Fairness of the Tax Burden in the Age of Globalization: the Panama Papers

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Introduction

Media reports on the Panama Papers have sparked public interest in tax havens and had significant political ramifications in several countries around the world. The Panama Papers attracted attention when data based on information leaked from the Panamanian law firm Mossack Fonseca was published by the International Consortium of Investigative Journalists (ICIJ). Not all the information that was leaked was included in the data published in May 2016. Still, it was a massive trove that spanned more than four decades and 210,000 offshore entities, much of it connected to the British Virgin Islands, Panama, the Bahamas, the Seychelles, and the like.

As the ICIJ itself emphasizes, not all of the individuals and businesses named in the Panama Papers are necessarily engaged in improper activities such as tax evasion. Indeed, there are many cases where offshore companies are used as a part of normal economic activities. However, the general public harbors deep-rooted suspicions that "a small number of the rich as well as big business are using tax havens to benefit improperly." The tax haven issue is particularly prone to serve as the catalyst for an increase in public suspicion regarding the fairness of the tax burden in many countries against the background of growing income disparities.

In this essay, I will give an explanation of the background and nature of the tax haven issue, refer to the international policy response to it, and conclude with an argument for a way to think about the "fairness of the tax burden" in the age of globalization.

Background to the Issue

One of the elements of the globalization of economic activities is the increase in transboundary direct investment. The global total of inbound direct investment outstanding grew 13-fold during the two decades between 1995 and 2014 *(Table)*. It increased much faster than global GDP (nominal), which grew by a factor of 2.5, from $31 trillion to $77 trillion, during the same period. That said, more and more globalization does not necessarily mean that tax havens will prosper.

What matters is the meaning of globalization. The *Table* shows the top 10 countries (or areas) in terms of inbound direct investment outstanding and ratio of inbound direct investment to GDP. The list of the top host countries for inbound direct investment was dominated by large economies in 1995. By contrast, small countries or areas whose inbound direct investment dwarf their respective GDP figure prominently in the 2014 list. Luxembourg in particular is host to direct investment 60 times as large as its GDP.

Countries with relatively small economies in the top 10 list for

TABLE

Top 10 countries in inbound direct investment outstanding (1995-2014)

1995 (Total amount outstanding: US$ 2.8 trillion)	2004 (Total amount outstanding: US$ 14.4 trillion)	2014 (Total amount outstanding: US$ 38.2 trillion)
1. US (15%)	1. US (25%)	1. US (36%)
2. France (21%)	2. Netherlands (311%)	2. Netherlands (495%)
3. UK (18%)	3. UK (44%)	3. Luxembourg(5,820%)
4. Canada (32%)	4. Luxembourg (2,776%)	4. China (26%)
5. Netherlands (26%)	5. Germany (31%)	5. UK (73%)
6. Belgium (39%)	6. France (31%)	6. Hong Kong (564%)
7. Australia (29%)	7. Canada (53%)	7. Germany (36%)
8. Spain (18%)	8. Hong Kong (291%)	8. Switzerland (164%)
9. Germany (4%)	9. Belgium (127%)	9. France (38%)
10. Switzerland (25%)	10. Spain (40%)	10. Belgium (197%)

Note: The ratio of inbound direct investment to GDP for each country is given in parentheses. Countries where this ratio surpasses 100% are indicated in red.
Source: Document submitted to the Government Tax Commission (May 26, 2015). Original documents are the IMF World Economic Outlook, *etc.*

2014 are the Netherlands (second), Luxembourg (third), Hong Kong (sixth), Switzerland (eighth), and Belgium (10th). Just missing the cut are Singapore and Ireland, at 12th and 13th respectively. These may not all be tax havens, but they all do offer various tax incentives to attract foreign investment. From this, it is fair to assume that national tax policies are having a significant impact on international investment activities. A recently released OECD report (*Measuring and Monitoring BEPS* (2015)) that describes the tendency of direct investment to converge on specific countries due to taxation factors is worth a look.

Reducing tax rates and providing tax benefits in order to actively solicit investment from abroad are not necessarily unreasonable. (That said, an international debate has been emerging in recent years on preferential treatment for foreign companies. In 2015 and 2016, the European Commission became the source of controversy when it ordered Ireland and the Netherlands among others to recover "unpaid taxes" from specific US companies, deeming selective tax advantages to be state aid that distorts competition.) Moreover, a state in principle does have the right to freely determine its own tax policy. And obviously it is not against the law for a taxpayer to use a tax haven. But there are activities using tax havens that must be called questionable.

Example of a Tax Haven at Work

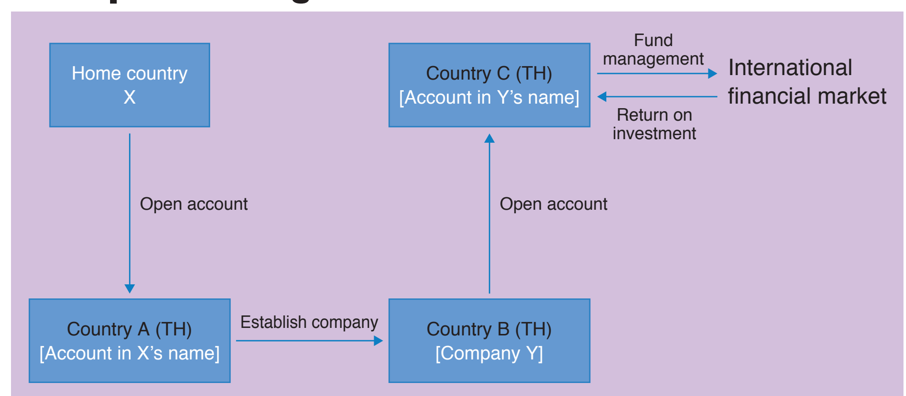
The adverse effects of tax havens arise more from the lack of information transparency than from low tax rates. When information on the assets of a taxpayer managed through tax havens and the income that they produce is obscured, it becomes difficult for the taxpayer's country of residence to assess taxes appropriately. Moreover, when information is obscured, tax havens run the risk of being used as a means to hide tax evasion and other crimes.

Take *Chart 1* as an example, which shows how taxpayer X, whose home country is, say, Japan, uses tax havens ("TH") to manage assets overseas. First, X opens an account in his name in country A (say, Hong Kong) and transfers cash to it. Next, X establishes company Y in country B (say, the Cayman Islands). Finally, an account in the name of company Y is opened in country C (say, the British Virgin Islands), where X gains revenue from his funds by managing them as funds in the account in the name of company Y.

In this case, the effective economic activity of X is the management of his assets in the international financial market. If X declares revenue from the asset management accurately in his country of residence and pays the taxes, there is no problem at all. (Since company Y is a corporation, its revenues will not be immediately taxed as the income of X. Even in this case, though, if controlled foreign company (CFC) taxation is applicable, X will assume the obligation to pay taxes in his home country when the revenue accrues.) Thus, using tax havens is not in and of itself illegal. However, countries A, B, and C are tax havens. If information necessary for taxation cannot be secured from these countries, it will be difficult for the tax authorities to catch X's income and tax it. In other words, even if X engages in tax evasion or other improper activities (hiding profits from illegal acts, etc.) the potential arises for shielding that information from the authorities in the home country.

CHART 1

Example of using tax havens



Source: Compiled by the author

Dealing with Tax Havens

As we saw, tax havens are an issue because of the information transparency, not the low tax burden itself. Thus, tax authorities worldwide must try to share information necessary for taxation in each country in order to deal with the tax haven issue. There has been rapid progress on this in recent years.

Triggered by the 2010 adoption of the Foreign Account Tax Compliance Act (FATCA) by the United States, discussions, mainly in the OECD, aimed at the automatic exchange of information on financial accounts held by non-residents began in earnest, resulting in the establishment of the Common Reporting Standard (CRS) in 2014. Since then, a multilateral system including many tax haven countries for the automatic exchange of information on financial accounts held by non-residents between the authorities is being steadily constructed. In August 2016, Japan concluded an agreement to exchange tax information with Panama, the first of its kind that the latter has concluded with any country.

The G20 finance ministers' communique in July 2016 states the following regarding the identification and treatment of countries and

areas that are uncooperative on information transparency and improvement in the transparency of information on the beneficial ownership of corporations and the like.

- We ask the OECD to report back to us by June 2017 on the progress made by jurisdictions on tax transparency, and on how the Global Forum will manage the country review process in response to supplementary review requests of countries, with a view for the OECD to prepare a list by the July 2017 G20 Leaders' Summit of those jurisdictions that have not yet sufficiently progressed toward a satisfactory level of implementation of the agreed international standards on tax transparency. Defensive measures will be considered against listed jurisdictions.
- We reiterate our call on the FATF and the Global Forum to make initial proposals by our October meeting on ways to improve the implementation of the international standards on transparency, including on the availability of beneficial ownership information of legal persons and legal arrangements, and its international exchange.

(Paragraphs 10 and 12, Communique, G20 Finance Ministers and Central Bank Governors Meeting, July 23-24, 2016)

International Tax Avoidance by Multinational Corporations

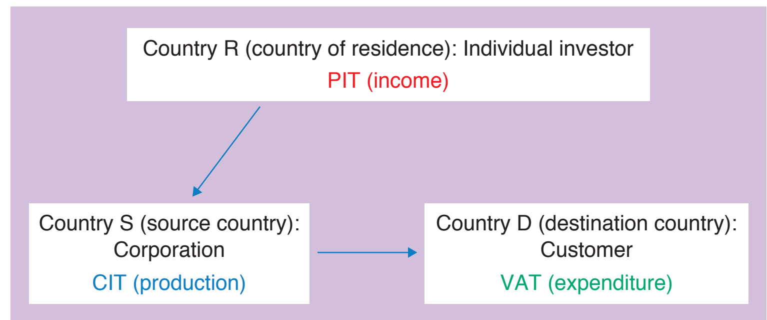
Multinational corporations also use tax havens. Much of that is legal, and one aspect of tax havens is that they play an essential role in the international economy, particularly in finance. But criticism is mounting against tax avoidance by multinational corporations using tax havens and other means. The Base Erosion and Profit Shifting Project (BEPS) conducted by the G20 and OECD deals with this issue.

Countries are using the Final Reports of the BEPS Project as the basis for taking international measures against tax avoidance by multinational corporations. Transfer pricing rules and CFC taxation rules are being improved and tightened, while a framework for country-by-country reports to grasp the overall profile of the activities of large multinational corporations and sharing information among countries is being introduced.

The country-by-country report in particular is a new arrangement. It shows the revenues, income, tax payments, paid-in capital, and the number of employees of large multinational corporations, and also the kind of businesses their subsidiaries and business operations in each country and area are engaged in. The statistical analysis of the data in the country-by-country reports should give important insights into revealing the real workings of large multinational corporations. That said, a country-by-country report is merely a very

CHART 2

Framework for international taxation



Source: Compiled by the author from Tax by Design: The Mirrlees Review (2011) *pp.430-431*

broad overview of the large multinational corporation, and is not material that should be directly applied to the individual transfer price taxation cases.

The BEPS Project presented a broad range of measures. However, it is unclear how effective those measures will be. That is because corporate taxation is faced with a huge problem as the result of the globalization of economic activities.

The Vulnerability of Corporate Income Taxation

Chart 2 shows where various taxes fit within an international framework. Here, we assume a case where an individual investor in country R establishes a corporation in country S, which sells merchandise to customers in country D. Here, the personal income tax (PIT) is levied in the country of residence, the corporate income tax is levied in the source country, where the corporation manufactures the merchandise, and the value added tax (VAT) is levied in the destination country, where the merchandise is consumed. Different taxes are levied by different countries.

It is relatively easy to identify the country of residence and the destination country, where the personal income tax and the consumption tax are levied, respectively. Of course there will be difficulties in identifying the country of residence of an individual who changes his/her address frequently or the destination country of cross-border services. But these are partial problems.

By contrast, it is very difficult to identify the source country for the purpose of corporate income tax, i.e. the country where the income subject to corporate income tax was generated. Multinational corporations in particular conduct production activities across many countries, making it extremely difficult to calculate how much value the production activity generates in each country.

From the multinational corporation's perspective, the overall tax burden becomes lighter if the production activity can be attributed to countries with lower tax burdens. When a shell company is established in a tax haven where little if any real economic activity is

conducted and accounting tricks are used to concentrate profits there, this will obviously be challenged by the authorities, who will take corrective measures. However, some multinational corporations use clever schemes to concentrate income in low income tax countries. The BEPS Projects was aimed at dealing with this problem.

However, as the economic significance of national borders declines, the economic value of services and information rises, and countries are competing with each other to provide a favorable physical and institutional business environment, it is all but impossible to create standards to distribute the economic value created by multinationals appropriately among countries. Corporate taxation is the form of taxation most vulnerable to globalization. The weight of corporate taxation in national jurisdictions is fated to decline whether or not the BEPS Project is successful.

Fairness of the Tax Burden

How should we consider fairness in taxation in the age of globalization in light of these circumstances? First of all, misuse of tax havens by the wealthy to hide income and assets is tax evasion, not tax saving, and can in no way be justified. Even if only a small fraction of the wealthy are evading taxes by misusing tax havens, letting this go untreated will destroy public trust in the tax system. This could work together with dissatisfaction that comes with growing income disparities to have a negative impact on public compliance with the tax system.

In order to deal with the misuse of tax havens by the wealthy, it is essential to make sure that the automatic exchange system for financial account information between countries including tax havens functions properly. For that purpose, it is necessary to utilize the tax identification number system in each country (the “My Number” system in Japan). Moreover, upgrading international cooperation with the aim of securing transparency on beneficial ownership of corporations and the like is necessary.

By contrast, international tax avoidance by multinational corporations is a more complicated challenge. This issue is related to the international distribution of tax revenue, which should be distinguished from the issue of fairness in the tax burden. Furthermore, international tax avoidance by multinational corporations is related to the competition to improve the business environment that countries engage in to attract inbound direct investment. In order to avoid excessive international tax competition, it would be nice if countries could come to an agreement on some standards on preferential tax treatment of revenue from intellectual property, for example. But in any case, the difficulties of corporate taxation in an increasingly globalized world will not be resolved.

The incidence of corporate income tax is unclear in the first place, and it is difficult to discern how income distribution will be impacted as it becomes more difficult to levy corporate income tax. Thus, it is misleading to put the corporate income tax issue and the question of fairness together to push an argument. In particular, politicians who make claims such as “if corporate profits hidden away in tax havens can be taxed, tax revenues can be raised that will make tax cuts possible” are resorting to populism.

To discuss fairness in the era of globalization, it is necessary to go beyond corporate income tax and income tax on high income individuals and consider the entire tax system consisting of personal income tax, corporate income tax, and the consumption tax, as well as social insurance premiums and social security benefits together. In the age of globalization, it is impossible to maintain an extremely progressive personal income tax (with extremely high marginal rates for high incomes) or a corporate income tax so onerous that it forces businesses to relocate overseas. It is necessary to accept this as the premise in achieving fairness in income distribution by securing the necessary overall fiscal revenue from personal income tax, corporate income tax, consumption tax, and social insurance premiums, and increasing social security benefits for low income individuals and the like.

Conclusion

Although the Panama Papers had been leaked, they evoked a huge social response by providing a glimpse into the realities of tax havens. It is commendable that this became the driving force for strengthening measures to counter the abuse of tax havens by some taxpayers. However, the sensationalism that the mass media and others brought to the Panama Papers runs the risk of obstructing a dispassionate discussion of the fundamental issues.

Growing income disparities and the globalization of international activities are the two major challenges confronting national tax systems today. The tax haven issue is relevant to both. However, given the difficulties of taxation in an increasingly globalized world, a comprehensive response that encompasses both the tax system and the overall social security system is needed in order to deal with the challenge of income disparities. Only by simultaneously maintaining economic vitality and equitable income distribution through such a comprehensive approach can fairness in the tax burden in our globalized world be achieved. To this end, it is of ever greater importance to promote the exchange of taxation information and other forms of international cooperation and to secure international compatibility between tax systems and tax administration, in addition to the efforts within individual countries. JS

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