: 90–91). The final advantage of a common base for accounting on a worldwide basis is that it provides a platform on which a common basis for assessing the profits of companies can be built. This would eliminate tax loss due to different accounting bases being used while still allowing individual states to set their own rates and allowances, as is vital for the democratic process.

In combination, these proposals create a framework that would, with international agreement,

enable states to tax transnational companies on a global unitary basis. Unitary taxation is widely known, particularly in the USA where it is the basis for allocating corporate profits to individual states for the purposes of assessing state taxation. There are numerous ways on which this can be done, but the most common involve a formulaic approach based upon three factors: third-party sales generated, labour value expended and actual capital committed within the territory that will charge the tax. On the basis of such a formula, the global profits of a transnational company could be allocated for taxation in the locations where value added was actually created.

Tackling the tax-avoidance culture

It is clear that policy measures are required to redress the distortions that have arisen as globalizing companies have left nationally based tax regimes floundering. Furthermore, the corporate citizenship debate needs urgently to address the issue of how company directors should act on tax avoidance in the context of their CSR agendas. Multinational companies make use of aggressive tax-planning strategies because they are able to operate in the legal vacuum that exists between nation states (Freedman, 2003). Directors now need to recognize that aggressive tax-planning strategies are not compatible with long-term sustainability, and therefore may not be in the shareholder's broader interests.

The current situation has not kept pace with the debate on corporate citizenship and should make way for a General Anti-Avoidance Rule that would guide directors in understanding their legal duties on tax payment. The publicity surrounding the Enron case has ensured that directors and audit committees can no longer turn a blind eye to the role of tax schemes in the wider context, even if there remains a legal vacuum in some areas of tax law.

Multinational companies should adopt clear CSR standards in the area of taxation, including requirements to publish all necessary accounting information and to refrain from the use of profits-laundering vehicles created without substantial economic purpose. CSR reports should list the countries in which the company trades, how much profit is derived from activities in each of these countries, and where these profits are booked for tax purposes, indicating any special purpose vehicles that are used, and the extent of tax avoidance arising from the use of 'novel tax planning ideas.' Only in this way can the relevant stakeholders, including governments, shareholders, employees and the general public obtain the data they need to determine whether the organizations that dominate the globalized economy are acting as good corporate citizens.

Notes

1 Oliver Wendell Holmes Jr, in the case of Compañia General de Tabacos de Filipinas v. Collector of Internal Revenue, 1904.
2 The term aggressive tax avoidance is used by revenue officials in the US and UK to describe transactions whose primary or whole purpose is the avoidance of tax.
3 Source: Statement by Senator Joseph I. Lieberman to the US Senate Committee on Governmental Affairs, 18 November 2003
4 This principle was firmly established in the UK by the Duke of Westminster case (1936) and applies in many jurisdictions around the world.
5 Source: French Finance Minister Dominique Strauss-Kahn, quoted from a speech to the Paris Group of Experts, March 1999.
6 Source: the Association for Accountancy & Business Affairs, quoted in 'Tax avoiders rob wealth of nations', *The Observer*, 17 November 2002.
7 The weakness of the Bolivian fiscal system illustrates the problems faced by so many developing countries. In 2003, the Bolivian National Congress sought to change the tax code in order to recover €355 million in revenue arrears and bring thousands of businesses into the formal tax sector for the first time ever. Facing a fiscal deficit of 8.8 per cent in the current budget, Bolivia is struggling to stave off economic collapse, but endemic tax evasion by local business elites has made the state increasingly reliant on multilateral credits and grants from donor countries.

References

Avi-Yonah, R. (2000) 'Globalization, Tax Competition and the Fiscal Crisis of the Welfare State', *Harvard Law Review* 13: 1573.
Atkinson, D. (2001) 'Revenue's Let-off for Big Business', *Financial Mail on Sunday*, 2 March.
Boskin, M.J. and W.G. Gale (1987) 'New Results on the Effects of Tax Policy on the International Location of Investment', in Martin S, Feldstein (ed.) *The Effects of Taxation on Capital Accumulation*. Chicago: University pf Chicago Press.
Christensen, J. and M.P. Hampton (2000) '*The Economics of Offshore: Who wins, who loses?*', *The Financial Regulator* 4(4): 24–26.
Fine, P. (2004) 'Tax Havens Exploited by US Businesses', *Accountancy Age*, 9 March.
Freedman, J. (2003) 'Tax and Corporate Responsibility', *The Tax Journal*, 2 June.
Gray, J. (1998) *False Dawn: The delusions of global capitalism*, London: Granta.
Hampton, M.P. (1996) *The Offshore Interface: Tax havens in the global economy*, Basingstoke: MacMillan.
Hampton, M.P. and J. Christensen (2003) 'A Provocative Dependence? The Global Financial System and Small Island Tax Havens', in F. Cochrane, R. Duffy and J. Selby (eds.) *Global Governance, Conflict and Resistance*, Basingstoke: Palgrave Macmillan.
Hines, J.R. (1999) 'Lessons from Behavioural Responses to International Taxation', *National Tax Journal* 52: 305.
Hutton, W. (2002) *The World We're In*, London: Little, Brown.
Johnston, D.C. (2003) 'Tax Moves by Enron Said to Mystify the IRS', *New York Times*, 13 February.
Lasch, C. (1995) *The Revolt of the Elites*, New York: Norton.
Mitchell, A., P. Sikka, J. Christensen, P. Morris and S. Filling (2002) '*No Accounting for Tax Havens*'. Basildon, England: Association for Accountancy & Business Affairs.
Murphy, R. (2004) 'Location, Location', *Accountancy*, March.
Oxfam, GB (2000) *Tax Havens: Releasing the hidden billions for poverty eradication*, briefing paper, Oxford June.
Palan, R., J. Abbott and P. Deans (1996) *State Strategies in the Global Political Economy*, London: Pinter Press.
PriceWaterhouseCoopers (2003) '17% premium for good governance'. World Watch Issue 1.
Sikka, P. (2003) 'A Taxing Account of Corporate Social Responsibility', *The Guardian*, 17 November.
Sikka, P. (2004) 'Nobody is Called to Account', *The Guardian*, 6 February.
Tanzi, V (2000) *Globalization, Technological Developments and the Work of Fiscal Termites*, WP/00/181. Washington, DC: International Monetary Fund.
The Economist (2004) 'A Taxing Battle', 31 January.