Tax Corruption and Parallel Economy

The Social Irresponsibility of Tax Avoidance Practice

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ABSTRACT

Indian economy is undergoing a sea change. Most of the economic models have tilted towards markets. This phase of globalisation has not only prompted change in the way of doing business but also touched significantly upon the everyday life of common man, his needs, and aspirations. The Social Irresponsibility of Tax Avoidance Practice is perhaps the most fundamental way in which private and corporate citizens engage with broader society. It is therefore curious that tax minimization through elaborate and frequently aggressive tax avoidance strategies are is regarded as one of the prime duties that directors are required to perform on behalf of their shareholders. It is even more curious that the debate about corporate responsibility which has touched on virtually every other area of corporate engagement with broader society has scarcely begun to question companies in the area where their corporate citizenship is most tangible and most important – the payment of tax. The free market tax competition model assumes that all tax-paying citizens and businesses are perfectly mobile and therefore able to migrate between different jurisdictions according to preference. Ironically the majority of tax havens have adopted elaborate defence strategies to prevent such migratory flows, but the otherworldliness of the perfect mobility assumption has not deterred these arguments in defence of the 'discipline' imposed by tax heavens.

1. INTRODUCTION

The World is well aware of the dramatic change that swept not only India but the entire sub-continent. The mission of market economy is to reduce the inequality of all kind through different marketing intervention techniques. However, corruption, tax evasion/avoidance are the main bottlenecks to the turn this dream into reality. A very strong political will together with an effective tax administration system is required to be put into place to curb the generation & flow of black money. Honorable Finance Minister Mr. P. Chidambarm has said he will soon initiate steps to cleanse the tax department with a view to improving revenues, including large-scale automation and identifying the black sheep.

The phrase "fatal conceit" was used by F.A. Hayek (1988) to label the idea that "man is able to shape the world around him according of his wishes". The key failing, according to Hayek, was the pretense to knowledge that underlay the socialist experiment. The use of the term "conceit" in the context of corruption & tax avoidance/ evasion is descriptive of a similar attitude displayed by democratic states. The key failing, however, has not been the inadequacy of information or knowledge available to the state. Instead, it has been the proclivity to disregard the actual preferences of its citizen.

The "common man" in India has held a very limited preference for collective provision of goods. The existence of a low preference for collective organization or the "peasant's age-old distrust of the tax-gatherer" is well recognized in the literature. What is not sufficiently explored, or even admitted, however, is the existence of a preference bias amongst the general population towards private, as opposed to public, goods. Such a preference bias may be illustrated with the help of a simple example – an individual's consumption of hygiene. Thus, an individual, while he may be particular about personal and household cleanliness, could be indifferent to sanitary conditions outside the confines of his home say, within his neighborhood, or the city. The existence of such a bias suggests a number of micro and macro implications for tax compliance behavior and public goods provision by the state.

Hidden from the public eye financial capital has been completely reconfigured over the past thirty years in order to bypass nationally-based tax and regulatory regimes. Using the 70 plus tax havens dotted across the globe, wealthy individuals and transnational businesses have adopted highly aggressive tax avoidance strategies, whilst also forcing the governments of mainstream nations to engage in a harmful tax competition to attract direct and portfolio investment capital. The existing framework for cooperation on tax affairs is substantially inadequate to its task, and the Whilst poor countries lose an estimated US$500 billion annually to parallel money flows, which includes tax avoidance and related capital flight, Civil society is now mobilising to counter the tax avoidance industry and to challenge the idea that tax competition can play a useful role in development strategy.

Global entrepreneurial systems struggling to protect themselves from tax avoidance/ evasion by high net worth individuals and profits-laundering by transnational businesses. At the same time tax competition has led to many governments cutting tax rates on income earned by non-residents in order to attract portfolio and foreign direct investment. Faced with this dual threat to their tax revenues, government havs increasingly resorted to shifting the tax burden from capital to labour, despite this being in most instances both regressive and counter-productive from an employment creation perspective. In practice the combination of capital flight, rapid repatriation of profits, high levels of state subsidy to attract investment and systematic tax avoidance have eroded the potential benefits of financial transfers from rich countries to poor. Most tax evasion and avoidance schemes, including profits-laundering techniques used by major corporations involve the use of offshore trusts, foundations, charities, holding companies, international business corporations, special purpose vehicles, and artificial transactions.Policy measures are required to redress the distortions that have arisen as globalising companies have left nationally based tax regimes floundering. Multinational companies make use of aggressive tax planning strategies because they are able to operate in the legal vacuum that exists between nation states, and because the current regimes for handling the use of transfer pricing mechanisms and for countering the use of thin capitalisation strategies have proved to be inadequate in tackling globalised business, particularly those operating in developing countries. To be able to meet their commitments to welfare provision and development programmes in the face of the fiscal pressures of globalisation, governments will need to cooperate in order to limit the scope for tax competition, whilst at the same time retaining their ability to determine the size and nature of their state sector through the normal democratic processes. Furthermore, the myth that tax breaks for business will strengthen an economy in the longer term is not supported by hard empirical evidence. At the micro-level of the firm the willingness of some businesses to engage in aggressive tax planning means that company directors who prefer to adopt ethical policies in respect of paying taxes in the jurisdictions in which their companies operates will place their shareholders at a distinct commercial disadvantage. This reveals a major new area of concern for the Corporate Responsibility (CR) agenda, which until recently had not even questioned companies in the area where their corporate citizenship is most tangible and most important the payment of tax.The scale of tax avoidance activity can be described as a shadow economy operating in the majority of globalise sectors, including and especially, the extractive industries, banking and finance, aviation, shipping, communications, pharmaceuticals, media, traded commodities. The secretive nature of this type of activity renders it impossible to accurately quantify the scale of this shadow or parallel economy. Whilst the tax avoidance industry is clearly damaging to the interests of developed countries, harmful tax practices are an even greater problem for economies in transition and developing countries. Resulting into a large swell in the black money and running a parallel Economy vis-à-vis.

2. BLACK MONEY

There is a phenomenon closely associated with inflation, both as a cause and consequence, viz., 'black money'. Black money is not a different form of money or currency, but essentially incomes which accrue through illegal measures and which, therefore, are kept out of accounts and escape taxation. One of the commonest ways of generating such incomes is the under-reporting of the value of property when it is bought and sold. To the person why buys property, under-reporting of the value makes it possible to reduce the cost of registrations which is a percentage of the reported value. It is advantageous to the seller because it will show a reduced capital appreciation and thus held to reduce or escape capital gains tax. The difference between the actual amount received and the reported value accrues as black money to the seller which he is in a position to use as he likes. Under-reporting of income to evade income tax (mainly because the rate of income tax goes up for higher levels of income) also generates black money for those who do it. Manufacturing concerns under-report the extent of production to escape excise duty and thus generate unaccounted incomes for themselves. All forms of bribes become unaccounted income for those who receive it. In all these ways the generation of unaccounted earnings or of black money is a widely prevalent practice in the economy. It provides additional purchasing power to those to whom it accrues and thus adds to the inflationary pressures. However, those who have fixed incomes can argue that when prices are rising they are not able to make both ends meet unless they have additional incomes, and to that extent black money may be thought of as a consequence of inflation also. Once unaccounted incomes are generated they tend to enter into the overall working of the economy in many different ways. There will be greater inducement to spend unaccounted earnings. Usually the spending will be on durables whose values are likely to appreciate because of the rise in price, particularly precious metals and real estates. And because unaccounted earnings are generated through such transactions a vicious circle soon sets in, as can be seen in the manner in which urban property values have been shooting up in recent years. But unaccounted incomes can be spent on just about anything, purchase of consumer durables, entertaining, giving 'gifts', financing crime and elections. In view of this easy access to the normal economy, it will not be correct to say that what unaccounted money does is to create a parallel economy or underground economy, distinctly separated from the actual economy. The relationship between the two is rather like milk and water in one container. It may be possible to say that the two do not remain horizontally or vertically separated.

Because of the very nature of the generation of unaccounted incomes and of their utilization it is not easy to make any precise estimate of their magnitude. But there have been attempts to arrive at some order of magnitude. A quasi-official estimate for late 90's showed that the quantum of black money was probably Rs. 6 lakh crores. Hence, it is impossible to overlook its impact on the economic processes in the system. As black money is largely generated by, and accrues to those who are direct tax payers and those involved in transactions of high magnitude, it must be taken to belong to the top layer of the economy, considerably enhancing their affluence and the power they exercise over the system. Theory of the firm to the political economic sphere of nation states, which manifestly cannot and do not compete with one another in the provision of public services and infrastructure to their citizens. The free market tax competition model assumes that all tax-paying citizens and businesses are perfectly mobile and therefore able to migrate between different jurisdictions according to preference. Ironically the majority of tax havens have adopted elaborate defence strategies to prevent such migratory flows, but the otherworldliness of the perfect mobility assumption has not deterred these arguments in defence of the 'discipline' imposed by tax havens.

3. TAX COMPETITION

Tax competition between states can be economically harmful in a number of ways: Tax competition shifts the tax burden between different factors of production and between different types of economic activity, thereby increasing the costs of labour in relation to capital and encouraging short-term speculative activity to the detriment of fixed, long-term investment; The greater mobility of high net worth individuals and Trans National Companies (TNCs) enables them to make full use of offshore tax vehicles, thereby undermining the integrity and equity of tax structures and creating a free-rider economy

The use of elaborate and typically aggressive tax avoidance structures increases the administrative burden of revenue collection; And perhaps most importantly, widespread tax evasion and avoidance increases income disparities within and between states, and is symptomatic of the withdrawal of wealthy elites from their economic and social obligations The benefits to developing countries of tax competition are questionable. In India also it had an negative and intended consequence. Which begs the question, why do governments persist with offering fiscal inducements when the evidence suggests that good social and physical infrastructure, an educated workforce, and stable social and economic conditions are a more important pre-requisite for investors? The answer lies with the fact that governments are under immense lobbying pressure, particularly from business consulting firms, to offer tax incentives in order to attract inwards investment. The Social Irresponsibility of Tax Avoidance Practices are perhaps the most fundamental way in which private and corporate citizens engage with broader society. It is therefore curious that tax minimization through elaborate and frequently aggressive tax avoidance strategies is regarded as one of the prime duties that directors are required to perform on behalf of their shareholders. It is even more curious that the debate about corporate responsibility (CR), which has touched on virtually every other area of corporate engagement with broader society has scarcely begun to question companies in the area where their corporate citizenship is most tangible and most important – the payment of tax.

4. TAX EFFICIENCY

"Tax is a cost of doing business so, naturally, a good manager will try to manage this cost and the risks associated with it. This is an essential part of good corporate governance." (Irish Times, March 2004)— Erneh & Young

First, tax is not a normal cost of production of either goods or services since tax avoidance does not in any way lead to improved production efficiency. Directors who pursue aggressive tax avoidance strategies automatically place businesses that adopt an ethical stance on tax at a commercial disadvantage even if their production processes are technically more efficient.

Second, paying tax can only be regarded as a business risk when directors choose to adopt aggressive tax planning strategies, and the comment is revealing of a cavalier attitude towards social responsibility.

Third, directors who take medium or high risk tax avoidance strategies do so in the knowledge that this will inflate price / earnings ratios, and that intervention by tax authorities is likely to lead to a downwards re-valuation.

*Fourth,*Researchers have identified corporate governance as an important area of concern for institutional investors, with issues such as reduction of corruption, collusion, nepotism; inadequate disclosure and insufficient transparency of financial statements; inadequate enforcement of existing rules, and a lack of clear separation of company ownership and management, all being seen as key areas of institutional concern.

Nonetheless, the seemingly related areas of compliance with taxation obligations, not using aggressive tax avoidance techniques and transparency of reporting of tax planning measures are not mentioned in the National reports on good governance.

5. CONCLUSION

An individual with preference bias towards consumption of private goods will expect to be worse-off with public goods provision as compared to a situation he avoids the tax burden through evasion or corruption, even though these may lead to a complete breakdown of public-goods provision. Very low levels of tax compliance are expected to persist along with poor, uneven or non-existent levels of public goods provision. Such a state of affairs is descriptive of the administrative history of public good provision. The dilemma of collective equilibrium under conditions of majoritarian democracy has been extensively studied by both the normative, social-choice literature and under the positive, public choice inspired political economy. The existence of a positive, if differing, preference for public goods however is taken for granted in both perspectives, and the ideal of politics as a positive sum game is upheld for the western democratic world. The West has sustained relatively high levels of public goods provision along with high levels of tax compliance and good governance in the allocation of public facilities. However, it is high time that we also have got to rise to the challenge of Tax efficiency to meet corruption, black money and Tax avoidance/ evasion.

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