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Globalization and Taxation: Trends and Consequences

by Ilan Strauss

To misuse Marx's often quoted phrase: governments are in love with tax revenue but 'the course of true love never did run smooth'. This failed romance should be of concern to those of us who prioritise egalitarian economic outcomes, because taxes and benefits can substantially mitigate the effects of poverty. Among OECD countries, differences in tax and benefit regimes are vital in accounting for differences in poverty rates. After the benefits of tax and welfare are taken into consideration, 'market poverty' in north European economies declines by around three quarters, whereas in the US this declines by only one-quarter. For low income economies the development of an effective tax regime can therefore be of great benefit to the working and non-working poor.

Given the above, it is important to ask if globalization has affected the ability of economies to implement an affective and progressive tax regime. And if so how? Although it is a mistake to attribute all the problems facing national tax regimes to globalization, it is equally incorrect to propose that globalization has played no role at all in shaping these issues.

The Welfare State

From a **national perspective** tax revenue has become even more important as higher levels of unemployment and the rise in the proportion of pensioners in most OECD countries has helped to create further demand for welfare spending. Even with the rise of neoliberalism, state spending has continued to increase, plateauing at around 35-40% of GDP in OECD countries. In order to try and keep up with state expenditure, tax revenue as a proportion of GDP has risen from 23% in 1965 to around 33% in 1999; with rising social security contributions the largest component of tax revenues in OECD countries at 26% of contributions, in 2003.

The **money to pay** for tax revenues has to come from either consumption or investment. And given the widespread slowdown in labour productivity growth in Europe since 1973 this poses a particular difficulty, since 'any increase in the tax share of GDP, required to finance increasing real costs of the welfare state, has to reduce what is already a slow growth of living standards' (Glyn, 2006). Globalization has placed new challenges on generating sufficient tax revenue, given the wider scope for evasion and avoidance, as well as greater openness generating forces for tax rates to converge (often downwards).

The Changing Tax Burden

The current national tax systems in place were **designed** after **World War 2** when trade protection and capital and labour immobility were commonplace. This made different rates of direct and indirect taxation feasible - if imperfectly so; because even as this tax regime was being implemented problems of jurisdiction and enforcement were encountered as currency controls were relaxed on non-residents by OECD countries in 1960. Since then growing income inequality and capital mobility have meant that the tax burden has shifted - but to whom?

An outgrowth of widening **income inequality** in most OECD countries is a tax system more reliant on a smaller percentage of its population for more of its tax revenue. In the UK, for example, 25% of tax revenue came from the top 10% of income tax payers in 1978, whereas 20 years later 48% of tax came from this top 10%. Put differently higher income groups contribute a greater share to total tax revenue even if the tax system has not become more progressive. This finding can be generalised to other OECD countries, however only a part of this trend is attributable to greater trade openness and global integration. Has a greater concentration of the tax burden led to labour, as a group, taking on a greater share of the tax burden?

This would seem not to be the case, as revenues in OECD countries from taxes on corporate income or profit have remained steady since 1980 as a proportion of GDP and government tax revenue. However beneath this seemingly stable relation corporate profits have fundamentally shifted - rising handsomely. The relation between corporate tax revenue and total tax revenue has remained stable only because top corporate income tax rates have been in constant decline, especially since 2000. But how important is this development for the purposes of building a progressive and effective tax system? Arguably not all that significant given that only a small proportion of tax revenue comes from corporate taxes in OECD countries (remaining at around 9% since 1980). That said, in times of less than spectacular growth in output per head, such pressures can exert a meaningful force on the fiscus. Moreover, for least developed countries (LDCs), where corporate income tax constitutes a larger proportion of total tax revenue, the ability to raise taxes from corporate activity is critical.

Historically, income tax has always been the mainstay of tax revenue, which falls disproportionately on salary and wage earners. Notably even countries with relatively larger welfare states tax consumption and labour incomes more heavily rather than capital. In the past this wage bias in taxation has been due to not wanting to kill the goose which lays the golden egg of investment by eating into corporate profits. Though more recently, the mobility of capital is having an influence on the composition of tax revenues.

Tax evasion and avoidance

In the USA between 1996-2000, around two-thirds of transnational corporations (TNCs) paid no tax at all, and over 90% paid below 5% of their total income. From 2005 to 2006, of the 700 largest firms in the UK, 220 paid no UK tax at all and a further 210 paid under £10m. Tax avoidance by TNCs has become increasingly commonplace due to growing global integration and it is LDCs who often bear a disproportionate cost of this, given that a much higher percentage of their capital stock is owned by foreign companies. This is not to say that these problems are new.

Historically, as states began to inconsistently tax individuals and companies according to their residence as well as according to where the source of their income arose, tax treaties were created as early as 1928 to ensure that double-taxation and double non-taxation did not occur. The basis to this is that the primary right to tax business income or profits rests with the host country, and the primary right to tax investment returns (interest and dividends) rests with the country of residence of the investor. In practise this can prove to be difficult to implement.

For example, Mopani Copper Mines (MCM), owned by Glencore International through a chain of holding companies, paid mining royalties to the Zambian government in 2006 of just 0.6% of sales. This amounted to an effective tax 'burden' of US$20 million on US$3.3 billion turnover - despite MCM being the largest mining corporation in Zambia.

The MCM paid virtually no taxes because on paper it apparently made no profits. In reality, this was a fiction facilitated by Glencore's controlling stake in MCM which provided Glencore with the access to manipulate MCM's costs and revenues. On paper Glencore inflated the costs listed on MCM's balance sheet by charging abnormal prices for items such as transportation. Similarly it deflated MCM's operating revenue by buying copper at below market prices. This is known as abusive transfer-pricing, because transactions between related parties (as in the above example) should be priced as if they were conducted at 'arms length' (i.e. by unrelated entities).

Glencore International wanted to shift MCM's tax burden onto its own balance sheet because it registers its profits in **favourable tax** locations, also known as tax havens. Tax havens exploit the fluid definition of the 'residence' of taxpayer and the 'source' at which income is earned in order to help minimise the tax paid by a company or individual. Tax havens are a part of the 'offshore' tax system which evade or avoid the tax laws of other jurisdictions through the use of a variety of methods. So what is the way forward in making tax systems more equitable and effective?

The Way Forward

A **unitary taxation system** is needed to remove the incentives for TNCs to shift their tax burden towards more favourable tax regimes (Picciotto, 2007). This System would mean instead of related companies being treated and taxed as separate entities, they would be taxed as a single unit on their consolidated accounts. The total income and profits of a company would be calculated based on their combined global operations, with the tax revenue from this being apportioned to countries on the basis of an agreed upon formulae. Corporate taxation between states in the USA is already done on a unitary basis; and the EU is attempting to work towards such a model, despite political opposition arising.

Lastly, improving the exchange of tax information between countries is critical to ensuring no lost taxation occurs through double 'non-taxation'. Currently bilateral tax treaties are used to provide other states with information concerning taxable revenue, though such agreements should be multilateral in scope.

In the final analysis, given the **more global nature** of markets and business operations, political support needs to be coordinated across countries to ensure that tax regimes 'race to the middle' and not the bottom. Important tax issues on double-taxation, information sharing and enforcement, offshore financial centres, and effective regional tax rules, all require some level of enhanced global and regional cooperation.

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