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Institutional Integrity, Corruption, and Taxation

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Institutional Integrity, Corruption, and Taxation

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Abstract

What is institutional integrity and how is it related to institutional corruption? In the first part of this paper an account of institutional corruption is presented, such that institutional integrity has been eroded in one or more of a set of relevant dimensions. However, the main part of this paper explores the ways in which institutional corruption exists in taxation institutions. The paper also begins the project of developing strategies for addressing the institutional corruption that the analysis exposes, clarifies some of the many agents whose participation is required to address the issues, and outlines the principles that could be used to assign responsibilities to relevant stakeholders in determining what various agents ought to do to combat fiscal institutional corruption.

Keywords:

Institutional corruption, institutional integrity, taxation, corruption, tax havens, tax abuse, fiscal corruption, transfer mispricing, lobbying for favorable tax treatment, distributing responsibilities, transparency and accountability tests, contagious institutional corruption.

Electronic copy available at: http://ssrn.com/abstract=2408183

1. Introduction

Issues of corruption infect a number of institutions. In this paper we examine some issues of institutional corruption in fiscal arrangements. While I am interested in diagnosing the sources and scale of institutional corruption, in this project I am concerned also with normative issues such as: How ought we to combat fiscal institutional corruption? How might we distribute responsibilities for bringing about important changes: who should do what in bringing about relevant reforms? Whose responsibility is it to take action or to show leadership and how might we fairly distribute any costs associated with these changes? In order to answer such questions we must first have a thorough understanding of the problem.

Those who are interested in institutional corruption have many reasons to find this paper of interest. First, I offer an account of institutional integrity as a baseline for examining the dimensions of institutional corruption. I also develop some usable tests and criteria by which we can diagnose whether institutional corruption exists and offer some principles that are relevant in allocating responsibilities. The account, tests, and principles may be usefully applied to institutional corruption in other domains. In addition, I also highlight a new form of institutional corruption that is particularly worrisome in its subversive, pervasive, and contagious effects.

It is also worth drawing attention to the fact that the issues related to taxation and institutional corruption are often something like the opposite problem from one of the insidious effects of too much money being involved in politics (especially in financing candidates standing for national elections in the U.S.). Often too little money goes into funding government's operations, which sets up an environment for equally insidious effects to take root. There is too much influence on law makers conjoined with too little support for effective maintenance of routine operations. In such cases not paying taxes is not paying a fair share of community sustenance, while having excessive influence over how that community is governed. This kind of radically inflated influence alongside inadequate contribution constitutes an important asymmetry. While there is quite a bit of attention on the "too much money" problem, there is not enough attention on the "too little money" problem. They are related problems as to why a system of governance might be unable to achieve obligatory purposes and be vulnerable to improper dependencies taking hold.

Another interesting feature of fiscal institutional corruption is that, unlike the case of the influence of money in U.S. politics, where the solutions are ones that can be implemented domestically without international cooperation, transnational cooperation is integral to solving the "too little money problem." It is harder to solve the problem—perhaps impossible—without such cooperation. So the analysis presented here might be relevant to other forms of institutional corruption where international cooperation is important to combating the phenomenon.

Institutional corruption that involves core state functions is an important failure of governance. Good governance has many aspects, but one especially important factor can be adequate public funds with which to build better institutions. Strong institutions are built and maintained by effective public financial management. We have then many important reasons to take an interest in corruption in taxation institutions.

2. What is Institutional Corruption? Does it Exist in Taxation Institutions?

In contrast to prominent accounts of institutional corruption in the literature, I offer an account that begins with the notion of institutional integrity and defines institutional corruption as a state in which institutional integrity has eroded in one or more of a set of relevant dimensions.[1] I start with the hypothesis that we have a state of institutional integrity when *all four* of the following conditions are met:

1) An institution achieves its purposes effectively and equitably.
2) Insofar as an institution is properly dependent on P (or parties P1, P2, . . . , Pn), is required to promote the interests of P (or parties P1-Pn), or is required to be accountable to P (or parties P1-Pn), it does so and does not improperly depend on or promote the interests of other parties.
3) Because 1) and 2) are the case, public confidence in the institution is appropriate. This confidence may assist the effectiveness of the institution.

[1] Especially Lawrence Lessig, "Institutional Corruption," The Lessig Wiki, http://wiki.lessig.org/InstitutionalCorruption (accessed February 26, 2014).

4) Public confidence in the institution's practices, operations, and policies can also survive appropriate transparency and accountability tests.

By contrast, institutional corruption occurs when *all four* of the above conditions fail to be the case:

1*) Institutions do not achieve their purposes effectively and equitably. These failures are a result of 2*).

2*) Some parties have improper influence over the institution's operations, practices, or policies resulting in important losses to effectiveness or equity.

3*) Because of 1*) and 2*) public confidence in the institution is inappropriate and this loss of trust can undermine the institution's ability to achieve its proper purposes effectively and equitably.

4*) Public confidence in the institution's practices, operations, and policies cannot survive appropriate transparency and accountability tests.[2]

In this paper I show how institutional corruption can corrode taxation institutions. I focus here on fiscal institutional corruption in the developing world since the magnitude of the problems is large and perhaps easier to see. But citizens of developed world countries have at least two important reasons to care about these results. First, the problems identified infect fiscal institutions in all countries, undermining all states' abilities to achieve their proper purposes concerning revenue collection. Second, similar problems concerning improper influence and dependencies corrode the fiscal institutions of developed countries as well. Much more work is needed to make the case for particular developed states. But it will be clear that a number of problematic features identified here will apply to many developed countries.

I summarize central views concerning institutional corruption in taxation next, though plenty of elaboration is needed in order to appreciate the various summarized points. This discussion occurs in Sections 3-9. Offering a summary of what institutional integrity in taxation arrangements consists of might help orient

[2] Institutional corruption may occur in degrees and when some of the conditions are also only partially met. Here I defend only the claim that we have a situation of institutional corruption when all four conditions are met, and do not consider issues of partial institutional corruption.

the reader, even if all points require further analysis before their plausibility can be assessed.

We have a state of institutional integrity with regard to tax institutions when the following four conditions are all met:

1) A tax institution achieves its main purpose when it raises revenues effectively and equitably for the state's necessary or legitimate activities and functions. Tax institutions have one "obligatory purpose" and that is to raise revenue effectively and equitably.[3]

2) State tax institutions are properly dependent on citizens. Though state tax institutions may collect revenue from a number of sources (through royalties, licenses, fees, taxes, and so on), tax institutions should also promote relevant interests of citizens, help citizens discharge their duties, and are required to be accountable to citizens. Tax institutions may derive revenue from other parties, but any dependence that arises therefrom must be mediated through full accountability to citizens.

3) Because taxes are raised effectively and equitably, in ways that promote citizens' relevant interests, help them discharge their duties, and are fully accountable to those citizens, public confidence in institutions that collect tax is appropriate. This confidence often assists the effectiveness of the institution, especially when high tax morale leads to high levels of tax compliance.

4) Public confidence in the institution's practices, policies, and operations can survive appropriate transparency and accountability tests.

By contrast, fiscal institutional corruption occurs when *all four* of the above conditions fail to be the case:

1*) Fiscal institutions do not raise revenue effectively and equitably, because of 2*).

2*) Because of improper dependencies, some parties have improper influence

[3] As I discuss in Section 8.1, they have additional "permissible purposes" but only one obligatory purpose. For an excellent account of the distinction between obligatory and permissible purposes see Marie Newhouse, "Institutional Corruption: A Fiduciary Theory," Edmond J. Safra Research Lab Working Papers, No. 25, October 3, 2013, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2335619.

over the institutional practices, operations, or policies. These improper dependencies and influences have resulted in important losses to effectiveness and equity.

3*) Because of 1*) and 2*) public confidence in the practices, policies and operations of a tax institution is inappropriate and this loss of trust can further undermine the institution's ability to achieve its proper purposes effectively and equitably.

4*) Public confidence in the practices, policies, and operations of tax institutions cannot survive appropriate transparency and accountability tests.

Corruption in fiscal institutions may occur in degrees, and when some of the conditions are also only partially met. But for a clear case of fiscal institutional corruption all four conditions must be met. I make the case for these views over Sections 3-9.

3. The Important Role of Taxation in Creating and Sustaining Effective States and Robust Domestic Institutions

Edmund Burke, an eighteenth-century philosopher, once remarked that "Revenue is the chief preoccupation of the state. Nay more it is the state."[4] Whether or not one endorses Burke's view, taxation is undeniably very important to the state: collecting taxes is typically necessary for the state to function effectively. And how taxes are collected and disbursed is important to state legitimacy and effective state building.

Constructing and maintaining robust taxation systems can be challenging for even the strongest states. Taxation systems should incorporate several desirable qualities that sometimes are in tension with each other. Ideally, taxation systems should be equitable, efficient, and effective. Equitable tax systems treat taxpayers fairly and promote social cohesion. Effective systems are ones which are administratively capable of delivering desirable policy objectives at the least

[4] Frederick C. Dietz, *English Government Finance 1485-1558* (Frank Cass, 1964), 213.

compliance and administrative cost. Efficient systems raise revenue at least cost without creating undesirable disincentives (such as undermining willingness to save or work).

Constructing efficient, effective and equitable tax systems can play an enormously valuable role in creating the ingredients for effective states, helping to sustain the legitimacy of the state and its accountability. Tax collection can strengthen the relationship between states and their citizens, empowering citizens to demand accountability from their states and therefore helping states to be more accountable to citizens. Moreover, a strong tax system is central to a state's financial independence. Ensuring appropriate revenue is available also helps sustain appropriate levels of state sovereignty.

Sustaining efficient, effective and equitable taxation systems is challenging for all states at all levels of development. Developing countries have additional challenges to meet including the following seven.

i) Weak Institutions. Developing states often have weak institutions and a state that is not yet very effective. Effective states are undeniably important for beneficial development and poverty reduction.[5] There are many reasons why this is the case. States ensure the availability of key goods and services including healthcare, education, water, sanitation, infrastructure, security, the rule of law, and at least a minimum level of social and economic stability, all of which are necessary precursors in building a dynamic economy capable of pro-poor growth. States are also in a unique position to regulate and develop the economy in helpful ways. All in all, the body of evidence that confirms the positive role effective states can play in reducing poverty is huge; on some accounts, states are altogether *essential* to the process.[6] In addition, actively engaged citizens can play a key role in helping to produce and maintain effective and accountable states.[7]

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[5] I cannot elaborate on all these vast themes here, but the interested reader might consult Duncan Green, *From Poverty to Power: How Active Citizens and Effective States Can Change the World* (Oxfam International, 2008), and Gillian Brock "Global Poverty, Decent Work, and Remedial Responsibilities: What the Developed World Owes to the Developing World and Why" in Diana Tietjens Meyers, ed., *Poverty, Agency, and Human Rights* (Oxford University Press, forthcoming).

[6] For a comprehensive summary of literature see Duncan Green, *From Poverty to Power: How Active Citizens and Effective States Can Change the World*, 2nd ed. (Practical Action Publishing, 2012).

[7] Id.

Furthermore, good institutions matter greatly for poverty reduction, whatever other factors are also significant.[8] For instance, those institutions that promote respect for the rule of law and accountability make for an environment conducive to innovation and investment in education, health, and infrastructure—all key ingredients for lifting people out of poverty. Creating better institutions is a significant component in helping people out of poverty, and a central factor in promoting development. Taxation has a tremendously important role to play in creating and sustaining effective and legitimate states with robust domestic institutions, and we discuss these issues in more detail below.

ii) Weak Tax Administration*.* Not only do developing countries have a general environment of weak institutions, but more particularly, tax administration is often very weak with the result that much owed taxation simply fails to be collected.[9]

iii) Large Informal Sectors. Large informal sectors can seriously restrict developing countries' abilities to tax all citizens fairly. Many developing countries have large numbers of workers who are employed in the informal economy. When workers are not formally employed, it is difficult to track their wages, let alone collect any taxation from that income.[10]

iv) Low Tax Morale. Tax morale—citizens' willingness to pay taxes and comply with tax laws—is a key factor that needs to be understood if revenue is to be collected

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[8] For just a small sample of the vast literature see Douglass C. North, *Institutions, Institutional Change, and Economic Performance* (Cambridge University Press, 1990); Daron Acemoglu, Simon Johnson and James A. Robinson, "The Colonial Origins of Comparative Development: An Empirical Investigation," *American Economic Review* 91.5 (2001): 1369-1401; Dani Rodrik, Arvind Subramanian and Francesco Trebbi, "Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development," *Journal of Economic Growth* 9.2 (2004): 131-165; Dani Rodrik, "What Do We Learn From Country Narratives?" in Dani Rodrik, ed., *In Search of Prosperity: Analytic Narratives on Economic Growth* (Princeton University Press, 2003), 10-11.

[9] In 2007, Yemen collected about 25% of the taxes it was due. In 2004, Nigeria collected only about 10% of taxation due. There are also reports that half the revenue collected was "lost" or embezzled. Moreover, the OECD estimates that, in developing countries, businesses representing only 5% of the taxable base meet their fiscal obligations. See Foreign Investment Advisory Services, "FIAS 2007 Annual Report: Investment Climate Advisory Service," January 7, 2007, 25, http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2007/12/28/000310607_20071228104904/Rendered/PDF/41919optmzd0FI1nual1Report01PUBLIC1.pdf and Ayodele Odusola, "Tax Policy Reforms in Nigeria," WIDER Research Paper No. 2006/03 (2006).

[10] In low-income, developing countries, the average size of the informal sector is reasonably high and employs large numbers of workers. For instance, the informal economy makes up about 55% of GDP in Sub-Saharan Africa, and 80% of the labor force. African Development Bank Group, "Recognizing Africa's Informal Sector," March 27, 2013, http://www.afdb.org/en/blogs/afdb-championing-inclusive-growth-across-africa/post/recognizing-africas-informal-sector-11645/.

effectively and equitably.[11] Perceived unfairness in the collection or disbursement of taxation revenue can significantly undermine such morale. When citizens do not feel that they are getting value for their taxes, they will be less willing to contribute the taxes that are owed. So, for instance, when core goods fail to be provided, when there is a perception that taxes collected will be wasted, embezzled, or otherwise not spent on their legitimate purposes, citizens will again be less likely to want to contribute their legally required taxes. Citizens will generally be unwilling to pay taxes unless they feel that the taxes themselves are legitimate, services will actually be delivered, and that others are also paying their fair share. When there is a sense of uneven contribution, disbursement, or enforcement this can undermine tax morale.[12]

v) Negative Feedback Loops Undermine the Fiscal Social Contract. Related to the previous point, the relationship between the state and citizens concerning tax matters is often described in terms of a fiscal social contract. This contract seems to involve an implicit agreement between citizens and the state that taxes can reasonably be expected in return for good governance. The robustness of the contract can reflect how well governments are performing in delivering good governance.

Positive feedback loops are created when there is high tax morale (citizens perceive that they are getting fair returns on their tax contributions and there is an even-handed approach to taxation policy, collection, and disbursement) and states are therefore able to discharge their functions effectively. And negative feedback loops can gain traction when the reverse is the case: low tax morale can lead to insufficient funds for executing core state functions effectively which can further undermine tax morale.

What sorts of factors undermine the fiscal social contract? Here are two examples. Large businesses can use their political connections and size to negotiate special

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[11] Bruno Frey, "The Role of Deterrence and Tax Morale in Taxation in the European Union," Jelle Zijlstra Lecture, Netherlands Institute for Advanced Study in the Humanities and Social Sciences, 2002; Herbert Edling and David Nguyen-Thahn, "Taxes and Culture—Tax Reforms for Sustainable Development" *Fiscal Studies* 5 (2006); Marcelo Bergman, "Who Pays for Social Policy? A Study on Taxes and Trust," *Journal of Social Policy* 31.2 (2002): 289-305; Richard Bird, "Tax Challenges Facing Developing Countries," Institute for International Business Working Paper Series, No. 9 (2008).

[12] Benno Torgler, "Tax Morale in Latin America," Research Conference on "Responsive Regulation: International Perspectives on Taxation," Australian National University (2003).

and favorable tax treatment (such as tax holidays, tax exemptions, or lower tax rates), thereby disadvantaging medium-sized firms. This can result in the "missing middle," whereby medium-sized businesses pay disproportionate amounts of tax relative to their larger competitors, and therefore are incentivized to reduce in size, operate in the informal economy, or operate illegally. For a second example, we might consider how an excessive interest in attracting foreign capital can also have a damaging effect on the fiscal social contract. In the scramble to attract foreign sources of capital, states are in competition with one another to create a favorable tax environment. There are pressures on them, therefore, to implement low (or no) tax rates and, other favorable tax treatment that considerably reduces revenues for developing states. Offering foreign businesses favorable treatment might be considered unfair to local businesses and can undermine their willingness to pay taxes owed. Problems with rampant tax escape also damage the social contract in multiple ways, as I discuss in vi) and vii) below.

vi) Background Features of the Fiscal Environment. There are also important background features that must be appreciated as they are integral to the landscape, facilitate so much institutional corruption around the world, and are especially challenging for developing countries. To pick one of the important ones for illustrative purposes, the existence of tax havens creates a variety of problems. Most importantly, tax havens divert revenue from governments and facilitate massive tax escape. The secrecy that surrounds such transactions means that solid figures on the size of the problem are, of necessity, hard to find. However, reliable sources estimate that developing countries are losing at least $385 billion per year because of tax evasion and avoidance.[13] Tax havens can provide important channels for tax evasion. For instance, economic activity is often declared as occurring in places where taxes are low, rather than accurately recorded where it actually takes place. "Transfer pricing" is a recognized accounting term for sales and purchases that occur within the same company or group of companies. For

[13] Alex Cobham, "Tax Evasion, Tax Avoidance, and Development Finance," Queen Elizabeth House Working Papers, No. 129 (2005). More recent estimates put the figure at U.S. $858.8 billion and U.S. $1,138 billion in 2010. See Dev Kar and Sarah Freitas, Global Financial Integrity, "Illicit Financial Flows from Developing Countries: 2001-2010," December 2012, http://iff.gfintegrity.org/documents/dec2012Update/Illicit_Financial_Flows_from_Developing_Countries_2001-2010-HighRes.pdf. Also, according to James Henry, "developing countries might be losing as much as $120-$160 billion per year in lost tax revenue on the interest and other income generated by all this unreported anonymous wealth--more than the entire global total of foreign aid from OECD countries." James S. Henry, Tax Justice Network, "The Price of Offshore Revisited," report, Tax Justice Network, July 2012, http://www.elcorreo.eu.org/IMG/pdf/Price_of_Offshore_Revisited_72612.pdf.

example, it is not uncommon for a company to produce goods in one country, "sell" them to a subsidiary in a tax haven at cost price, then "sell" them again at an inflated price to a third subsidiary. The end result is that when the product is finally sold to a consumer in that third country, it misleadingly registers as a tax loss. These transactions create significant opportunities to disguise profits and report instead losses that attract no fiscal obligations. About half of all world trade passes through tax haven jurisdictions, as profits are shifted to places where tax can be avoided.[14] Tax havens have further far-reaching effects, for instance they destabilize the international economy.[15] Tax havens support illegal activity including bribery, organized crime, and tax evasion. In 2005 the World Bank estimated the annual flow of illicit money across borders to be $1 to 1.6 trillion.[16] And over the last decade this has grown to approximately U.S. $5.86 trillion, according to the Financial Transparency Coalition.[17]

Tax evasion and avoidance also constitute grave impediments to development and democracy, especially in developing countries.[18] Because large corporations and wealthy individuals are effectively escaping taxation, the tax burden is frequently shifted onto ordinary citizens and smaller businesses. Governments often thereby collect much-reduced sums insufficient to achieve minimal goals of social justice, such as providing decent public goods and services, which can also have a dramatic effect on developing or maintaining robust democracies.[19]

It is worth pointing out, before we continue, that there is a large grey area between evasion and avoidance; aggressive tax planning often can involve elements of both,

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[14] John Christensen, Pete Coleman and Sony Kapoor, "Tax Avoidance, Tax Competition and Globalisation: Making Tax Justice a Focus for Global Activism," in Jorma Penttinen, Ville-Pekka Sorsa and Matti Ylönen, eds., *MORE TAXES! Promoting strategies for global taxation* (ATTAC Finland, 2005).

[15] Rachel Keeler, "Tax Havens and the Financial Crisis," *Dollars & Sense*, May/June 2009, 21-25, http://dollarsandsense.org/archives/2009/0509keeler.html.

[16] Raymond W. Baker, *Capitalism's Achilles Heel: Dirty Money and How to Renew the Free-Market System* (John Wiley and Sons, 2005).

[17] E.J. Fagan, "New Report: Developing Countries Lost $5.86 Trillion from 2001-2010," Financial Transparency Coalition, http://www.financialtransparency.org/2012/12/18/new-report-developing-countries-lost-5-86-trillion-from-2001-2010/. See also Tax Justice Network, "The Cost of Tax Abuse: A Briefing Paper on the Cost of Tax Evasion Worldwide," November 2011, http://www.tackletaxhavens.com/Cost_of_Tax_Abuse_TJN%20Research_23rd_Nov_2011.pdf.

[18] Oxfam GB, "Tax Havens: Releasing the Hidden Billions for Poverty Eradication," June 1, 2000, http://policy-practice.oxfam.org.uk/publications/tax-havens-releasing-the-hidden-billions-for-poverty-eradication-114611; Oxfam International, "Money for Nothing: Three Ways the G20 Could Deliver up to US$280 Billion for Poor Countries," 2009, http://www.oxfam.org/sites/www.oxfam.org/files/money-for-nothing-g20-sept09.pdf.

[19] Juan Hernandez Vigueras, *Tax Havens: How Offshore Centres Undermine Democracy* (Akal, 2005).

and even specialists do not always agree on how to distinguish the two. I refer to the most aggressive schemes that include tax evasion and the grey area of tax escape, such as is represented by transfer mispricing schemes, as tax abuses.[20]

vii) Non-Transparency in the Sale of Natural Resources Facilitates Corruption. In many cases, the revenue that poor, developing countries could obtain from natural resource sales would be more than enough to finance what is needed for the state to be effective; that is to say, if the revenue were actually received and appropriately disbursed. The problem of corruption in the sale of resources is large. McFerson makes the following estimates of losses from corruption in Africa: $1 billion a year has been stolen from the Angolan people since 1996; one third of Democratic Republic of Congo's oil revenue is not shown in the country's budget; and despite $7 billion in annual oil profits, 60% of Guinea's population live on less than $1 per day.[21] Corrupt resource sales harm more than just the economy. For instance, corruption is strongly linked to severe restrictions on political and civil rights.[22] Governments (and individuals within governments) who stand to gain from corrupt deals are apt to take extreme measures to retain their position. Non-transparent processes for resource sales have enabled massive corruption and theft of resources, the proceeds of which could have been used to build effective states.

These seven factors present important challenges for developing countries, and provide fertile ground for institutional corruption to take root, and for improper influences and dependencies to result. We explore these issues in the next section. As this short summary highlights, there are a number of problematic behaviors that undermine effective and equitable achievement of proper purposes in tax regimes. We need to understand several of these in more detail to see the pervasive ways in which they undermine institution's proper purposes and beneficial development. While there are a number of behaviors that are potentially quite worrying, in the next section I identify only four of these.

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[20] Here I follow the convention adopted in International Bar Assocation's Human Rights Institute Tax Force on Illicit Financial Flows, Poverty and Human Rights, "Tax Abuses, Poverty and Human Rights," October 2013, http://www.ibanet.org/Document/Default.aspx?DocumentUid=4977CB3D-4988-4C9C-84C7-9050A5CB2311.

[21] Hazel McFerson, "Governance and Hyper-Corruption in Resource-Rich African Countries," *Third World Quarterly* 30.8 (2009): 1529-1547.

[22] Id.

4. State Tax Institutions and Proper Dependence

There are at least two ways in which tax institutions may not be properly dependent on appropriate parties. They may be improperly *dependent on inappropriate parties*. And they may be *improperly independent of others* (or even the same inappropriate parties but in different respects). How could it be that they are both improperly dependent and improperly independent on the same set of parties? Here is one way. In trying to attract Foreign Direct Investment (FDI), some parties may have extraordinary and inappropriate influence over tax practice, policy and law, and yet be able to ensure that some of the same laws and policies that they help craft do not apply to them, so that they are not required to pay a fair share of taxes.

Wealthy individuals and multinational enterprises have excessive influence in shaping the tax laws and practices in their favor. They also have extraordinary abilities to engage tax and legal advisors to help create sophisticated structures that enable them to circumvent the law. Such systems facilitate massive tax abuse by enabling these parties to circumvent the law, effectively providing one set of rules for the wealthy or well-connected, and another for others not so positioned.

At least four worrisome behaviors should be discussed in more detail, which can highlight some of these features.

i) Transfer mispricing and other techniques of corporate profit shifting.
ii) Practices concerning non-transparent natural resource sales.
iii) High levels of lobbying by businesses, the wealthy, or well-connected for tax holidays, exemptions, and other favorable treatment.
iv) The role of offshore and secrecy jurisdictions.

I discuss all of these next.

i) Transfer Mispricing and Other Techniques of Corporate Profit Shifting

Microsoft reported a $12.3 billion profit in 1999, but paid no tax at all for that year.[23] Despite sales of over $3 billion in the United Kingdom between 1998 and 2014, Starbucks paid only £8.6 million in British taxes, equivalent to less than 1% in tax.[24] In 2012, 2011, and 2010, Starbucks paid no taxes at all in Britain. Google declared paying £11.6 million in British taxes in 2012 despite generating $5.5 billion (£3.4 billion) of business in the U.K. SABMiller subsidiary Accra Brewery paid corporate tax in only one of the four years during 2007-2010 in Ghana, despite producing £29 billion worth of beer per year.[25] How do companies such as Microsoft, Starbucks and Google get to do this?[26] Are taxes, after all, "just for the little people" as Leona Helmsley once remarked? The use of tax havens is an important channel for tax evasion and constitutes a significant reason why many corporations pay very little, or even no, income tax. Economic activity is often declared as occurring in places where taxes are low, rather than accurately recording where it actually takes place. The basic idea behind these strategies is to make use of techniques to transfer profits to jurisdictions with low tax rates. This kind of tax abuse is known as base erosion and profit shifting. It aims to move profits to places where low taxes apply and move expenses to jurisdictions where the tax rate relief they afford is comparably higher. The overall effect is one of eroding the corporate tax base. A central mechanism for enacting this strategy is transfer mispricing.

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[23] See the U.S. General Accounting Office's website at: http://www.gao.gov/. For claims relating to similar practices see Glenn R. Simpson, "Irish Subsidiary Lets Microsoft Slash Taxes in U.S. and Europe," *Wall Street Journal*, November 7, 2005, on how Microsoft has used its Irish subsidiary to avoid tax. See also Richard Murphy, "Microsoft Does Tax Avoidance in Secret," Tax Research U.K. blog, July 10, 2006, http://www.taxresearch.org.uk/Blog/2006/07/10/microsoft-does-tax-avoidance-in-secret. These are by no means isolated cases. For the years 1996-2000 in the U.S., 60% of corporations with $250 million or more in assets reported having no federal tax liability at all. See, e.g., U.S. General Accounting Office, "Tax Administration: Comparison of the Reported Tax Liabilities of Foreign- and US-Controlled Companies, 1996-2000," February 2004.

[24] *BBC News,* "Starbucks 'Paid Just £8.6m UK Tax in 14 Years,'" October 16, 2012, http://www.bbc.co.uk/news/business-19967397.

[25] International Bar Assocation's Human Rights Institute, "Tax Abuses, Poverty and Human Rights," 36.

[26] Id. See also Tom Bergin, "Starbucks Reports UK Loss, Pays No Tax for 2012," *Reuters*, June 28, 2013, http://uk.reuters.com/article/2013/06/28/uk-starbucks-tax-britain-idUKBRE95R0YI20130628; *Al Jazeera,* "Starbucks 'Paid No UK Tax Since 2009,'" October 16, 2012, http://www.aljazeera.com/news/europe/2012/10/2012101615283844679.html and Jennifer Rankin, Lisa O'Carroll and Angela Monaghan, "Google Paid £11.6m in UK Corporation Tax Last Year," *The Guardian*, September 30, 2013, http://www.theguardian.com/technology/2013/sep/30/google-paid-uk-corporation-tax.

Transfer mispricing constitutes one of the most damaging international tax abuses. Its scale is phenomenal. For the last ten years, transfer mispricing has accounted for about 80 percent of illicit financial flows out of developing countries, which is around U.S. $4.688 trillion of the estimated U.S. $5.86 trillion in total illicit financial flows.[27] Sixty percent of trade involves sales and purchases that occur within the same company or group of companies.[28] Because these transactions occur within the company, there is wide scope to trade at arbitrary prices instead of market-attuned ones. Here is a simplified example.[29] A multinational company has a factory in one country. The factory produces products, say, microwave ovens for $50, and sells these to a subsidiary in the same group that is based in another country which is a tax-haven. The price of the transfer might be defined by the accountants as the cost of production, so in this case as $50. Then the subsidiary in that tax haven sells the product to a foreign subsidiary in a third country, for (say) $200. If the price of the good to consumers in that third country is $150, the good has then been sold at a loss of $50, technically. Because the cost of the good from the tax-haven country is $200 and the sale price to an actual consumer is $150, a net loss of $50 may be recorded in the country where the sale finally takes place, a loss that can be offset against other taxes to be paid (in that country). Despite a real profit of $100 ($150-$50, the actual sales price less the actual cost of production), the company may declare a net tax loss. These kinds of accounting schemes, which do not reflect "arms-length" pricing (that is, prices the market would use for trade between unrelated parties), and variations on these general themes are extremely widespread and many of them are perfectly legal.

> You only have to look at the miraculously low global tax payments by many multinationals through the 1990s, or at the vast amounts of crude oil which are traded in a mountain village in landlocked Switzerland, to suspect that this is both well organized and widespread. The aggregate figures for world trade confirm it: around 60% of all trade takes place within multinational corporations, and around 50% appears to pass through tax havens, even though there is scant productive activity

[27] Fagan, "New Report: Developing Countries Lost $5.86 Trillion from 2001-2010." Older estimates include staggering amounts as well. See for instance, Oxfam GB, "Tax Havens: Releasing the Hidden Billions," 3. See also Cobham "Tax Evasion, Tax Avoidance and Development Finance."

[28] Christensen, Coleman and Kapoor, "Tax Avoidance, Tax Competition and Globalization."

[29] For instance, it ignores transport costs.

> occurring there. Evidence from the U.S. suggests that accounting practices masquerading as transfer pricing "policies" are having a bigger impact on wealth transfers from ordinary people to corporations than any of the headline financial scandals (for example, Enron, WorldCom).[30]

These tax havens clearly have enormous consequences for multinationals' home countries. In addition to the losses sustained directly through the transfer pricing schemes (which for the U.S. amounted to $175 billion from 1998-2001), there are also big losses sustained because of phony company headquarters or residences set up in offshore tax havens.[31] U.S. corporations have approximately $1.7 trillion in such havens, with Apple alone holding $100 billion in tax haven accounts.[32] Quite simply, when the home country collects less tax revenue, less is available to spend on public goods and services. In an era where government shutdowns are a regular feature of the political landscape, even in developed countries, we do not need to dwell on how destructive too little revenue can be for maintaining an effective state.

ii) The Corrupting Influence of Non-Transparent Natural Resource Sales

In many cases, the revenue that would be derived just from resource sales, if received and properly spent, would be more than enough to finance the necessary provisions for an effective state capable of helping citizens to live decent lives. This is especially clear if we look at the case of oil and the crippling corruption that sometimes surrounds its sale.

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[30] Tax Justice Network, "Inaugural Newsletter," September 2003. For similar claims see John Neighbour, "Transfer Pricing: Keeping It at Arm's Length," *OECD Observer*, July 3, 2008, http://www.oecdobserver.org/news/archivestory.php/aid/670/Transfer_pricing:_Keeping_it_at_arms_length.html. See also, Association for Accountancy and Business Affairs, "Offshore Watch," webpage, http://visar.csustan.edu/aaba/aaba.htm (accessed February 26, 2014).

[31] Tax Justice Network, "Inaugural Newsletter." For a more recent figure consider the data provided by Tax Justice Network, "The Cost of Tax Abuse," in which it is claimed that the United States lost approximately $337 billion in tax as a result of the shadow economy in 2011.

[32] Financial Times, "Apple, Leverage and Tax Avoidance," *Financial Times*, May 2, 2013, http://www.ft.com/intl/cms/s/0/b5d2bd7e-b326-11e2-95b3-00144feabdc0.html#axzz2uT12coPf; Nelson D. Schwartz and Charles Duhigg, "Apple's Web of Tax Shelters Saved it Billions, Panel Finds," *New York Times*, May 20, 2013, http://www.nytimes.com/2013/05/21/business/apple-avoided-billions-in-taxes-congressional-panel-says.html.

Consider how, for instance, more than $4 billion in oil revenue disappeared in Angola between 1997 and 2002, which equals the entire amount the state spent on social programs during the same period.[33] As the international oil companies refused to disclose how much money they paid for oil in Angola, it proved impossible for Angolans to monitor where money paid for oil actually went. Natural resources should be held in trust by the state for the benefit of (at least) all citizens of a country. Citizens thus should be entitled to information concerning the sale of their resources. Moreover, recognition of ownership of these resources is acknowledged in the law of developing countries. For instance, Angolan Law N. 13/78 of August 26, 1989 "establishes that all deposits of liquid and gaseous hydrocarbons which exist underground or on the continental shelf within the national territory . . . belong to the Angolan People."[34] If they do so belong, those people are entitled to information about how their resources are being managed. Such information helps citizens keep governments accountable for the sale of their resources and the management of revenues that are thereby generated.

This problem is very serious. For instance, in Angola, oil revenue makes up nearly 80% of the state budget. It is estimated that from 2007 through 2010 about a quarter of the entire state budget disappeared. The U.N. has been relied on to assist with the shortfall.[35] A similar picture emerges in many other developing countries, such as Nigeria and Equatorial Guinea.[36]

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[33] Human Rights Watch, "Angola: Account for Missing Oil Revenues," January 12, 2004, http://www.hrw.org/news/2004/01/11/angola-account-missing-oil-revenues.

[34] Global Witness, "A Crude Awakening: The Role of the Oil and Banking Industries in Angola's Civil War and the Plunder of State Assets," December 1, 1999, 5, http://www.globalwitness.org/sites/default/files/pdfs/A%20Crude%20Awakening.pdf.

[35] African Economic Outlook, "Angola," http://www.africaneconomicoutlook.org/en/countries/southern-africa/angola/ (accessed February 28, 2014) and Human Rights Watch, "Angola: Explain Missing Government Funds," December 21, 2011, http://www.hrw.org/news/2011/12/20/angola-explain-missing-government-funds.

[36] About 70% of Nigeria's income derives from oil. Between $2 and $5 billion of these funds are estimated to have been stolen by General Abacha and deposited in offshore accounts. See Revenue Watch Institute, "Nigeria," http://www.revenuewatch.org/countries/africa/nigeria/overview (accessed February 28, 2014) and Asset Recovery Knowledge Centre, "Sani Abacha," http://www.assetrecovery.org/kc/node/52f770df-a33e-11dc-bf1b-335d0754ba85.0 (accessed February 28, 2014).

Equatorial Guinea has extremely lax reporting requirements for oil revenues, which account for roughly 70% of the government budget. Global Witness reports that as much as $500 million of these revenues may have been transferred into secret overseas bank accounts between 2001 and 2003. See Global Witness, "Time for Transparency," March 2004, 53-64, http://www.revenuewatch.org/countries/africa/equatorial-guinea/overview and Revenue Watch Institute, "Equatorial Guinea," http://www.revenuewatch.org/countries/africa/equatorial-guinea/overview (accessed February 28, 2014).

Not only is there massive revenue leakage related to natural resources sales, there are often few mechanisms in place for citizens to know that natural resources are being sold, so it is no surprise that they are frequently unable to track where money for these sales have gone. Deals are often forged in private without proper oversight or democratic accountability. Other areas of institutional weakness thus contribute to the problem. But the non-transparent resource sales assist in exacerbating institutional weaknesses, as due funds which could be used to strengthen institutions are not collected.

iii) High Levels of Lobbying for Favorable Treatment

Governments perceive the need to provide favorable tax treatment to attract inward investment. Taking advantage of this perception, corporations also lobby governments for special consideration and favorable treatment in tax arrangements as a condition of investing in those countries.

But offering favorable tax treatment to some can promote unfairness to other taxpayers who do not have the same kind of bargaining power that multinational enterprises and the well-connected do to negotiate such advantageous terms. There is also huge potential for corruption in negotiating these tax concessions.

Furthermore, tax holidays and incentives do not always bring the societal benefits imagined, as is discussed in more detail in the next section. As we see, there is vast capacity to use sophisticated measures such that tax burdens can be minimized and can, in any case, be largely diverted into offshore accounts. And providing too many tax holidays and incentives risks eroding the link between taxpayers and the political system. Tax holidays and incentives may result in a perverse form of "representation without taxation," which undermines fundamental democratic principles.

iv) The Offshore Impact

Enormous amounts of private wealth are stored in what are variously called "offshore" or "secrecy" jurisdictions. These secrecy jurisdictions have minimal or no tax obligations, but more importantly, they offer secrecy about financial information and shield those who operate in them from laws in their residency jurisdiction.

It is hard to see why bank secrecy is legitimate, especially when one considers the effects this has on attempts to enforce the law in all countries. Secrecy jurisdictions are places that create regulation specifically and primarily for the benefit of non-residents. This regulation is intentionally designed to facilitate the circumvention of legislation or regulation in another jurisdiction. And to make sure that those who use the secrecy jurisdiction are protected, elaborate, legally-backed structures can ensure that non-residents cannot be identified by outside parties.

Securely investing large amounts of private wealth in offshore jurisdictions is a complex matter and relies on a number of expert skills such as those of financial planners, tax lawyers, accountants, bankers, and estate planners. Those who embark on such ventures rarely do so without enlisting the help of such experts. And, indeed, an entire industry of firms has flourished to address this lucrative international market.

5. Does Favorable Tax Treatment Help Promote Important Goals which Developing Countries Have Reasons to Care About?

There is a common view that tax incentives, especially those that attract foreign direct investment, are of benefit to developing countries—by assisting job creation, expanding lucrative industries, stimulating growth, or otherwise promoting positive developmental outcomes. However, despite these common assumptions, the evidence does not substantiate the view in many cases, especially at critical stages of development. I review some of this evidence next.

The rationale for tax incentives is often not well-defined. Some stated objectives include the desire to promote industrialization, technology transfer, provision of jobs, or development of regions perceived to be languishing economically. Even when objectives are clearly articulated and sensible, they frequently do not justify favorable tax treatment or alternatively have unwanted consequences. An example of the former is when the investment would occur whether or not tax concessions are given, as it is anticipated the investment will be sufficiently profitable.[37] And an

[37] A 2003 report by the global consulting firm McKinsey states: "popular incentives such as tax holidays, subsidized financing or free land serve only to detract value from those investments that would likely be made

example of the latter is that in promoting industrialization, undesirable side-effects sometimes include encouraging migration to cities, which aggravates urban problems.[38] Also, taxing agriculture in efforts to stimulate manufacturing generally involves transfers from the poorest members of society to those who are better off.[39]

A common stated rationale for tax incentives is job creation, especially in labor-surplus economies. But increased employment of the right kind is not always the result. It is difficult to monitor whether job creation is occurring in the targeted sectors or whether more low-skill, low-paying jobs are being created, which may not be what the government intends to happen with its incentive programs. This often happens in the mining sector.[40]

Granting tax incentives to stimulate new industries is often ill-conceived, as new industries typically have little tax burden, so tax incentives are not a big issue. Tax holidays often favor the interests of so-called footloose industries (such as basic manufacturing) that begin to make profits during the holiday period. But such industries typically require relatively little investment. Footloose industries can also leave easily when the holiday period expires. This runs counter to the rationale of trying to attract more permanent investment. What many states also fail to appreciate is the spectacular opportunities afforded for corporate profit shifting such as by manipulating transfer pricing arrangements. Multinational enterprises have enormous ability to shift income to areas attracting favorable tax treatment and to move deductions to firms where tax credits can be maximized.[41] Anticipated future tax revenues therefore frequently fail to materialize.

Furthermore, there is a lot more gaming of the system that thwarts its intended purpose. If new firms attract favorable treatment and old firms do not, there is a strong incentive to reconstitute old firms pretending they are new ones when the

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in any case." McKinsey, "New Horizons: Multinational Company Investment in Developing Economies," October 2003, 14, http://www.mckinsey.com/insights/economic_studies/new_horizons_for_multinational_company_investment.

[38] Charles McLure, "Tax Holidays and Investment Incentives: A Comparative Analysis," *Bulletin for International Fiscal Documentation* 53.8/9 (1999): 326-339.

[39] Id.

[40] Important research also suggests that, at least in the case of resource extraction, benefits in the form of employment, profits (and so on) do not go, on balance, to the host country. John Soussan, *Primary Resources and Energy in the Third World* (Routledge, 1988), 34-39.

[41] Such findings also confirmed by Anwar Shah, "Overview," in Anwar Shah, ed., *Fiscal Incentives for Investment and Innovation* (Oxford University Press for the World Bank, 1995), 27; and Jack M. Mintz, "Tax Holidays and Investment," in Shah, *Fiscal Incentives for Investment and Innovation*, 178.

holiday period expires. There are also the problems of "yo-yoing" or "round-tripping." This occurs when local investors wish to take advantage of opportunities available to foreign investors, such as favorable tax treatment. So local investors move revenue to an offshore or secrecy jurisdiction that then obscures the true ownership and source of the money. If that local investor then invests the money back in her home country, she is said to have "round-tripped" the money back to her home country. She can then take advantage of the same favorable treatment available to her foreign competitors.

Further damage can result for the integrity of a tax system. Tax incentives can undermine the equity of the tax system, as they are of benefit primarily to wealthy investors. They also undermine the perception of fairness in the tax system. Favorable tax treatment that is offered on a discretionary basis creates opportunities for corruption, discrimination, cronyism, and political favoritism. Tax incentives can also entail that higher taxes are needed to compensate for revenue foregone.[42]

While there is a role for FDI in development, caution is advisable as consideration must be given to the institutional factors enabling the poor to benefit from this kind of investment.[43] Favorable tax treatment to attract FDI can frequently damage institutional quality and undermine desirable development outcomes. Let us review briefly. Frequently, FDI has no effect on growth and a markedly negative effect on human development, especially in the least developed countries.[44] Several leading economists are also skeptical about claims that FDI invariably has good effects for the least developed countries, especially concerning growth. It appears that when

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[42] Though it is also worth observing that there is very little evidence of a direct relationship between the amount of direct investment and the rate of tax. See Thomas Rixen and Susanne Uhl, "Europeanising Company Taxation—Regaining National Tax Policy Autonomy," International Policy Analysis, July 2007, 6, http://library.fes.de/pdf-files/id/04750.pdf. Furthermore, many players in the foreign investment game prefer lower tax rates rather than incentives since it involves greater clarity, predictability, and the perception that they will be dealt with fairly relative to competitors.

[43] Christian Aid, "Supplementary Written Evidence: A Note to the House of Lords Economic Affairs Committee: Research into FDI, Economic Growth and Human Development," in the House of Lords Select Committee on Economic Affairs, "The Economic Impact and Effectiveness of Development Aid," December 27, 2011, 130-135, http://www.parliament.uk/documents/lords-committees/economic-affairs/DevelopmentAid/DevAidEvidenceVol.pdf.

[44] Bruce A. Blonigen and Miao Wang, "Inappropriate Pooling of Wealthy and Poor Countries in Empirical FDI Studies," National Bureau of Economic Research Working Papers, No. 10378 (2004), show misleading results from pooling developed and developing country data. Other critical accounts can be found in Dierk Herzer, Stephan Klasen and Felicitas Nowak-Lehmann, "In Search of FDI-led Growth in Developing Countries: The Way Forward," *Economic Modelling* 25.5 (2008): 793-810.

certain initial conditions are present, FDI can have positive growth benefits; when the country's institutions and financial markets are sufficiently strong, this is possible. But for those countries with the weakest institutions, FDI is often a hindrance. For those countries, FDI is more often than not in the extractive industries, and is likely to rely on low-skilled labor and imported capital goods. Corruption is rife in such cases and economic benefits for those countries hard to locate.

What seems to emerge quite strongly is that if a state does not yet have sufficiently robust institutions set up, the FDI is not necessarily a positive factor, as it leads to further opportunities for corruption, thus thwarting attempts to shore up robust institutions.[45] Another important finding is that the benefits of FDI may depend on countries meeting a threshold level with respect to secondary education.[46] FDI can also discourage investment by individuals in higher levels of education, as lower value-added FDI tends to promote demand for low-skilled labor.[47] For these and other reasons, some theorists argue that policies of providing favorable tax treatment are not advisable.[48]

Despite these weaknesses, it is important to stress some key points. While there might be a role for FDI in development, careful consideration should be given to evidence about anticipated benefits to check whether the balance of costs and benefits for particular countries plays out favorably for them. Special attention should be given to effects on institutions, growth, and human development. If sufficiently robust institutions are not yet established, FDI is not necessarily beneficial, as it leads to further opportunities for corruption, thus thwarting attempts to shore up robust institutions. While there is huge variation in the effects of FDI for different countries, these are mediated through the quality of institutions.

[45] How do we create robust institutions without FDI, some might wonder? This is a huge topic with many competing views. Perhaps all we need to point out here is that it must be possible to do this in the absence of FDI: witness the success of various states (indeed, empires) over time in the absence of FDI, including the U.S., the so-called Asian Tigers, China, and the United Kingdom. Arguably, all of these had sufficiently robust institutions before FDI became a factor. For one plausible view of how to create robust institutsion without FDI, see Daron Acemoglu and James A. Robinson, *Why Nations Fail: the Orgins of Power, Prosperity and Poverty* (Profile Books, 2012).

[46] Eduardo Borensztein, Jose de Gregorio, and Jong-Wha Lee, "How Does Foreign Direct Investment Affect Economic Growth?" *Journal of International Economics* 45.1 (1998): 115-135.

[47] Sjoerd Beugelsdijk, Roger Smeets and Remco Zwinkels, "The Impact of Horizontal and Vertical FDI on Host's Country Economic Growth," *International Business Review* 17.4 (2008): 452-472.

[48] McLure, "Tax Holidays and Investment Incentives." Also, much literature suggests it is better to focus on actual impediments to investment and aim at reducing those directly, such as a lack of infrastructure.

If you have strong institutions in place, FDI has different effects from those which occur when robust institutions are not established.

So we need to take cognizance of certain extremely worrisome effects that undermine primary factors that will be beneficial to prosperity in the long run. From the discussion so far, it should be clear that tax havens undermine the functioning of the tax system in providing channels by which a tax system's proper purposes are thwarted. Those who lobby for the subversive practices can also take advantage of sophisticated ways to avoid having to pay almost any tax at all; indeed, possibly being entitled to tax credits and rebates. In providing channels whereby the most well off can escape taxation and others, including the least well off, cannot, we would not have a system of taxation that is equitable, even in the unlikely event that it manages to be effective.

Finally, two important points deserve emphasis in closing this section. First, the strategy of over-reliance on FDI is not always judicious. But being unwise is not the same as being corrupt. When the institution is manipulated by multinational enterprises (MNEs) such that it promotes their interests at the citizens' expense, we have the makings of corruption. Allowing structures of tax abuse to flourish and facilitate schemes whereby little revenue is collected does, in general, thwart citizens' interests. Though each case should be judged on its merits, as we have seen there is strong evidence that suggests caution concerning relying on FDI to be a positive engine for beneficial development.

Second, we have seen that tax havens damage institutional quality in developing countries. Another problematic feature they have is that in providing regulation-free zones, secrecy jurisdictions undermine respect for the rule of law everywhere. And in doing so, they undermine institutional quality everywhere. Offshore financial centers and secrecy jurisdictions create zones of secrecy that protect those from outside the jurisdiction from regulations that would apply to them in other places. This facilitates massive ability to evade regulation, monitoring and oversight. In our globalized world, a zone of unregulated international finance has profound effects on respect for the rule of law and the quality of institutions—both domestic and international.

6. What Solutions are Available to Problems Identified?

Combatting the problems identified here will involve several reforms and participation from a range of actors. Key components of solutions seem to include at least the following ten features:

i) Raising awareness concerning tax issues and their harmful effects.

ii) Reworking international standards, practices, laws, codes, and policies.

iii) Promoting a culture of compliance through appropriate monitoring, oversight, and mandatory information sharing.

iv) Increasing appropriate levels of transparency concerning tax and related affairs.

v) Devising systems and institutional innovations that can harness the power and opportunities related to transparency initiatives.

vi) Increasing cooperation and collaboration among multiple stakeholders on tax issues.

vii) Sharing financial information across states.

viii) Increasing international assistance to help governments in developing countries who would welcome such support in improving tax performance.

ix) Ensuring relevant professionals are mindful of their professional and legal obligations related to tax duties.

x) Strengthening the role of civil society in improving governance and accountability.

Here I discuss four kinds of efforts: improving exchange of information, improving transfer pricing arrangements, supporting initiatives that harness the power of transparency in productive ways, and increasing international assistance. Some examples of each are discussed next.

Sharing Information

A common recommendation that is repeatedly endorsed in the literature is that there is a need for much greater exchange of information to tackle various tax abuses. It is simply impossible to assess proper tax obligations in the absence of accurate information. Effective tax enforcement relies on such accurate information and its absence can have a deterrent effect on other taxpayers' levels of compliance. A system of automatic exchange of information is preferable to one where information is shared only on request.

Under the current standard, domestic tax authorities have to have a reasonable degree of suspicion before they can make a request to other jurisdictions. But that means, in many cases, they must know quite a lot already, perhaps all the information they are requesting—such as the names of entities in which accounts may be held and who the beneficial owners actually are. By contrast, automatic exchange of information is more proactive. To be helpful, information should be exchanged automatically on a range of items, including full names and details of persons about whom data is being supplied (including passport number, residential address, tax identification number, and other details which can help to uniquely identify particular individuals who aim to shield their wealth and income from tax authorities).[49]

There are promising steps to require the sharing of information in efforts to end bank secrecy. The U.S. Foreign Accounts Tax Compliance Act (FATCA) came into force in January 2013. This Act makes it mandatory for foreign financial institutions to determine which of their clients could be "U.S. Persons," and to pass on account details to the U.S. Internal Revenue Service. The aim is to identify U.S. tax evaders. This significant step has added considerable momentum to global efforts towards automatic exchange of information, the elimination of offshore bank secrecy, and tax evasion. Recent prosecutions have had notable effects as well. Wegelin and Co., one of the oldest Swiss banks, was successfully sued and found guilty of helping Americans evade taxes through secret accounts. There are similar investigations currently underway into a number of other Swiss banks to examine whether they are guilty of similar offenses.[50]

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[49] Richard Murphy, "Information Exchange: what would help developing countries now?" Tax Research LLP, June 2009, http://www.taxresearch.org.uk/Documents/InfoEx0609.pdf.

[50] In 2009 the U.S. Department of Justice successfully sued UBS, forcing it to disclose identities of over 50,000 U.S. account holders hiding U.S. $14.8 billion of assets in Swiss bank accounts. See International Bar Association's Human Rights Insitute, "Tax Abuses, Poverty and Human Rights," 61.

Considering Appropriate Revisions to International Practices, Laws, Codes, and Policies

There is much scope for international cooperation in managing destructive effects resulting from tax abuse. In addressing problems related to transfer mispricing, some solutions include developing better guidelines on systems of unitary taxation for multinationals to stop the entirely false shifting of profits to countries with low or no taxes, prescribing transfer pricing formulae which share taxes on profits among all the states in which the corporation engages in economic activity, and, more generally, harmonizing tax rates and policy. There are promising steps in some of these directions. The U.S. Treasury has proposed several international reforms, including the "world-wide formula apportionment" model. This involves assigning the corporate tax base across jurisdictions according to a formula reflecting the global dispersion of firm activity and distributing profits across countries more evenly.[51]

The Organisation for Economic Cooperation and Development (OECD), which includes 30 high-income countries and is the developed world's most influential economic think-tank, has done much useful work on possible solutions, including developing guidelines and policy on issues such as information exchange, harmful tax practices, and transfer pricing. It has produced a number of important documents such as codes, standards, and guidelines for tackling tax havens.[52] The OECD solution to transfer mispricing currently constitutes the effort that enjoys the greatest international consensus on the issue of taxing multinational enterprises. Given that it is the solution that currently enjoys this status, and that momentum has gathered around it, it is worth at least understanding what it is. Very briefly, the OECD solution to the problems of transfer mispricing involve clearer, more equitable rules for dealing with the "arm's length principle," offering international, market-attuned transfer pricing standards that the various OECD member countries have agreed should be the ones in use for determining tax obligations. It claims to provide a better alternative than the main rival idea, which is global

[51] Jack Mintz and Joann Martens Weiner, "Exploring Formula Allocation for the European Union," *International Tax and Public Finance* 10.6 (2003): 695-711.

[52] The approach has been one of aiming to combat harmful tax practices through mutual undertakings and exchanging information, promoting the forging of bilateral treaties.

formulary apportionment.[53] There is much controversy around this, but at any rate, OECD members have adopted these guidelines, along with some other nations, so some common ground has been achieved, even if further refinements are needed on improved transfer pricing standards.[54]

Increasing Transparency: The Extractive Industries Transparency Initiative

There has been some notable progress in the area of mandating transparency in efforts to promote greater accountability. New legal initiatives are requiring greater transparency concerning revenues from natural resource projects. Some examples of these include regulations associated with the Dodd-Frank Act in the United States and the European Union Accounting and Transparency Directive. One especially promising initiative gaining momentum is the Extractive Industries Transparency Initiative which, if successful, would have far-reaching implications. The problems that surround non-transparent natural resource sales and the scale of those affected is often unappreciated. Approximately 3.5 billion people live in countries rich in resources.[55] Yet all too often many poor citizens do not benefit from the extraction of their natural resources. Citizens could be considerably assisted in keeping their governments accountable for resource sales through international measures that promote transparency and accountability, such as the Extractive Industries Transparency Initiative (EITI). The EITI promotes transparency of revenue flows at the local level and seeks to make public and verify both company payments and government receipts of payments for resources such as oil, gas, and other mined resources. Companies disclose their tax and royalty payments for resources to governments. Governments disclose what they receive in payments. The tax and royalty payments are then independently verified and made

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[53] On the latter proposal, there is one entity for the purposes of tax reporting and liability, and taxes are paid more evenly across all the jurisdictions in which the entity operates. What global formulary apportionment has in its favor is that there is greater administrative convenience and certainty for taxpayers, reduced compliance cost for taxpayers, and consolidation better reflects the underlying reality that there is just one enterprise at issue. Critics worry about double taxation, that the pre-determined formulas are rather arbitrary and not sufficiently market-attuned, there are difficulties associated with fluctuations in exchange rates, and that it disregards genuine differences between generating profits and losses in each jurisdiction, amongst a host of other concerns. A detailed analysis of the strengths and weaknesses of the two proposals would require discussing technical detail that is beyond the scope of this particular paper's primary objectives.

[54] There are many factors to be balanced in reaching a fair solution. Maybe no solution will convince all critics, but it is important that some standards be followed as this step constitutes progress over the status quo that is deeply worrying from the point of view of institutional corruption.

[55] See the EITI website at http://eiti.org.

public in a process overseen by several key stakeholders, including representatives from governments, companies, and civil society. This initiative allows for consensus-building development, and helps create trust, stability, coherence, good governance, and confidence in judicious revenue collection and disbursement. The initiative provides mechanisms for relevant information gathering, participation, and accountability, such that citizens and the private sector in those countries can help improve governance.[56] In Section 9 we return to this initiative which incorporates many exemplary features that usefully harness the power of transparency in productive ways.

Increasing International Assistance to Help Governments in Developing Countries Improve Tax Performance

How can developed countries assist developing countries in improving their domestic tax systems to make them more effective, efficient and equitable? How can developed countries assist in strengthening the fiscal social contract and tax morale identified in Section 3?[57]

All the mechanisms discussed so far should facilitate such strengthening. But more targeted assistance is also possible. Modern tax systems aim to promote voluntary tax compliance through a number of desirable features, including good public information, clear and simple laws, low compliance costs, simple tax forms, sufficient enforcement power for competent tax administration, automated processes for filing returns and payments (which limit direct contact between tax administrators and taxpayers), promoting professionalism and integrity in human resource management, and a low tolerance environment for cases of corruption or dishonesty. Developed countries can assist by sharing knowledge related to a number of these features, for instance, they can share knowledge about

[56] Almost everyone, whether they reside in developing or developed countries, has a role to play in supporting such worthwhile initiatives. Citizens of countries in the developed world can assist poor citizens in resource-rich, developing countries by making participation in the EITI mandatory when operating in key organizations under their jurisdiction. For instance, they could require that all multinationals that list on developed world stock exchanges comply with transparency practices such as those outlined by the EITI. They could make membership of EITI mandatory for participation in desirable opportunities such as being involved in contracting agreements with government.

[57] Even though many acknowledge that local solutions should be found for particular country's tax problems, nevertheless there is also widespread insistence that there are some common lessons to be drawn from the experiences of many countries already having travelled on similar paths, and so they can offer to share these experiences.

technological innovations in tax collection, monitoring and auditing. Information technology solutions can play an important role. Automation of tax administration processes can not only reduce burdens on personnel, but also provide fruitful areas for reducing corruption and evasion. Developed countries can also assist by ensuring tax processes are transparent and largely non-discretionary (in efforts to block corruption opportunities), and they can ensure there are many vehicles for active citizen engagement, such as ensuring feedback mechanisms like hotlines, corruption report cards, or surveys are a regular part of evaluative processes. There is a clear need in many cases to train suitable personnel and grow local fiscal capacity, and developed countries can assist with this training. Additional personnel are also needed for a range of other tasks such as improving taxpayer compliance and updating the legislative framework where this is needed to counter tax evasion.

Developed countries can also help organize the international response to issues that benefit from cooperation among tax authorities, especially through sharing of information and supporting those initiatives that facilitate transparency and block tax evasion. Developed countries can also support developing countries in understanding how to apply transfer pricing rules and thereby enable them to collect their appropriate share of taxes owed in multinational enterprises. They can establish panels of experts who can provide real time advice on a case by case basis to tax administrators in developing countries trying to adopt and implement transfer pricing rules. They can assist countries with exercises such as joint transfer pricing audits where this would enhance effective compliance. And they can assist developing countries in establishing a transfer pricing dispute resolution mechanism and fund the participation of personnel from developing countries' participation. They could also support dialogue networks, and international meetings for tax officials to share information about successful experiences or new ideas in strengthening tax administration that can support tax policy reform.[58]

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[58] Many of these suggestions are drawn from a few helpful reports including OECD, "Governance, Taxation, and Accountability: Issues and Practices," DAC Guidelines and Reference Series (2008), http://www.oecd.org/dac/governance-development/40210055.pdf and OECD Informal Task Force on Tax and Development, "Summary Record from the Second Plenary Meeting of the Informal Task Force on Tax and Development," April 11-12, 2011, http://www.oecd.org/ctp/48438749.pdf.

While this is clearly not anything like a complete list of useful solutions, this short discussion is sufficient for us to engage in some of the normative work that this project hopes to advance.

7. Distributing Responsibilities for Reforms

Now that we understand some ways in which tax institutions might get corrupted and some remedies, we turn to responsibilities for addressing the problems identified. Consider the wise words of two of the most influential writers on institutional corruption.

Dennis Thompson writes that "just 'blaming the system' lets too many individuals in the system off the moral hook. It ignores the need to pin some responsibility for making changes (or failing to make changes) on some people in the institution. And it neglects the possibilities for making less radical but important reforms within the system. There can be degrees of institutional corruption, and degrees of individual responsibility for it, even within the system. There are better and worse ways of working inside a corrupt institution."[59]

And Lawrence Lessig remarks that "that's not to deny individual responsibility within such a system. It's just to shift that responsibility from changing individual behavior within the system to the responsibility for changing the system itself. So specifically, the sin of a Congressman within such a system is not that she raises campaign money. It is that she doesn't work to change the corruption that this dependence upon a small set of funders has produced."[60]

Why might someone have a duty to reduce corruption concerning taxation? In particular, why might those in developed countries have duties to assist in developing better tax institutions? This is a huge topic that I cannot do justice to here.[61] Instead, I offer three kinds of answers that should be compelling from a

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[59] Dennis Thompson, "Two Concepts of Corruption," Edmond J. Safra Working Papers, No. 16 (2013): 17, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2304419.

[60] Lawrence Lessig, "Institutional Corruptions," Edmond J. Safra Working Papers, No. 1 (2013): 15, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2233582.

[61] In a sustained treatment elsewhere, I argue that we all have obligations to one another to ensure we have the necessary ingredients for a decent life (and we have especially strong obligations not to get in the way of what people need for such a decent life through our harmful activities and practices). Effective states are an essential component of enjoying a decent life in our world. So we have obligations to support states' attempts

range of normative perspectives that will be sufficient for allocating some relevant responsibilities. One is oriented around our duties not to cause harm, the other around our duties to respect human rights, and a third concerns our special responsibilities to remedy problems in certain cases. So, roughly, these strategies would be that we all have basic duties not to harm others and so when our tax practices do this, we have special duties to take care that we reform them. And we also have a responsibility to care about reforming tax practices in virtue of commitments to human rights. Furthermore, we have special responsibilities to remedy problematic tax practices that we have caused, benefited from, and have capacity to fix. More detail about each strategy follows.

(i) Duties Not to Harm: One central point of convergence in normative discussions is a common view that we ought not to do any harm. Whatever the merits of taking actions to benefit or assist others, we should be especially vigilant to avoid doing harm to others. The so-called negative obligations are our strongest duties and we must attend to these as a matter of great moral importance. We might draw attention to the fact that the taxation arrangements and practices described here often do facilitate vast levels of tax escape that have profoundly harmful consequences, especially for those in developing countries. When developing countries fail to collect revenues owed to them on such a grand scale, they often have inadequate funds with which to provide the essential public goods and services necessary to prevent massive harm to their populations.

(ii) Duties to Respect Human Rights: Inadequately funded governments are also unable to secure and provide what people need to realize their human rights. Tax

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to be effective and we have a range of other obligations to help secure for others core elements of a decent life. But we need not rely on this more elaborate account because we can marshal a sufficiently compelling argument in terms of remedial responsibilities. In particular, those in developed countries have a significantly greater share of the remedial duties associated with reducing global injustice, and we can argue for this position on several grounds. While we might all acknowledge that poor citizens and their governments are key actors in relieving poverty in poor, developing countries, they can be considerably helped or hampered in these efforts through actions, institutions, practices, and policies that are under the control of those in developed countries. Developed world actors currently are too much part of the problem in undermining states' abilities to be effective through their support for a variety of institutions that govern global practices—especially those found in the global economy—including those that govern trade, investment, international financial markets and taxation, all of which can undermine revenue raising capacity and job opportunities in those countries. Developed countries also undermine the empowerment of citizens by failing to support an international and domestic environment conducive to accountability, self-organization, and freedom of expression, to name but a few central ways in which they are currently contributing greatly to important global problems. For a sample of arguments see Gillian Brock, *Global Justice: A Cosmopolitan Account* (Oxford University Press, 2009); Gillian Brock, "Health Inequalities and Global Justice," in Patti Lenard and Christine Straehle, eds., *Global Health Inequality* (Edinburgh University Press, 2012): 102-118; and Brock, "Global Poverty, Decent Work, and Remedial Responsibilities."

abuses have important impacts on human rights realization.[62] Quite simply, when governments are unable to collect the revenue they need, human rights go unrealized or are under threat. Insufficient funds means inadequate resources and institutions that are designed to uphold civil and political rights, and insufficient funds to provide the programs that secure economic and social rights. Under international conventions, the primary obligation for protecting human rights lies with states. If tax abuse results in threats to human rights, it is primarily the responsibility of states to make necessary revisions, such as to tax law and practice. But there are many who are obligated to assist states in this enterprise, including citizens, accountants, lawyers and transnational organizations. And weak states' attempts to make necessary revisions will be considerably assisted with appropriate support from stronger states.

(iii) Remedial Duties: Alternatively (or in addition), we might make use of a connection theory of remedial responsibility. In assigning remedial responsibility for addressing the defects with our tax practices, we can usefully draw on dominant patterns of connection that can link particular agents (A) to people suffering deprivation (D).[63] Three connective grounds are especially salient.

- *Causal or contributory connection:* if one causes or significantly contributes to deprivation, this can be one sufficiently connective ground on which to allocate remedial responsibility.
- *Benefit: A* might have had no role in a process leading to *D*'s deprivation, but might nonetheless have benefited from it. Benefiting from such a process might be sufficient to make *A* remedially responsible for helping *D*.[64]
- *Capacity:* Here the focus is on who is capable of assisting. There are actually two issues related to capacity: first, the effectiveness with which one can render assistance and, second, the costs to the rectifier of remedying the situation. For instance, the strongest swimmer might be

[62] For an excellent accessible overview see International Bar Assocation's Human Rights Insitute, "Tax Abuses, Poverty and Human Rights."

[63] Here I draw on dominant accounts in the literature, notably that of David Miller, *National Responsibility and Global Justice* (Oxford University Press, 2007), chapter 4.

[64] This consideration seems especially strong when receiving benefits simultaneously exacerbates injustice, for instance, benefiting from unjust practices also helps to sustain them.

> expected to effect the rescue, but only if this is also going to involve low cost to him.

Especially strong obligations are generated when all three of these connective grounds converge. When agents, *A*, are connected to those suffering deprivation, *D*, through contributing to their plight, benefiting from it, and having the capacity to assist with the deprivation, those agents have stronger obligations than others to remedy the situation.

So who should do what in trying to remedy fiscal institutional corruption? There are many who have responsibilities, and to identify just some of these candidates, they would include multinational companies, international organizations, professional organizations, governments, accountants, lawyers, bankers, and taxpayers. While many agents have role-related responsibilities, there are some actors that may have particularly weighty obligations, especially to absorb more of the costs associated with moving to equitable taxation institutions. The parties who have stronger obligations would include multinationals that have engaged in tax abuse, a range of professionals (such as accountants and tax lawyers), international agencies (such as the IMF and World Bank), and other powerful actors who have much capacity to act now, who have benefited greatly from the institutional corruption documented here, and who have contributed greatly to its existence.

A number of agents could be assigned an appropriate share of responsibility for addressing the problems identified here concerning fiscal institutional corruption, in virtue of their enhanced contributions to the situation, their benefiting from unjust practices, and their capacity to make needed reforms now. These include accountants, lawyers, bankers, multinational companies, architects of secrecy jurisdictions, also certain governments, and taxpayers. We briefly review some of the ways in which the connection factors converge and indicate some responsibilities for reform.

The IMF and World Bank have, for several decades, promoted an influential consensus according to which corporate taxes should be reduced while the base for consumption taxes should be expanded. Trade liberalization has also been a key goal, which involves reducing export and import taxes. These actions have often led to a sizable reduction in government revenues for many countries, which has sometimes resulted in the collapse of domestic industries and increased informal sectors.[65] Another policy recommendation that has been promoted as part of this package has been the phasing out of property and capital gains taxes, increasing consumption and VAT taxes leading to more regressive tax systems. Often capital account liberalization has also been recommended alongside the removal of mechanisms to monitor inflows and outflows, which facilitated vast illicit capital flight.[66] It is notable that at the same time as there were record levels of international borrowing, there were also record levels of capital flight, with about 60 cents for every dollar borrowed leaving the country during 1970-2004.[67] Furthermore, many of the tax policies recommended by the IMF and World Bank are often overly influenced by parties with particular interests, such as to promote the interests of international finance institutions. Also noteworthy is that the huge lack of tax personnel able to deal with tax issues within developing countries is, in some cases, attributable to austerity program requirements prescribed by the international finance institutions.

Multinational companies have played an enormous role in the institutional corruption documented. They have taken advantage of governments' perception that FDI is beneficial and have used it to extract enormous concessions. They have lobbied for and gained all sorts of favorable treatment. They have also engaged in aggressive tax avoidance.[68] Extractive industries are also deeply implicated. Many governments became heavily dependent on resource rents extracted from a small number of powerful multinational companies. This dependence has resulted in improper influence over tax policy. In such cases mining companies would be especially responsible for showing due care in making reforms.

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[65] Allison Christians, "Global Trends and Constraints on Tax Policy in the Least Developed Countries," University of Wisconsin Legal Studies Research Paper No. 1086 (2009), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1445433.

[66] In addition, a history of corruption now fuels institutional weakness and inability to combat further corruption, such as in the case of servicing odious debts, the debts contracted by corrupt regimes without the consent of ordinary citizens and without their benefiting from it. We could consider freezing assets or cancelling debts, along with other remedies to address this history, as citizens from countries struggling with widespread poverty should not have to pay for the collusion between dictatorial regimes and private creditors.

[67] Léonce Ndikumana and James K. Boyce, "Capital Flight from Sub-Saharan Africa," *Tax Justice Focus* 4.1 (2008): 5-6.

[68] There are a number of key international standards that clarify businesses' responsibilities including the U.N. Guiding Principles on Business and Human Rights and related international standards for corporate responsibility, and the responsibilities of business enterprises under the U.N. Guiding Principles on Extreme Poverty and Human Rights." See International Bar Assocation's Human Rights Institute, "Tax Abuses, Poverty and Human Rights," 117. These responsibilities also apply to lawyers according to the American Bar Association.

There is a symbiotic relationship between multinational corporations and accountants. Both are frequently dependent on each other for their success. But accountants have a large role to play if new practices are to take hold. There are four major accountancy firms, often referred to as "the big four" (PriceWaterhouseCoopers, KPMG, Ernst and Young, and Deloitte Touche Tohmatsu.) The combined annual revenue of these four formed over U.S. $102.6 billion in 2008 and $110 billion in 2011.[69] They operate in almost every country and all have registered subsidiaries in secrecy jurisdictions. The global accounting firms reinforce and promote the culture of tax avoidance through various means. They claim that they have a professional duty to minimize tax liabilities for their clients. But there is no such proper professional duty, and most reputable codes of conduct include clauses concerning accountants' public duties as well, which would at best be in tension with the alleged avoidance duty.

Accountants have an important role to play in working towards solutions. They should respect several important professional duties such as to report earnings truthfully, to be mindful of conflicts of interests (such as occurs when auditing and tax advice services are provided by the same supplier), to respect duties to the public, and in cases where codes or laws are defective, to support appropriate revisions to reflect such duties.

Lawyers often actively advocate for secrecy jurisdictions and recommend them to their clients. Lawyers often play an active role in lobbying on behalf of their clients to try to dilute legislation which aims to protect public interests. Lawyers are regulated by the state and by professional associations, and both have a role to play in adequate reforms. Bar associations could assist in developing further professional guidance, helping promote awareness of lawyers and law firms concerning duties to respect human rights and could also positively assist in contributing to useful tax law reform.

This is clearly just a sketch of how we might begin the normative work of allocating responsibilities for reforms. This project requires further discussion. The purpose of this paper is to motivate the need for such work through our concern with

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[69] Big4, "The 2012 Big Four Firms Performance Analysis," January 2013, 2, http://www.big4.com/wp-content/uploads/2013/01/The-2012-Big-Four-Firms-Performance-Analysis.pdf.

institutional corruption. It is time to return to that core motivating concern and tie together some loose ends.

8. Tax and Institutional Corruption: Putting the Pieces Together and Some Clarifications

With this understanding of some core features of the fiscal landscape that provide fertile ground for institutional corruption to take root, we return to the account of institutional corruption to clarify some of its dimensions. First, I summarize the account of integrity and corruption in tax institutions, as outlined previously.

We have a state of integrity in tax institutions when all of the following four conditions are met:

1) A tax institution achieves its main purpose when it raises revenues effectively and equitably for the state's necessary or legitimate activities and functions. Tax institutions have one "obligatory purpose," and that is to raise revenue effectively and equitably.

2) State tax institutions are properly dependent on citizens. Though state tax institutions may collect revenue from a number of sources (through royalties, licenses, fees, taxes, and so on), tax institutions should also promote relevant interests of citizens, help citizens discharge their duties, and are required to be accountable to citizens. Tax institutions may derive revenue from other parties, but any dependence that arises therefrom must be mediated through full accountability to citizens.

3) Because taxes are raised effectively and equitably, in ways that promote citizens' relevant interests, help them discharge their duties, and are fully accountable to those citizens, public confidence in institutions that collect tax is appropriate. This confidence often assists the effectiveness of the institution, especially when high tax morale leads to high levels of tax compliance.

4) Public confidence in the institution's practices, policies, and operations can survive appropriate transparency and accountability tests.

Fiscal institutional corruption occurs when *all four* of the above conditions do not hold. So, more specifically:

1*) Tax institutions do not raise revenue effectively and equitably. This is a result of 2*).

2*) Because of improper dependencies, some parties have improper influence over the institutional operations. These improper dependencies and influences have resulted in losses to effectiveness or equity.

3*) Because of 1*) and 2*) public confidence in the institution's practices (and so forth) is inappropriate and this loss of trust can undermine the institution's being able to achieve its proper purposes effectively and equitably.

4*) Institutional operations and public confidence in the institution's practices (and so on) cannot survive appropriate transparency and accountability tests.

There are two key outstanding issues that warrant attention. I have been developing the account assuming only one obligatory purpose for taxation institutions. We should examine whether tax institutions have other purposes (Section 8.1). We also need to clarify what these appropriate accountability and transparency tests are before we are in a position to understand my account more fully (Section 8.2). Section 8.3 begins the project of developing more sophisticated transparency and accountability tests.

8.1. Do Tax Systems Have Only One Obligatory Purpose?

The core purpose of tax institutions is to collect revenue that the state needs to function effectively and legitimately. In raising revenues equitably, robust tax systems should endeavor to raise revenues from a number of sources (to include a wide tax base), making use of several different kinds of taxes, such as income taxes, sales taxes, royalties from extractive industries, taxes on financial transactions, capital gains, and property taxes. Good tax systems should also aim to treat taxpayers in the same situation in the same way. Furthermore, they should accommodate the fact that because of radically different situations, some have far greater capacity to pay taxes than others. So it is unfair if taxes impose a disproportionate burden on those who are worst off when others far better positioned to pay taxes escape the burden or bear little of it. Such so-called regressive policies would be inequitable.

Some tax systems also aim at other goals, such as the redistribution of income or wealth in efforts to combat poverty and inequality, or they might re-price goods and services to encourage socially beneficial activities and dissuade harmful ones. There is widespread debate about whether redistribution and re-pricing are legitimate policy goals, and if so, how much use should be made of them. In my view, these are certainly permissible purposes for a tax system to pursue on many occasions. However, more libertarian style theorists might argue that they are not permissible ones (let alone obligatory) and they are not relevant to the core legitimate function.[70]

At any rate, and as a strategic matter, we can make the central points concerning fiscal institutional corruption without invoking these more controversial claims about other obligatory or permissible purposes. The minimalist account of obligatory purposes will be all we need to make the central case.[71]

8.2. Towards Some Appropriate Transparency and Accountability Tests

There are many ways in which we might develop appropriate transparency and accountability tests. Here is one version.

> **The Simple but Effective Transparency and Accountability Test:**
> If the institution's practices, operations, or policies were made public via the most popular news medium in a particular country, attracting the most diverse audience from that population (such as on the most popular TV news or current affairs program attracting viewers from the widest cross-section of the population), would those responsible for the practice be able to defend it in that forum such that a clear majority of the audience would find the purported justification compelling? Can full

[70] There are a number of other permissible purposes a tax system may legitimately pursue. It may use taxation to promote important social, political, and economic objectives. Tax policy may also be sensitive to issues of competition aiming not to undermine appropriate, fair and non-destructive competition or prevent activities communities should otherwise encourage. But again, there is wide diversity of opinion about whether, and if so, when, these goals should be attended to and balanced against each other (since they often pull in opposite directions).

[71] I offer a lean account of tax institutions' obligatory purposes. With this lean account I can make a compelling case for fiscal institutional corruption. Even if there are other obligatory purposes, these might give additional grounds on which to locate further forms of institutional corruption. There are also no *plausible* obligatory purposes a tax institution should achieve that are in conflict with the analysis presented here.

> transparency about the institution's operations, practices and policies be made public in this way—that is, be put to the test of having to account for why the institution operates as it does—and be found by that audience to have offered a sufficiently compelling justification of the behavior?[72]

There are probably many issues over which we will not be clear as to whether the parties' offered account is sufficiently convincing to qualify as a compelling justification. There will probably also be wide disagreement among different constituents about this on many occasions. However, the fact that there are a number of behaviors (such as the ones described in Section 4) that we can anticipate will not pass the test at all well suggests that this crude test does have some force.[73] So to be specific, I believe the practices involving transfer mispricing, secrecy jurisdictions, lack of appropriate transparency and oversight in the sale of natural resources, and high levels of lobbying by business for special treatment that sustains fiscal institutional corruption would not pass the tests. The crude test can rule out egregiously unjust behavior such as these forms of tax abuse.

Why do I believe that the four types of tax abuse would not pass the test? Because of the kind of evidence that is already available. Consider the following. In a 2013 survey of U.S. voters, a clear majority of those polled support closing various tax loopholes.[74] In particular, 79% support closing tax loopholes to ensure corporations pay equally on foreign profits, and 62% support ending special tax breaks for oil and gas companies.[75] In a 2012 survey of British adults, 74% felt that "David Cameron should be demanding international action to tackle tax evasion and avoidance," 55% agreed that "the British government should make helping developing countries combat tax avoidance a greater priority than it is at

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[72] There is an issue when the worrisome behaviors are international. A group of citizens from one country might find the behavior defensible because it serves their interests, but those at whose expense those interests are served may well find the practice objectionable. So we may need to reformulate the test for many international practices. But in the case of international fiscal arrangements we can rely on this test, as both groups have good reasons to find the practices objectionable.

[73] Accountability to *whom* is also an issue. Taking a diverse sample of the population as the group of citizens to whom the behavior must be justified is crucial to the tests being reliable..

[74] Allen Freyer, "Big Public Support for Closing Corporate Tax Havens," NC Policy Watch, the Progressive Pulse blog, November 22, 2013, http://pulse.ncpolicywatch.org/2013/11/22/big-public-support-for-closing-corporate-tax-havens/. Full Hart Research Associates—Americans for Tax Fairness survey available at http://www.americansfortaxfairness.org/files/ATF-Oct-2013-Poll-Toplines-Public.pdf.

[75] Id.

present," 75% believed that multinational corporations (MNCs) enjoy more lenient taxation treatment than British individuals, and 79% agreed that it is "too easy for MNCs in the U.K. to avoid paying tax."[76] Similarly, in a 2011 survey of British adults, 84% agreed that the U.K. government "should crack down on tax avoidance by businesses" in the U.K. and 60% agreed that the U.K. government "should crack down on tax avoidance by businesses" in the U.K. even if this causes unemployment or MNCs to leave the U.K.[77] Furthermore, in a 2013 Institute of Business Ethics Survey, members of the British public ranked "corporate tax avoidance" as the most urgent business ethics problem in 2012, and again in 2013.[78] Also, consider widely documented public outrage in high profile cases, such as the attempted justifications offered by Google and Starbucks in the U.K. as to why paying no taxes was justified; their statements were widely thought to be inadequate.[79] There is quite a bit of data, therefore, that would support my claim that these practices do not pass the texts.

This simple kind of test seems quite usable as a way to gauge public opinion. Gauging public opinion about the tax abuse practices is an important component of assessing whether institutional corruption exists, as such opinion indicates not only whether public confidence is *warranted* but also whether it is forthcoming (and so tracks warrant). So in offering these tests, I have described one important, usable channel that can provide a useful means of determining whether institutional corruption has taken place. And the test also provides an important part of the means to root out institutional corruption, when we suspect we have located some. Forcing transparency and accountability, under certain conditions, can also form part of the solution to the institutional corruption exposed.

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[76] ComRes, "Poll Digest—Political—Christian Aid Tax Avoidance Poll,"http://www.comres.co.uk/poll/723/christian-aid-tax-avoidance-poll.htm (accessed February 26, 2014).

[77] ComRes, "Poll Digest—Political—BCC Radio 4 Decision Time Tax Avoidance Poll," http://www.comres.co.uk/poll/235/bbc-radio-4-decision-time-tax-avoidance-poll-.htm (accessed February 26, 2014).

[78] Institute of Business Ethics, "Attitudes of the British Public to Business Ethics: 10 Year Trends and 2013 Findings," *Business Ethics Briefing* 35 (2008): 7, http://www.ibe.org.uk/userfiles/surveys/attitudes10yr2013.pdf.

[79] *BBC News,* "Starbucks Paid Just £8.6m UK Tax in 14 Years." Starbucks' subsequent actions of voluntarily paying taxes (Starbucks paid £18 million of taxes after the event) can be interpreted as a concession that their behavior did not pass the accountability test well. Indeed, they declared that was pretty much the case. See Simon Neville and Jill Treanor, "Starbucks to Pay £20m in Tax Over Next Two Years After Customer Revolt," *Guardian*, December 6, 2012, http://www.theguardian.com/business/2012/dec/06/starbucks-to-pay-10m-corporation-tax. See also Bergin, "Starbucks Reports UK Loss, Pays No Tax for 2012"; *Al Jazeera,* "Starbucks 'Paid No UK Tax Since 2009'" and Rankin, O'Carroll and Monaghan, "Google Paid £11.6m in UK Corporation Tax Last Year."

Note that the test will only give reliable results under certain conditions, such as when we are indeed sampling a wide cross section of the population rather than gauging opinion from a partisan group with well-known entrenched sectarian views. And the interview should be conducted according to norms of fairness in journalistic ethics. The interview should avoid framing the questions in a particular way or leading the interviewee to make certain points. Rather, the interviewer should (insofar as possible) let the interviewee give his or her own preferred strongest justifications for the behavior.[80]

8.3. Towards More Sophisticated Transparency and Accountability Tests

Crude tests, such as the one just outlined, can also pave the way for gains in transparency to yield more accountability in more sophisticated tests. Let me explain.

As is well documented in the literature, transparency just by itself may or may not yield accountability.[81] Transparency can lead to participation, and this can lead to accountability, but not always. Information has to be made available in a form that is usable and connects with people's interests, and often there need to be formal mechanisms for people to be able to use that information in ways that might force relevant agents to be responsive. Responsiveness, especially government responsiveness, is a key issue.[82] The prospects of impact are enhanced by the presence of important freedoms, such as freedom of expression, particularly press and media freedoms. An active media thus plays a very important role, as do intermediaries who can communicate relevant information effectively to citizens.

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[80] In a longer treatment I hope to be able to address further concerns that could be voiced about the reliability of the test. One of these might concern whether institutional corruption in the media will influence how the interview is conducted, who does the interview, who is chosen as a spokesperson (and so on). I believe we can allay such concerns by finding formats where both the interviewer and the forum have a high reputation for credibility, legitimacy, and fairness.

[81] A good overview can be found in Archon Fung, Mary Graham and David Weil, *Full Disclosure: The Perils and Promise of Transparency* (Cambridge University Press, 2007).

[82] Certain preconditions are necessary before budget transparency can have positive effects for accountability. For example, there needs to be a certain type of regime: transparency in one party states will not yield accountability in the same ways that such transparency in more robust democracies might. See, for instance, Sanjeev Khagram, Paolo de Renzio and Archon Fung, "Overview and Synthesis: The Political Economy of Fiscal Transparency, Participation, and Accountability around the World," in Sanjeev Khagram, Paolo de Renzio and Archon Fung, eds., *Open Budgets: The Political Economy of Transparency, Participation, and Accountability* (Brookings Institution Press, 2013). For more excllent work on how transparency could be converted into more socially productive uses see Fung, Graham and Weil, *Full Disclosure*.

Transparency frequently results in good participation and accountability when there are effective mechanisms to force accountability. For instance, powerful governments may easily be able to ignore calls for reforms if they are not forced to make changes in ways where multiple pressures are usefully brought to bear. How can policymakers and activists convert transparency into accountability?

> Part of the answer may lie in the construction of formal mechanisms in which social actors can trigger action and sanctions through the use of information. Procedures for public hearings and investigations, public audit and transparency institutions, and independent judiciaries capable of prosecuting malfeasance fall into this category. But a wide range of less formal mechanisms and practices, such as social audits, public expenditure tracking surveys, and data-driven tools, can increase the conversion rate from participation to public accountability.[83]

There are some notable successes of this type that are championed as models of transparency and accountability that we can usefully learn from and draw on. Multi-stakeholder and cross-sector initiatives often have good prospects for success, and one case of this is the Extractive Industries Transparency Initiative that I introduced earlier. Here we have collaboration among a number of key stakeholders, both locally and internationally, with formal mechanisms in place to convert transparency into participation and for that in turn to result in appropriate levels of accountability. There are clear channels for participation by members of civil society, government and business, and all three have a role in keeping each other accountable. The international nature of the initiative also ensures that powerful domestic actors have a strong interest in participating with integrity, as significant pressures can be brought to bear from outside, should agents' behavior be found wanting. So, for local governments, they have an interest in reliability concerning budgetary matters, or they may find themselves under pressure from credit rating agencies, banks, international organizations, and so on.[84] One quite practical implication of improper behavior for them might be that the costs of borrowing increase. Multinationals have an interest in proper participation, without

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[83] Khagram et al., *Open Budgets*, 47.

[84] So, for instance, governments with more transparent budgets often attract lower borrowing costs. Khagram et al., *Open Budgets,* 8.

which they could find themselves under pressure from domestic audiences, consumers, transnational social movements, and so on. One implication for them might be that they find themselves to be the target of international consumer boycotts and activism, stockholder pressure, and pressures from international organizations.

We have noted that the EITI is a prominent case of success that can serve as a useful transparency and accountability model for other initiatives in which good participation and oversight by multiple stakeholders can combine to produce models of accountability.[85] Such initiatives could also be the grounds for formulating a more sophisticated test of whether there is sufficient transparency and accountability in the institution's practices, operations, and policies to allay any suspicions of institutional corruption. In working towards more sophisticated tests, we might inquire: have those who engage in the practice, policy or activity participated in the program designed to secure transparency and accountability in a sufficiently satisfactory way? More generally, we can inquire: have all stakeholders participated well in the transparency and accountability initiative?[86] And when the public judges that they have not (under the right conditions), they fail the test. So, for instance, in the case of the EITI: have those who must make or receive payments done so properly? Have all the payments that should have been made actually been made? Have all the payments that should have been received been received in a timely manner and accurately reported? And if these questions receive negative answers, we have detected some institutional corruption.

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[85] We could explore the potential to develop other accountability initiatives around this kind of model.

[86] Collaborative opportunities abound for government reformers, civil society advocates, international agencies and the private sector to promote change. Often external pressure is more effective than local pressure, though frequently this is not the case. In any case, local pressure has a role to play in building internal demand for relevant information, understanding when political opportunity is right for ramping up local activism that is likely to result in desirable change, and so on. There are several worthwhile multi-stakeholder initiatives that aim to advance global accountability norms. Some examples include the Global Initiative for Fiscal Transparency (GIFT) and the Open Government Partnership (see www.fiscaltransparency.net and www.opengovpartnership.org). These kinds of initiatives are likely to create pressures to increase the rate at which transparency yields accountability.

Some further remarks are worth making. When we think about increasing transparency, who is the correct user of the transparent information? First, the correct user is not necessarily individual citizens, but rather organizations, independent media, civil society organizations, advocacy groups, opposition and reform politicians, and international organizations, such as lenders of funds to governments and credit rating agencies. Second, there are effects on the discloser that can be considerable. Anticipating that disclosure will be required can have powerful effects on those who may otherwise wish to keep matters from becoming transparent. Providers of information may well over-estimate the likely effect of the disclosure. See George Loewenstein, Cass R. Sunstein and Russell Golman, "Disclosure: Psychology Changes Everything," Harvard Public Law Working Paper, No. 13-30 (2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2312708.

Before we close this section, it is worth underscoring that these kinds of tests can serve as useful tools in both detecting and working towards remedying institutional corruption.

9. Contagious Institutional Corruption

We are now in a position to describe a form of institutional corruption that we have uncovered in this paper (mostly in Sections 4 and 5), that we should view as particularly pernicious, because it not only undermines one institution but also infects other institutions, undermining them as well, and undermining them through mechanisms of institutional corruption. We might call the form discovered "contagious institutional corruption."

Contagious institutional corruption occurs when *all four* of the following conditions are the case:

1) An institution does not achieve its purposes effectively and equitably because some parties have improper influence over the institution's operations, practices, or policies, resulting in losses to effectiveness or equity.
2) Because of 1*) public confidence in the institution is inappropriate and this loss of trust can undermine the institution's being able to achieve its proper purposes effectively and equitably.
3) Public confidence in the institution's practices, operations, and policies cannot survive appropriate transparency and accountability tests.
4) The failures outlined in 1*) through 3*) infect other institutions that are then also unable to achieve their purposes effectively and equitably because of the improper influences or dependencies that corrupt those institutions.

Contagious institutional corruption spills over from one institution to another, undermining public confidence in the integrity of institutions and systems of rules. It is of special concern when the corrupted institutions are designed to promote the public interest. Infectious institutional corruption can be particularly pernicious in undermining general levels of trust in a society, or willingness to engage in social cooperation, or in other ways promoting a toxic effect on the climate and ability to promote institutional integrity, either indirectly or more directly.

Fiscal institutional corruption has highly contagious qualities and its defects easily spill over into other institutions and domains, undermining their quality. As we saw in Sections 4 and 5, examples would include the spillover corrupting effects for several of the factors that contribute to strong institutions and effective states, especially in developing countries, such as robust rule of law, strong bureaucratic capacity, high levels of trust and social cooperation.

Also noteworthy is that contagious institutional corruption is a kind of corruption that cannot be entirely solved without tackling its infectious qualities. It resists single domain solutions, and is rather something that must be tackled over multiple domains in order to be effectively addressed.

It is possible that all forms of institutional corruption have some potentially contagious attributes, and so have a disposition in this direction. For instance, corruption in the U.S. political system spills over into corruption in the pharmaceutical industry, amongst others. Even if this is right, there seem to be some forms of institutional corruption that are more contagious than others, and it is worth understanding when and why this is the case. That further exploration must be left for another time.

10. Concluding Reflections

In this paper I have developed an account of institutional corruption, showed how it applies to the case of fiscal institutions, and offered some useful tools in detecting and combating institutional corruption. I presented an account of institutional integrity as a baseline for examining the dimensions of institutional corruption. I also developed some usable tests and criteria by which we can diagnose whether institutional corruption exists, and offered some principles that are relevant in allocating responsibilities. The account, tests, and principles may be usefully applied to institutional corruption in other domains. In addition, I also highlighted a new form of institutional corruption that is particularly worrisome in its subversive and contagious effects.

Governments might be mistaken about the effects of offering favorable tax treatment in efforts to attract FDI. They also have the right to make judgments about what is in the best interests of the country, even when they make bad calls.

That does not constitute corruption. But institutions of taxation can get corrupted when they become overly influenced by, and improperly dependent on, those who lobby for certain treatment which promotes their goals at the expense of citizens' in such a way that institutions cannot achieve their proper purposes. There are a number of ways in which revenue is not being collected effectively and equitably because of improper dependencies and influences. Tax abuse allows some to bypass rules that apply to others, effectively providing one set of rules for the wealthy or well-connected, and another for others not similarly situated. The super-wealthy are able to take advantage of a range of schemes and techniques which facilitate tax evasion and anonymity, and yet are unavailable to most ordinary citizens who lack the funds to make use of the expertise necessary to participate in these morally dubious schemes. Such practices cannot survive appropriate transparency and accountability tests, nor would they be equitable ways to collect revenues.

Developing robust tax systems that are effective, efficient, and equitable is very important for sustaining legitimate and effective states with resilient fiscal social contracts and good tax morale. We saw how developing countries face special challenges in realizing these goals, such as weak tax administration and collection capacity and being highly vulnerable to destructive effects of global tax arrangements that also enables vast tax escape. These kinds of challenges undermine effective government and opportunities to develop in beneficial ways. A range of important solutions is available to address the problems canvassed. We saw, for instance, there is much scope for harmonizing tax rates and policy and that plausible proposals and feasible arrangements for tackling such issues are available and, in some cases, partially implemented at least on a small scale. We also saw the powerful ways in which supporting international transparency initiatives can enhance accountability and be a constructive force in improving governance, trust, consensus-building, beneficial development, and effective and legitimate states. Further, we saw how several agents within developed countries have an immensely important role to play in assisting developing countries with strengthening their tax and accounting institutions, by offering relevant knowledge transfer, training, support, and help with capacity building, and also by taking an appropriate lead on a number of international norms and laws that should be reformed.

One important anticipated obstacle in generating the motivation to tackle the problems identified is that those who need to take action are likely to resist doing so. I discussed normative issues such as why there is a responsibility to address the problems identified and offered some analysis concerning distributing responsibilities for implementing changes. I identified some of the many agents whose participation is required to address the issues, and outlined some principles that could be used to assign responsibilities to relevant stakeholders in determining what various agents ought to do to combat fiscal institutional corruption. A number of relevant stakeholders have important responsibilities to initiate improvements, and I began the work of highlighting some important responsibilities for key stakeholders. Much remains to be done, but I hope to have at least made the case as to why such work is important.

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