A Grand Evasion: How Corporations Deprive Workers, Government, and Society by Widespread Tax Avoidance

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Abstract

Corporate tax avoidance is a growing concern for the stability of America. Corporations are able to avoid paying their dues to society and instead extract economics rents from both workers and the government. This paper will begin by proving that the typical neoclassical assumptions about marginal productivities are flawed and that corporations have wage setting power. The second section will include an analysis of the strategies for and the prevalence of corporate tax sheltering, including a few case studies. The third section will address the negative externalities of tax avoidance on citizens and the government, and the fourth section will culminate the argument with a discussion of possible reform measures, including an extremely creative idea. The goal is to illuminate the irresponsibility of corporate tax avoidance and to encourage cooperative global efforts to redistribute income from the companies who hoard profits to the citizens they take it from.

Introduction

In *The New Nationalism*, Theodore Roosevelt insightfully claimed, "We think that normally and in the long run the rights of humanity, coincide with the rights of property . . . But we feel that if in exceptional cases there is any conflict between the rights of property and the rights of man, then we must stand for the rights of man" (241). This fundamental notion about the preeminence of humanity over property has noticeably eroded in the last forty years, as capital owners have collected an increasing and disproportionate piece of the nation's output. As Steven Greenhouse, journalist and author of *The Big Squeeze*, observes, "the nation's economic pie is growing, but corporations . . . have not given their workers a bigger piece" (5). In fact, by 2006, "corporate profits climbed to their highest share of national income in more than six decades, while wages fell to their lowest share since the Great Depression" (Greenhouse 38), a trend that accelerated after the neo-liberal deregulation of corporations and the tax code in the 1970's. The correlation between skyrocketing corporate profits, plummeting corporate tax receipts, and stagnating real wages is not a fluke—rather, the story of modern corporate governance is a story of corporations *looting* both the American government and the American people.

One of the primary mechanisms driving the concentration of corporate profits is large scale, intentional corporate tax avoidance. Given that corporate tax avoidance "promotes social inequality and undermines public confidence in the tax law" (Dowling 179), it seems obvious that the literature of Corporate Social Responsibility (CSR), which dives into corporate ethics and integrity, would focus heavily on the issue. However, CSR "has scarcely begun to question companies in the area where their corporate citizenship is most tangible and most important: the payment of tax" (Christensen, "The Social" 37). Therefore, this paper will attempt to fill the gap in CSR literature and contest that corporate tax avoidance, especially offshore tax sheltering by multinationals, is both socially irresponsible and economically undesirable. This discussion will begin by giving a legitimate reason for undertaking such an endeavor, namely that neoclassical assumptions about marginal productivity are flawed and that redistributive policies are just and necessary. Next, after examining the strategies for and the scope of corporate tax sheltering and evaluating the ramifications of these avoidance strategies on society, this paper will offer a few reforms that the global regulatory community could undertake to change the corporate tax code. Modern corporations have shirked their responsibility to society and tax policy must be overhauled to restore fairness in an environment that regularly places the rights of property over the rights of man.

A Flawed Neo-Classical Assumption

A foundational variable in neoclassical economic models, the *marginal product of labor* is defined as the additional output obtained from adding an additional unit of labor. Traditional neoclassical models predict that competitive, cost-minimizing, and profit-maximizing firms hiring in a competitive labor market comprised of utility maximizing individuals will be forced to pay a wage equal to each worker's marginal product of labor. These assumptions help to explain why neoclassical economists disapprove of a minimum wage—since competitive labor markets drive the wage to an equilibrium level where the price of labor is exactly equal to the value of labor, minimum wage laws simply interfere with market forces that set a fair wage and that create the highest possible output at the lowest possible cost. Tyler Cowen, economics professor at George Mason and author of the blog "Marginal Revolution," follows this logic to explain wage stagnation: "The sad reality is that many of these [laid-off] workers you don't want at all . . . I believe these 'zero marginal product' workers account for a small but growing percentage of our workforce" (57). As a dutiful marginalist, Cowen assumes that market forces set wages directly proportional to worker productivity; stagnating wages simply reveal stagnating productivity, an analysis directly in line with neoclassical tenants. This section will endeavor to debunk such an oversimplified correlation between productivity and wages.

Contrary to Cowen's assertion, evidence actually suggests that real firms do not pay workers their marginal product of labor. Adam Isen, economist at the University of Pennsylvania, conducted an ingenious study to prove this point. After finding instances of accidental employee death in small firms, Isen tracked the immediate changes in both the firm's payroll and its output. Isen, after adjusting for variance in relative wage levels, geographic location, and decreased tax costs due to lower output, found that firm revenue falls much less than labor costs, "allowing [him] to reject the null hypothesis that workers are paid their marginal product" (3). In fact, Isen writes that "workers are on average paid no more than 85 percent of their marginal product" (3). This surprising finding, which casts neoclassical assumptions under serious doubt, is affirmed by Robert Frank of Berkley. Frank argues that standard neoclassical predictions are "sharply at variance with pay schedules observed in practice," estimating that "the most productive members within an organization appear to be paid substantially less than their marginal products while the least productive members appear to be paid substantially more" (570). In seems clear, then, that marginal productivity and wages are not as simplistically intertwined as Cowen and the other neoclassicists believe.

The next step in understanding the ramifications of this incongruity is to understand what causes such a discrepancy. Frank and Isen offer a variety of reasons for the difference between wage levels and marginal productivity, a majority of which are natural frictions of a labor market composed of conscious individuals. Frank asserts that workers value the consistency of corporate hierarchies and actually prefer workplaces where wages are determined by tenure and rank instead of productivity (570), while Isen claims that the heterogeneous preferences of workers with regards to location, working conditions, and benefits account for the observed incongruity (25). None of these tensions truly condemn the neoclassical models; they simply overlay some real-world inconsistencies. However, Isen also introduces a far more insidious explanation: "Wielding some amount of market power over their potential workforce, a traditional monopolist faces an upwards sloping supply curve for labor and can set the price" (25). This is the explanation that shatters neoclassical assumptions about productivity—firms, operating with monopolistically competitive power, as nearly all major firms do in practice, have the power to set wages rather than take them. Simply put, firms pay workers less than their marginal product *because they can*, allowing powerful companies to extract economic rents from their labor à la Karl Marx.

Only this rationale can explain the divergence of real wages and corporate profits since the 1970's. As observed by Greenhouse, "From 1947 to 1973, productivity and the average wage rose . . . in tandem, with each roughly doubling. But from 1973 to 2006, productivity jumped by 83 percent while the average hourly wage essentially remained flat" (39), all while corporate profits have grown to "take the highest share of national income since the government started measuring [it] in the 1920's" (Porter). These statistics bear out that corporations increasingly deny wage increases because they possess the power to do so, especially in an American economy marked by instability and frequently high unemployment since the 70's. Workers have the choice between accepting the low wages that corporations set or making nothing, while corporations are incentivized to keep wages as low as possible to maximize profits—quite a noxious combination that directly results in historically high profits and historically low wages. Corporations do not pay workers their marginal product, but instead assert their dominance to reimburse labor only fractionally, destroying neoclassical assumptions about marginal productivities.

While including this discussion of marginal productivities may seem trivial, it is actually foundational for properly justifying corporate tax reform. To rightly argue for changes, it is paramount to determine a motive for doing so. This flawed assumption, and the hands-off policies it encourages, provides one. If corporations were exploiting tax shelters in an effort to pay workers a wage commensurate with their productivity, then the impetus for redistributive tax policy withers. However, if imperfectly competitive firms, as many are in practice, abuse power to manipulate wages, as it appears they do, redistributive polices become vital to ensuring fairness and stability in the labor market. Before suggesting reforms, however, the next section will develop an image of the current environment of corporate tax avoidance in order to suggest that corporations intentionally skirt their tax obligations.

Prevalence of and Strategies for Corporate Tax Sheltering

Corporations not only abuse their market power to pay wages lower than their workers' marginal productivity, but also to avoid their tax responsibilities to the federal government. Pulitzer Prize winning journalist David Kocieniewski argues that despite an official corporate tax rate of 35 percent in the US, which is higher than only Japan and is often cited to thwart reform efforts, American corporations actually pay far less taxes than other nations ("US Business"). Corporate taxes account for only "1.3 percent of the nation's gross domestic product" while "Most industrial countries collect more from companies, about 2.5 percent of output" (Kocieniewski "US Business"). The fraction of federal income maintained by corporate taxes has also collapsed, as Kocieniewski notes: "corporate share of the nation's tax receipts [has fallen] from 30 percent of all federal revenue in the mid-1950's to 6.6 percent in 2009" ("G.E's Strategies"). Importantly, the drop-off in corporate tax receipts cannot be explained by falling corporate profits, which have doubled since November 2001 and nearly quadrupled since the end of WWII (Greenhouse 5, 41). Corporations pay nearly 40 percent less of their profits in taxes than they did in the post-war period (Porter). Quite simply, corporations pay a historically and globally miniscule amount of taxes, begging the following question: what systemic factors create an environment where such aggressive tax avoidance is possible? This section will contest that globalization of the capital market, which allows corporations to shelter their income internationally, is the main force behind modern corporate tax avoidance.

Admittedly, the US tax code itself must accept some responsibility for falling corporate tax receipts, as the highly complex tax laws filled with loopholes, exemptions, and opacity permit and encourage creative accounting, making US companies the global leaders in tax avoidance (Kocieniewski "US Business"; Dowling 175). However, given that the US tax code has been messy for generations, it appears that something far more powerful and universal has taken place—globalization of the tax market. The rapid and recent increases in communication and information technology make capital a highly mobile asset, allowing corporations to shuffle profits all over the world at the click of a mouse. Rather than domestic tax code shortcomings, accessible global markets "constitute the most serious compliance issues threating the American tax system" (Desai 145). As the world shrinks, corporations' power to avoid taxes grows.

Corporations take advantage of a globalized capital market to capitalize on quirky international tax rules by *tax sheltering*. Broadly defined, offshore tax sheltering, also known as profit laundering, tax arbitrage, or the utilization of tax havens, "is the practice of using artificial transactions to shift revenue to low tax countries while recognizing expenses in high tax countries" (Dowling 176). The most common method of tax sheltering is *transfer pricing*, defined as "subsidiaries in different countries [charging] each other for goods or services 'sold' within the group" (Wooldridge). The strategy is eloquently simple, especially easy for firms that rely on intellectual property (IP), an asset that is highly mobile and notoriously hard to value. An American corporation, facing a tax rate of 35 percent, "buys" services, IP, or even goods from a foreign subsidiary of itself, counting the domestic expense as a cost that is not taxed. The subsidiary, which, to stress, is just another arm of the same corporation in a different country, counts the transaction as a "sale" and records the transaction value as revenue subject to the tax rate in the foreign country. This tax arbitrage, which is an accounting trick that creates no real value, explains why "the top five countries for American affiliates, measured by jobs, are Britain, Canada, Mexico, China and Germany" while "Measured by reported profit they are the Netherlands, Luxembourg, Ireland, Canada, and Bermuda" (Porter), all countries with highly favorable corporate tax codes. By simply moving profits by sham transactions, corporations shield a large fraction of their income from US taxation.

In addition to transfer pricing, corporations use a second strategy for sheltering that relies on expatriating currency. America does not tax corporate income until it is repatriated into US dollars, allowing corporations to spend and amass cash abroad without ever paying taxes; in fact, "American firms hold $1.5 trillion overseas, 60% of their total cash" (Wooldridge). Additionally, a strange loophole in the tax code allows corporations to repatriate currency temporarily and tax-free by using "revolving short term loans between head office and subsidiaries to minimize profits" (Dowling 176). This exception considers loans under 60 days long as non-taxable foreign cash holdings—as if the cash never returned to the country. Corporations use this strategy to "provide a steady flow of liquidity . . . and unbroken funding" (Wooldridge) to their American division by loaning themselves money from foreign subsidiaries. Corporations simply hold their income in a rotating turntable of short-term loans, which is easy given modern technology, in order to finance domestic operations with the company's own cash but without the burden of paying income taxes. These short-term loan taxing rules combine with transfer pricing regulations to make corporate tax sheltering highly profitable and, unfortunately, quite simple.

A few short case studies, focusing on the behemoth corporations General Electric and Microsoft, drive home the prevalence of these two sheltering methods. Microsoft, based largely on intellectual property, reshuffles income by transfer pricing through subsidiaries in Puerto Rico, Ireland, and Singapore, areas with an average tax rate of just 4 percent (Wooldridge). These three subsidiaries booked 55 percent, or $15.4 billion, of Microsoft's 2011 global profit while employing only 2.2 percent of the company's workforce (Wooldridge). In fact, the subsidiaries' "1,914 employees generated an eyebrow-raising $8m of profit each, compared with $312,000 each for the 88,000 working in the rest of Microsoft" (Wooldridge). By using transfer pricing on IP to shift earnings from technology developed, sold, and consumed in America to low-tax countries, Microsoft shields over half of its profits from American taxes. On the other side of the same coin, G.E, which relies on goods rather than IP, exploits foreign income and loan rules not only to avoid taxes, but to *collect* them. In 2010, G.E reported global profits of $14.2 billion, but paid nothing in income taxes, instead collecting a $3.2 billion refund from the government (Kocieniewski "G.E's Strategies"). In fact, "in the last five years, G.E has accumulated $26 billion in American profits and received a net tax benefit from the I.R.S of $4.1 billion" (Kocieniewski "G. E's Strategies"). As these examples reveal, corporations take advantage of the globalized world to carry out tax sheltering on an unprecedented and highly profitable scale. As the next section will demonstrate, such tax avoidance has far reaching consequences for the global economy.

Undesirable Domestic and Global Impacts of Corporate Tax Avoidance

Socially irresponsible tax sheltering has a plethora of negative economic consequences. This section will prove that tax sheltering shifts the tax burden to labor, precipitates a race to the bottom in global tax policy, and handicaps government programs. Combined with the previous discussion about marginal productivities, it becomes obvious that corporate tax sheltering harms both society and citizens and must cease.

First of all, not only do corporations extract rents from labor by paying non-neoclassical wages, but they also force workers to bear the brunt of federal taxes. Corporations take advantage of the mobile nature of capital to create state-less income, something that labor does not have the capacity to do. While income taxes are designed to be progressive, corporations have the means to avoid most of their tax burden, making the income tax effectively a regressive tax on labor. In fact, "in 1953 families and individuals paid 59 percent of federal revenues and corporations 41 percent . . . this ratio has now shifted to approximately 80:20 in favour [sic] of corporations" (Christensen, "The Social" 39). Subject to the tangible requirements of human life (that corporations are, of course, not required to uphold) citizens find themselves powerless to dodge taxes like multinationals. Instead, Americans must pay up to support a government deprived of corporate tax revenue, implying that tax avoidance further restricts the real value of wages already under pressure from corporate power over the labor market.

Secondly, tax avoidance encourages global tax competition that no country can stop but all countries suffer from. Reuven Avi-Yonah, director of the International Tax Program at the University of Michigan Law School, focuses heavily on this point. Avi-Yonah argues that developing nations, desperate for capital inflows to spur growth, grant corporate tax breaks in an effort to invite foreign direct investment. In fact, even more developed countries like Ireland find crafting lax tax codes highly profitable due to the taxable corporate income that such codes attract. As a result, nations become competitors in a global tax market, fighting to set the most inviting corporate tax laws to steal business transactions away from highly developed nations like the US. And the US, in turn, is powerless to impose taxation on corporate foreign income because, if it did, "new multinationals would choose to become residents of jurisdictions that do not tax such foreign source income" (Avi-Yonah 1577). Thus, Avi-Yonah contests, the race to the bottom in corporate tax policy results in a classic multiple-player assurance game: all developed countries would benefit from taxing the foreign holdings of multinationals, but no country is willing to change their laws to do so out of fear of capital flight. The mobility of capital ties the hands of developed nations like the US and forces them to accept a status-quo global environment that emboldens corporate tax avoidance.

The powerlessness of the US government to change the global tax situation plays directly into the third consequence of corporate tax sheltering: the elimination of social welfare programs. It is estimated that the government loses upwards of $100 billion in tax revenue annually due just to corporate tax sheltering, and this value could be even higher given measurement difficulties (Dowling 176). The government is also forced to spend millions in bureaucratic costs to handle the complexity of corporate tax regulation. The 2010 G.E tax return was 57,000 pages long, and the IRS established permanent offices in two HP facilities and has been continually auditing them since 1962 (Dowling 176). As a result, "globalization and tax competition lead to fiscal crises for countries that wish . . . to provide social insurance" (Avi-Yonah 1576). This externality of tax avoidance is especially detrimental, as social insurance policies are increasingly needed to combat stagnating wages and income inequality. But without tax revenue, such policies become impossible, crippling the effectiveness of government.

In the end, corporate tax sheltering is not a victimless crime—tax avoidance punishes citizens and governments, both of which are increasingly unable to grab hold of ballooning corporate profits. Considering the incongruity between marginal productivities and wages, the prevalence of corporate tax sheltering, and the rippling negative effects of corporate tax avoidance, the problem is clear: corporations have reneged on their responsibility to workers and society. And, while difficulties persist, the next section will demonstrate that solutions to this insidious problem do exist.

Corporate Tax Reform

After identifying the problems associated with corporate tax sheltering, the challenge becomes developing policies that can combat it—this section will detail both a subtle and a radical proposal. First, however, it is important to consider the work of David Weisbach, professor of law at the University of Chicago, who discusses how substitution effects could render certain genres of tax reform ineffective. Weisbach first notes that tax shelters are, by nature, non-homogenous and widely available. Were the government to outlaw certain types of shelters by specific rules in the tax code, a few corporations might stop sheltering income, but the vast majority would simply substitute a different flavor of tax shelter. Weisbach contests that "it is highly inefficient to attack most shelters, at least on a piecemeal basis" and suggests that a tax code relying on rules would muddy up the tax code and "be subject to easy manipulation" (10, 14). Because corporate accountants are highly flexible and incentivized to avoid taxes, any case by case, rules-based approach would be unable to outlaw every type of sheltering activity, rendering this strategy impractical. Weisbach's second point touches on the substitution effects of tax reform as they relate to punishments. Weisbach notes that obscenely high sanctions for even minor forms of tax sheltering would probably not discourage major offenders, who have already decided that currently strict ramifications are worth the risk, from continuing their tax avoidance. Weisbach asserts that for "a tax payer who engages in a minor type of evasion . . . [there would be] no incentive to avoid more egregious evasions" (12). In this way, legislating piecemeal rules or boldly high penalties creates substitution effects that negate the impact of such policies. Understanding Weisbach's cautions lays an important foundation for evaluating potential reforms—for a policy to be effective, it must meet Weisbach's criteria. Both proposals in this section do just that.

Initially, however, it is essential to note that a meaningful portion of the global community must undertake communal reform if the effects of tax competition are to be overcome. The Organization for Economic Cooperation and Development (OECD), comprised of economically powerful nations vulnerable to the abuses of tax sheltering, could have enough clout to impose a meaningful new global tax standard. Encouraging international cooperation is admittedly highly difficult and subject to diverse political pressures; in fact, Christensen notes that "the principal barrier . . . towards achieving these goals [of tax reform] is the lack of political will on the parts of the governments of the leading OECD nations" ("Looting Continues" 193). This fact, however, can also be taken optimistically: under intense revenue pressures and citizen discontent, governments may have no choice but to cooperate, removing the only roadblock to meaningful reform. As Avi-Yonah points out, "international governance is not impossible" (1676), and it is the only way to change the current environment.

Understanding that any proposal must be undertaken on an OECD—if not a global—scale, it becomes possible to discuss reforms, beginning with an approach that operates within the realm of current tax standards. The current tax code, filled with explicit rules and definitions, hamstrings regulatory agencies and forces them to evaluate the form, and not the intention, of transactions. While the crafty transfer pricing abuses of Microsoft are clearly undertaken only to avoid taxes, the ability to make a sale is completely legal, and regulators are unable to use discretion when evaluating these dealings. To combat this, the OECD should adopt a general anti-avoidance rule which "authorizes the tax authorities and the courts to vault substance over form" (Dowling 179). Armed with a legal impetus to use discretion, regulators would be empowered to discount the strict definitions of the law and instead differentiate between transactions made for a business purpose and those made solely to avoid taxes. This simple reform would cut out a mountain of loopholes; allowed a touch of human awareness, the tax code could evolve to combat new offshoring threats without the need for constant retooling. This would immediately increase corporate tax revenue by rendering all flavors of offshoring for the sole purpose of tax avoidance illegal.

The second, and more radical, solution comes from Edgar L. Feige, Professor Emeritus at the University of Wisconsin, Michele Boldrin, economics professor at the University of Washington in St. Louis, and Harry Huizinga, professor of international economics at Tilburg University. Feige *et al*. suggest eliminating every form of tax worldwide, except for one: the Automated Payment Transaction tax (APT) which would consist of an "automatically assessed and collected . . . flat tax levied on all transactions" (475). This tax would be progressive, since the richest corporations, traders, and individuals carry out "a disproportionate share of total transactions and therefore bear a disproportionate burden of the tax despite its flat rate structure" (475). The APT tax, ironically, relies on the very same technological revolutions that made tax sheltering possible (like computerized payments) to destroy it. Sham transactions, short-term loans, sketchy payments—it does not matter. Every transaction, no matter the motivation, would be automatically and immediately taxed, completely disincentivizing tax sheltering. In fact, under this paradigm, the frequent transactions associated with tax avoidance would actually increase a company's tax burden. Feige *et al.* estimate that, even if substitution effects decrease transaction volumes by one-half, the APT tax would only need to be around .6% per transaction to maintain revenue neutrality (500). If transactions fell less sharply, which seems likely given the small amount of the tax, or if the tax were increased, the APT could easily increase government revenue. While this proposal is admittedly bold, it washes away the muddied tax code built on complicated rules and replaces it with a transparent, progressive, and automatic system. If nothing else, the APT tax offers a fascinating glimpse into just how radically the tax code needs to be reformed if governments are to overcome tax sheltering.

In the end, either a global anti-avoidance policy or an APT tax could eliminate large swathes of corporate tax sheltering, and both strategies meet Weisbach's criteria and avoid the pitfalls of setting more rules or heightening punishments. With some careful negotiations between OECD countries, there exist multiple policy reforms that could curtail corporate tax avoidance and increase government tax receipts worldwide. Governments could then share the wealth with citizens through social insurance policies, effectively redistributing income from corporations whose profits are soaring to workers whose wages are stagnating.

Conclusion: Placing the Rights of Man over the Rights of Property Once Again

After dispelling the neo-classical notion that workers are paid their marginal productivities and evaluating the prevalence of tax sheltering by American corporations, it becomes clear that American companies have reneged on their social responsibilities. Corporate profits have skyrocketed while wages and tax receipts have stagnated or fallen, resulting in a sharp and painful divide in the American economy between capital owners and laborers. The discussion about the causes of income inequality is complex, but it is clear that the wealthiest corporations use tax avoidance to extract rents from both citizens and the government, directly contributing to growing inequality. As a result, "income inequality in the United States is so great that it more closely resembles the inequality of a third world country" (Greenhouse 5). Discouragingly, corporations, by refusing wage increases and shifting the tax burden to individuals, have both created the need for a social safety net and undermined the ability of the government to provide one.

Finally, because the very system of capitalism itself, which values profit-making over all else, endogenously incentivizes private tax avoidance, regulatory steps must be undertaken to tame the profit-maximizing beast. Corporations, whether they like to admit it or not, bear some responsibility for the well-being of the society from which they profit—corporate profit hoarding represents a fundamental breakdown in American notions of fairness and equality that should be counteracted. The American government has a duty to reform the corporate tax code and redistribute the revenue to workers, and weapons like the general anti-avoidance rule or the APT tax are available if America facilitates global cooperation. However, without such changes, the "nation of the people” will never return to Roosevelt’s image of a nation that justly places the rights of man over the rights of property.

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