International

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Equity, Transparency, Cooperation and the Taxation of High Net Worth Individuals

This article discusses the taxation of high net worth individuals with the objective of achieving an equitable and transparent tax system. The article provides a review of the growth of top incomes over time, the taxable capacity of top income earners and their effective tax rates. It also discusses the ability of such individuals to evade taxes and the measures that should be in place to curb such revenue loss.

1. Introduction

"An imbalance between rich and poor is the oldest and most fatal ailment of all republics" – Plutarch

In *The Wealth of Nations*, published in 1776, Adam Smith described the characteristics that a good tax, or a good tax system, should have. These were certainty, convenience, economy, and equity. By equity, he meant mostly *horizontal* equity. Smith maintained that, when any of these characteristics is missing, a tax, or a tax system, could not be considered good.

Writing in the pre-industrial revolution and pre-globalization era, Adam Smith could not have been concerned with modern tax issues such as progressivity, transparency, complexity and international tax evasion, because these issues were largely absent at that time. The world has changed a great deal since 1776 and the pace of change has accelerated in recent decades.

Tax levels have increased significantly, raising the question as to how the high tax burdens should be shared among individuals belonging to different income classes, especially when:
- before-tax incomes are distributed very unevenly;
- tax rates are much higher than in the past;
- taxes have become more complex;
- some individuals and capital have become highly mobile; and
- the globalization of economic activities and of the capital market have created opportunities, for evading taxes that had not existed in the past.

These developments were taking place at a time when the governments' perceived need for additional public revenue was growing. The governments of both rich and poor countries have been forced to rely on loans to finance their public spending. This has led to worrisome growth in public debts, and to potential fiscal crises. The need for higher tax revenue in future years will continue to be acute in developed countries, to help them get out of their current fiscal difficulties and to finance their fast-growing future needs, and in developing and emerging markets, to allow governments to promote policies for growth, and for raising the living standards of poorer sections of the population.

2. High Net Worth Individuals and Their Income Levels

"Ability to pay" has been an important guiding principle of taxation for at least a century. The view that people with high income, or high net worth individuals (HNWIs), should pay more taxes than their less fortunate compatriots has, over the years, received much support from tax experts, citizens at large and most governments. While there has been some academic and political debate on the merits of this principle, a debate that continues today especially in the United States (US), the principle has not been widely challenged.

Some political observers have maintained that HNWIs are the creators of jobs and the promoters of economic growth. Therefore, their incomes ought to be protected. Those who strongly hold this view, such as the members of the Tea Party in the US, tend to assign little importance to the role that governments play or can play in the growth process. They think that governmental activities are inherently unproductive. On the other hand, those who tend to assign greater importance to what governments do or can do, argue that governments can play their growth-promoting or socially important role, only if they have the needed financial resources for building infrastructure, educational spending, etc. An area where tax resources can be found is obviously in the HNWIs.

Before dealing more directly with tax questions, let us briefly review the evolution over time of top incomes, to get a better quantitative idea of how much taxable capacity exists, or can be assumed to exist, among them. In countries with relatively even income distributions before tax (those whose markets produce low Gini coefficients[1]), the HNWIs, by definition, receive modest shares of the countries' total income. However, when the before-tax Gini coefficients are high, the HNWIs receive higher shares

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1. The Gini coefficient measures the degree of inequality of a variable in a distribution of its elements. The Gini coefficient ranges between 0, where there is no concentration (perfect equality), and 1 where there is total concentration (perfect inequality).

of total income and consequently, have a higher taxable capacity.

In addressing the question of the taxation of the HNWIs, we need to start with some definition of what makes an individual belong to the HNWIs. Such a definition cannot be based on the absolute income of the taxpayers but must be related to the per capita incomes of the countries. In low-income countries, the HNWIs may have *absolute* income, that would make them part of the middle class of richer countries. For this reason, the definition of the HNWIs must be country specific.

According to a recent study prepared by Wealth-X, a Singapore-based research and advisory firm, and reported by Bloomberg News on 1 September 2011, there are 62,960 *ultra* HNWIs in North America, 54,325 in Europe, and 42,525 in Asia-Pacific. These are individuals with a net worth of at least USD 30 million each. India was reported to have 8,200 such individuals, and Indonesia 725. The report stated that:

> "US wealth managers [hire] hundreds of advisers to handle the[ir] assets ...". Many of these "advisers" are "tax planners".

Presumably, the *ultra* HNWIs of other countries do the same. However, one does not need to have a net worth of over USD 30 million to be considered rich and to be able to pay higher taxes than the rest of the population. In recent years, some academic literature has focused on the incomes of individuals at the top 1% or, in some cases, at the top 0.1% of the population or of the taxpayers. In relative terms, these individuals must be considered rich, within the countries in which they have residence.[2]

Obviously, the reliance on tax data is likely to bias downward the income estimates of the richest 1% (or 0.1%), especially for recent decades when the countries' economies were more open, the financial market more global, the tax consultants more active and alert, and the possibilities for rich individuals to avoid taxes were more easily available. The tax advisers were at times paid, for their advice on how to save taxes, on the basis of the taxes actually "saved". The existence of many tax havens and offshore centres was of great help. It should also be kept in mind that capital gains that had not been realized were not reported to the tax authorities. These capital gains are likely to have been concentrated at the top and can be significant in a period of growth.

The academic studies have reported that the shares of total taxable income attributed to top incomes dropped dramatically in the first part of the 20th century, until the late 1960s or early 1970s, because of two Great Wars and the Great Depression. These events lowered the returns on capital or destroyed much privately owned capital. During this period, the tax rates on income from capital also sharply increased, especially in the period during World War II and in the years immediately after. In the mid-1960s, these taxes became so high that they even inspired a Beatles' song called "Taxman". Its lyrics were:

> I will tell you how it will be, one for you, nineteen for me, 'cause I'm the taxman.

The marginal tax rate at that time exceeded 90% in the United Kingdom (UK), where the Beatles paid their taxes. So there was no exaggeration in their counting.

For the US, an American think tank known as the Tax Foundation has estimated the effective tax rate for heads of households that had earnings equivalent to USD 1 million for the 1913-2010 period, at 2010 prices, as shown in Table 1. The rise and fall of these rates over the period is evident.

Table 1: Effective tax rates on millionaires in the US

Year	Effective tax rate (%)
1913	1.6
1929	13.4
1945	66.4
1965	55.3
1982	47.7
2000	36.4
2010	32.4

Source: Tax Foundation.

After the elections of Margaret Thatcher in the UK and Ronald Reagan in the US, views about taxes started to be influenced by what came to be called "supply-side revolution", accompanied by its popular expression, the "Laffer curve". The impact on policy was a progressive lowering of statutory tax rates in those two countries that soon spread to other countries, during the late 1980s and later.[3] All tax rates, but especially those on income from capital were significantly reduced. At the same time, other developments (globalization of economic activities, the creation of a global financial market, the growing international mobility of goods, capital and high-skilled individuals) contributed to the increase in the share of total personal income received by top income earners. In those years, while the tax rates went down significantly, the pre-tax income shares of the HNWIs were going up dramatically. These trends continued in recent years at least until the financial crisis.

The increase in the share of total income received by top income earners was much greater in English-speaking countries, India and China, than in European countries and Japan. An interesting aspect of this change was that the increase in those income shares in Anglo-Saxon countries was caused by sharp increases in labour compensation (wages), that included the compensation received by managers.

Over the past three decades, the compensation packages of managers and other top income earners rose dramatically, compared to the wages of workers with average incomes

2. *See* T. Piketty & E. Saez, *The Evolution of Top Incomes: A Historical and International Perspective* (2006), 96 AEA Papers and Proceedings 3 (May), 2000-2005; and Atkinson et al., *Top Incomes in the Long Run of History* (2011), Journal of Economic Literature, 49:1, 3-71. This literature has traced, over the years and through tax data, the trends in the share of total income received by these lucky individuals.

3. *See* V. Tanzi, *The Response of Other industrial Countries to the U.S. Tax Reform Act* (1987), XL National Tax Journal 3 (September), 339-355.

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that largely stagnated. Capital incomes (passive returns to the investments of savers) grew much less. Those who *manage* wealth have done much better than those who *generate* savings.

There has been a heated debate about why this has occurred. The net result has been that there is now a larger share of what can be broadly called "wage income" in the total income of top income earners, lending itself more easily to the argument made by some politicians or even some conservative economists, that high tax rates would have disincentive effects if they were levied on high-level taxpayers.

In the US, the income of those in the top 10% rose from about 35% of total income in 1970, to 50% in 2007. Income of the top 1% rose from about 10% in the 1960s and 1970s to close to 25% in 2007 according to data issued by the Congressional Budget Office (October 2011). The latest US Inland Revenue Service (IRS) data indicate that the pool of taxpayers with an adjusted gross income of USD 10 million or more fell by 55% between 2007 and 2009 as a consequence of the financial crisis. These individuals' combined income fell from USD 561.6 billion in 2007 to USD 240.1 billion in 2009. In 2009, 81.9% of taxpayers with an adjusted gross income of more than USD 10 million earned a salary or wage, down from 85.4% in 2000.

With some differences, the behaviour in the trend of the top income earners (the top 1%) in the US was replicated in Canada, Ireland, the UK, Australia and New Zealand.[4] However, it was not replicated in France, the Netherlands, Japan, Germany and Switzerland, where the share of the top 1% had fallen significantly until World War II and continued to fall, but at a very slow pace, after World War II until the present. This difference raises the inevitable question of whether the attitudes or the norms of the population of the Anglo Saxon countries, vis-à-vis income distribution and the role of the state in the economy, are different from those of the countries in continental Europe and Japan. There have been statements about "winner take all" attitudes in Anglo-Saxon countries, attitudes that are criticized in continental European countries.

The compensations of bankers and other participants in the financial market, such as hedge fund managers, (the *allocators* of financial capital) have attracted a lot of negative attention in recent years especially in the US and the UK, where large bonuses were paid to many of them in the middle of the financial crisis and often to the same individuals that had created the crisis and had driven their banks to the point where they had to be rescued by huge amounts of taxpayers' money.[5]

Many complex tax preferences and compensation packages have made it possible for financial managers to get huge incomes even when those incomes were clearly not merited and when they were so large that they attracted many critical comments. As an author put it:

> ... handsomely paid lawyers and accountants ... made sure [that] every practice could be defended as legal ...[6]

So the legal problems were controlled but the ethical ones remained and became more acute and annoying to people not benefiting from this bonanza.

Broadly similar results to those of the non-Anglo-Saxon group of countries reported above were seen in Northern Europe (Sweden, Finland and Norway) and Southern Europe (Spain, Portugal and Italy). For these countries there was some increase since the 1980s, in the share of income received by the top 1% of the population. However, with the exception of Norway, in all of the above non-Anglo-Saxon countries, the share of the total income going to the top 1% remained near 10%. This compares with the significantly higher percentage for recent years in the US and in some other Anglo-Saxon countries, as shown in Table 2 below.

These differences in income shares have stimulated an intense debate, during and after the financial crisis, between those who favour greater income redistribution, especially through higher taxes on high-income earners, and those who oppose such policies as interference in the work of the market. These arguments have become particularly heated in the US where they have contributed, on one side, to the creation of a so-called Tea Party, and on the other side, to a growing number of sit-ins and demonstrations. The realization that some individuals who receive very high incomes (hedge fund managers, bankers, chief executive officers (CEOs), etc.), have accumulated huge assets while paying very little taxes (often paying taxes on their incomes that were lower percentages than those paid by their drivers or secretaries) has led to strong popular reactions. These reactions have been particularly intense when the incomes have not been seen as merited, or as clearly contributing real value to the economy. On the conservative side, there have been complaints that the critics were engaging in what was described as "class warfare" and advocating populist and anti-market attitudes.

The arguments *against* collecting higher taxes from HNWIs can be *political* – high taxes reduce the liberty of individuals who in a market economy, can be assumed to "get what they deserve", through their greater ability, hard work and better effort, a view attributed by Ron Suskind to Larry Summers[7] or *economic* – high taxes negatively affect the incentives and the economic performance of the very individuals who are assumed to be the main agents of economic growth.

The validity of the economic arguments have been dismissed or minimized over the years by some prominent economists (including Samuelson, Atkinson and others) and have been given much weight by conservative economists and politicians, especially in the US. It has also been argued that, when there is social mobility in a country, there are no reasons, and less calls, for having highly pro-

4. *See* Atkinson et al., n. 2, p. 41.
5. *See* many recent books including, H. Sinn, *Casino Capitalism* (Oxford University Press 2010) and R. Suskind, *Confidence Men* (HarperCollinsPublishers 2011).
6. *See* id., R. Suskind, p. 236.
7. *See* n. 5, R. Suskind, p. 231.

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gressive taxes. Over the years, this latter argument was made when comparing Europe, with its low, upward, social mobility, with the US, with presumably high mobility. However, recent information has indicated that social mobility has become less common in the US, so that the poor tend to remain poor more frequently than in the past, an outcome that had been attributed to Europe.

The arguments *for* more income redistributions, presumably through higher tax rates on the incomes of HNWIs, have often been made by economists in international organizations and by some academic economists, including Nobel Prize winners, Amartya Sen and Paul Krugman. Sen has argued that an individual's capacity to choose (a measure of economic liberty) depends on his/her standard of living. When the standard of living is very low, *economic* liberty is much reduced and *political* liberty becomes less important. To a person who does not have enough to eat, the right to vote is likely to lose much of its appeal. Governments can increase the *economic* liberty of individuals, and maintain their attachment to democratic institutions, by increasing their economic *opportunities*. To be able to do so, they need revenue, and the tax revenue can be obtained from those who have taxable capacity. Significant ability to pay, or significant taxable capacity, in many countries, is concentrated among the HNWIs.

A different and perhaps novel argument can be made in support of higher tax rates on HNWIs. This argument challenges the view, attributed to Summers but widely shared by mainstream economists, that in market economies, "people get [the incomes that] they deserve". It could be argued that the HNWIs owe significant shares of their wealth to the particular institutions and arrangements that have been created, or that have been allowed, by governments, in the societies in which the HNWIs live. In other words, large shares of many, though not all, of the high incomes can be assumed to be rents. They are not *genuine* and *deserved incomes* in the economic definition of the term. As a consequence, these high net wealth, or high-income individuals, have some obligations towards other individuals of the society in which they live. It is this society that has made it possible for them to receive their incomes. Less lucky individuals, who benefit less from these institutions and arrangements, do not have the same tax obligations.

The incomes received by the HNWIs have not been earned in a Robinson Crusoe's, isolated economic environment. They have been earned in an environment in which particular institutions, rules and specific governmental actions, or, at times, inactions, have made it possible for many of these individuals to earn very high incomes. Just think of the actions taken by many governments, during the 2008-2009 financial crisis, to save the financial systems, and thus to protect the incomes (and bonuses) of bankers and many others operating in the financial market, including hedge fund managers. Or think of the role that patents, copyrights, trademarks, limited liability rules, restrictions to entry in some professions, import duties, monopolies, monopolistic practices, tax incentives, "too big to fail" conditions, and other institutions promoted or allowed by governments, play in generating the very high incomes. Without the existence of these institutions, rules and actions, it would be very difficult for many HNWIs to receive the high incomes that they receive.

The existence of this kind of, what could be called, government-created *institutional capital* makes it possible for many lucky, or well-placed and well-connected individuals to become HNWIs. In a truly free economic environment, one characterized by "perfect competition", these incomes would not exist and the income distribution would be much more even, requiring a less redistributive role on the part of the government.

An additional and totally different argument for justifying high tax rates on HNWIs, can be based on the impact, or lack of high tax rates on the incentives of *very* high-income individuals. For many of the *very* HNWIs (e.g. CEOs of large corporations, famous athletes, famous artists, hedge fund managers and so on), by the time they become HNWIs, they have acquired a social status or social position that they would want to maintain and defend regardless of their tax rates. A top athlete, artist or the CEO of a large corporation is not likely to reduce his or her effort to remain at the top position acquired only because he or she is being taxed at a higher rate. This reaction must be true for many *very* HNWIs. For them, the presumed negative impact on incentives from higher tax rates is doubtful.

While taxes may create disincentives *on the way to the top* (at levels of income and prestige when the income is of overwhelming importance), their negative impact is likely to weaken *once one has reached the top*, and has acquired a social status or position that gives a lot of fame or prestige and thus merits to be defended. For many HNWIs, the social position may become more important than the income that accompanies it. If this argument has merit, it would justify the use of higher tax rates at *only very high income levels*, say at the level of the *very* HNWIs income. This would be a kind of millionaires' tax rate. For lower incomes, the disincentives that high tax rates create could be more damaging, because the individuals have not yet achieved the high social statuses (that provide the important, additional, "psychic income" to individuals). For lower income individuals, the financial compensation is the total compensation (both financial and psychic).

The argument above would acquire even more weight when it is assumed that some of the top income earners have not contributed, or are not contributing something of real value to society. Some economists have made this point with respect of the activities of the high income earners who have been operating in a financial market characterized by excessive financial engineering, that, some have maintained, has transformed it into a "Casino Capitalism".[8] However, this additional argument would require making distinctions among very HNWIs, a distinction that is impossible to make in practice.

8. *See* Hans-Werner Sinn, *Casino Capitalism* (Oxford University Press 2010) and Tanzi, *Government Versus Markets* (Cambridge University Press 2011).

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The economic and political powers of individuals tend to be correlated in many countries; in some more than in others. This might be seen as a further reason to tax very HNWIs at higher rates. More income and more wealth give individuals more political power. That relation is enhanced by the increasing complexity of laws and regulations, that has become common in many countries and that allows rich individuals to better exploit to their advantage, the existing laws, regulations and institutions that constitute the "institutional capital" mentioned earlier.

In recent decades, some financial instruments and some forms of compensation such as differed-stock distributions have been created explicitly to get around existing taxes. Globalization has facilitated this objective. High-income individuals have the financial means to hire able and specialized individuals (lawyers, tax experts, financial advisors, accountants and others) that, for their clients, can search for loopholes and exploitable ambiguities in the complex tax laws and regulations. If the individuals are really rich, they can also hire lobbyists who, in the words of a famous Washington lobbyist, know "... the Byzantine legislative process and how to make it work for clients", to change some of those laws or regulations.[9]

Some of these individuals, and especially those who operate as lobbyists and who are both experts and have good political connections, can more easily access the civil servants, the high level bureaucrats, and the politicians who have some power of interpretation over the rules and the laws. This implies that the state should make every effort to:

- make the economic system as competitive as possible;
- make the laws and the rules as transparent as possible; and
- remove (at least some of) the factors that provide rents to the HNWIs.

When this is not possible, higher tax rates on higher income individuals could become more justifiable.

Table 2 provides some estimates of the shares of taxable income received by the top 0.1%, 1% and 5% of taxpayers. These are different definitions of HNWIs. The table shows large differences among countries and especially the large shares of total income going to the HNWIs in the US, the UK and Argentina. It should be recalled that these estimates have been derived from tax data. They are likely to underestimate the true, economic incomes of these groups. For example, they do not include unrealized capital gains and non-reported incomes. For the US, recently released data from the Congressional Budget Office (October 2011) have reported shares of total income, for the top 1% of the population, that are significantly higher than those in the table and that exceed 20% of total income for 2007.

The data in Table 2 is mostly for developed countries. Data on income distribution, as measured by Gini coefficients, can also be helpful in assessing the importance of tax equity especially in developing counties where tax data are very deficient. They are shown, for different *regions*, in Table 3. Data for specific countries, both developing and developed, are easily available from several sources such as the World Bank, the US Central Intelligence Agency, and the United Nations.

Table 2: Comparative top income shares (2005)

Country	Top 0.1%	Top 1%	Next 4%	Top 5%
Argentina	7.02	16.75	–	–
Australia	2.68	8.79	11.2 (2002)	20.0
Canada	5.23	13.56	15.4 (2000)	29.0
China	1.20	5.87	11.9 (2003)	17.8
Finland	2.65	7.08	9.5 (2004)	16.1
France	2.48	8.73	13.0	21.7
Germany	4.40	11.10	13.1 (1998)	24.2
India	3.64	8.95	–	–
Ireland	–	10.30	–	–
Italy	2.55	9.03	12.3 (2004)	21.3
Japan	2.40	9.20	16.1	25.3
Netherlands	1.08	5.38	11.79 (1999)	17.08
New Zealand	2.51	8.76	12.7	21.5
Norway	5.59	11.82	11.3	23.1
Portugal	2.26	9.13	15.4 (2003)	24.5
Singapore	4.29	13.28	14.6	27.9
Spain	2.62	8.79	13.4	22.2
Sweden	1.91	6.28	11.1	17.4
Switzerland	2.67	7.76	11.5 (1955)	19.3
UK	5.19	14.26	14.5	28.7
US	7.70	17.42	15.2	32.6

Source: Adopted from tables in Atkinson et al. (2011).

Table 3: Gini indexes and poverty by region (Ginis for 2004; poverty for 2005)

Country	Ginis	Poverty *
Developed countries	32.2	n.a
Eastern Europe and Central Asia	33.6	12.9
South Asia	38.9	84.4
Middle East and North Africa	38.9	28.4
East Asia and Pacific	39.1	50.7
Sub-saharan Africa	44.7	80.5
Latin America and Caribbean	52.2	22.1

* Less than USD 2.5 dollars a day.

Source: Adapted from Lustig (2010); and Chen and Ravallion (2008).[10]

9. *See* http://www.bloomberg.com/news/2011-11-18/-willing-vassals-in-congress-do-lobbyist-bidding-jack-abramoff.html.

10. N. Lustig, *Latin America Social report Card: A Scorecard of Governments' Commitment to Social Equity* (2010): S. Chen & M. Ravallion, *The developing world is poorer than we thought, but no less successful in the fight against poverty* (2008), Policy Research Working Paper 4703 (World Bank).

The data in these two tables, together with data on world income inequality (available from the World Bank's World Development Index) that also provides shares of total income going to the lowest 20% of the population, indicate the clear need to pay attention to the taxation of HNWIs.

If the emphasis was not on income but on the net wealth of the top 1% of the population, that 1% would be seen in the US to appropriate 34.6% of the total, compared with only 15% of the total wealth owned by the bottom 80% of citizens. For financial wealth, the percentages are 42.7% of the total for the top 1% and 7% for the bottom 80%.[11] The share of total wealth held by the top 1% fell from 44.2% in 1929 to 19.9% in 1974. It increased sharply after the 1970s, and reached 38.5% in 1995 before falling a little to 34.6% in 2007. The data on wealth distribution indicate equally high degrees of unevenness for several other countries.

3. The Government's Role in Reducing Income Inequality

At least since the decade of the 1880s, when Adolph Wagner, a famous, German economist, advocated that governments should play a role in making the income distributions more even in countries with a market economy (a role that was different from the one advocated by socialist economists, who had no use for a market economy and no respect for property rights), citizens have expected their governments to ensure that the income distribution does not become excessively uneven and thus becoming the "most fatal ailment of ... republics", as Plutarch wrote 2,000 years ago.

Governments can play such a role by:

- improving the working of the market, because a well–working market economy is less likely to produce excessively uneven income distributions. Therefore, the government should go forcefully after all monopolies, all rents of particular categories of citizens, acts of corruption and other market failures or abuses. As argued earlier, the "institutional capital" that establishes itself in a country must not be allowed to create unusual advantages for particular groups. In such a country, there must be no role for "crony capitalism", "too big to fail" institutions, politically too powerful lobbies, and corrupt practices that allow some individuals to become rich at the expense of others;
- enhancing the productive capacity of poorer groups of citizens, with good basic education and training, necessary infrastructures, essential basic medical assistance, and, when possible and necessary, even with some distribution of assets. However, the government must make sure that the public programmes are not accompanied by inefficiency, corrupt practices, or even rents, on the part of the providers or the beneficiaries of these programmes. When inefficiency, rent seeking and corruption are allowed to prevail in public programmes, they provide a ready and convenient justification on the part of some observers to oppose any government role in income distribution. Obviously government programmes require resources that in most countries, must come mainly from taxes; and
- the intelligent use of the tax system. The system must:
  - generate enough revenue to allow governments to perform their essential roles at an adequate and efficient level;
  - have taxes that respect both horizontal and vertical equity. In other words, the taxes must be as horizontally neutral as possible, and as vertically progressive as is economically feasible, however with statutory tax rates that do not create significant disincentive effects; and
  - pay special attention to individuals with high net worth, to make sure that these individuals, who have more taxable capacity, contribute their fair share of tax revenue without being over-burdened with punitive tax rates or excessive compliance costs.

The balance between the need for revenue on one hand, and the danger of creating significant disincentive effects, or strong pressures on the taxpayers to look for escape clauses from the high taxes through tax evasion on the other, must receive careful and sustained attention. The issues in this section have received a lot of attention by tax experts over the years, so they will not be discussed further in this paper. Having argued in favour of the need to collect more taxes from HNWIs, the following section will focus on some of the difficulties in making them contribute adequately to tax revenue.

4. The Taxation of HNWIs

By definition, the HNWIs have more wealth, more income, better social connections, better tax advisers, better access to the "institutional capital" of countries, and increasingly, more activities that are global in scope. They operate in a more open world, a world where tax rates are high in some countries and low, or even zero, in others, in the so-called tax havens. This difference allows them to search for some tax arbitrage among countries.

Complexity in tax systems, lack of transparency or objectivity in accounting procedures, limited administrative capability and resources of tax administrations, corrupt tax administrators, and a culture that may tend to condone tax evasion in some countries are likely to facilitate for the HNWIs, the non-reporting to their tax authorities of some, or all of their incomes. Accounting tricks may also be used to report the incomes in countries in which tax rates are low, or to transform normal compensations for individuals into lower-taxed capital gains.[12]

For enterprises, the use of "transfer prices", the (arbitrary) valuation of the cost of borrowed capital, use of

11. W.G. Dumhoff, *Wealth, Income, and Power*, in *Who Rules America?* (University of Santa Cruz 2011).

12. For various examples of how HNWIs can evade taxes, *see* J.G. Gravelle, *Tax Havens: International Tax Avoidance and Evasion*, Congressional Research Service Report for Congress 7-5700. http://www.fas.org/sgp/crs/misc/R40623.pdf.

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loans channelled from tax havens, the manipulation of the cost of using patents, trademarks and copyrights, or even insurance costs for goods transported, can all provide possibilities of reducing, at times to zero, the taxes paid to specific countries on incomes earned.

Some direct "estimates" of the size of tax evasion *at the global level* are available. For example, Guttentag and Avi-Yonah,[13] have estimated that the revenue loss to the US, due to international tax evasion by HNWIs, is USD 50 billion, a figure that has been challenged by other tax experts. The Tax Justice Network (TJN) has estimated a worldwide revenue loss from international tax evasion of USD 255 billion for all countries for similar activities by individuals. While these estimates can be challenged, there is a lot of indirect evidence on international tax evasion. The direct estimates often are more "guesses" than genuine estimates because generally, something that cannot be fully observed or controlled cannot be properly measured.

The TJN, a think tank that aims to promote justice in taxation, has reported that the assets held offshore, "beyond the reach of effective taxation" are "about a third of total global assets". This is an enormous figure. For sure, there are a lot of assets held in offshore centres and in tax havens, as the statistics indicate. The TJN has estimated that:

> the amount of funds held offshore by individuals [in addition to those held by corporations] is about USD 11.5 trillion.

As a consequence of these large funds held offshore, large amounts of tax revenue are likely to be lost every year, by the countries where the owners of these funds have their legal residences. The beneficiaries from this tax evasion are mostly HNWIs. One should add the non-payment of taxes because of the funds held offshore and not distributed by corporations. Estimates made by Global Financial Integrity (GFI) of the global proceeds from criminal activities and major acts of corruption amount to USD 1-1.6 trillion per year. These also have tax implications. Alex Cobham, at St Anne's college at Oxford, has estimated that developing countries lose USD 385 billion annually in tax revenue mostly because of international tax evasion.

There is now vast literature that has described the way in which "tax planning", by both individuals and corporations, can lead to tax avoidance and tax evasion. It would require too much space to review this literature. The manipulation of input and output prices in the operation of enterprises, plays a significant role. For individuals, secrecy is especially significant. There are many jurisdictions that allow depositors banking and other kinds of secrecy, on grounds of respecting the privacy rights of individuals from aggressive governments. There is clearly some merit to this argument. However, it should not be used to prevent the fair taxation of HNWIs and corporations. It should be mentioned that some of these jurisdictions now have the highest per capita incomes in the world. This indicates that the provision of secrecy to foreign taxpayers can be a lucrative activity for tax havens. It is easy to appreciate their reluctance to exchange information with the countries in which the taxpayers reside.

As the TJN has stated, "secrecy comes in various different flavors" – e.g. banking secrecy, trusts, vehicles such as foundations and *Anstalt* (establishment), offshore companies and other corporate vehicles, the use of nominees, the refusal of jurisdictions to provide information, their refusal to collect relevant data, etc. A recent major study by the World Bank, *The Puppet Masters*, has studied the related problem of "how the corrupt use legal structures to hide stolen assets". This is another aspect with large revenue implications for particular countries.

Some data[14] is indicative of the scope of the problem as seen for example from the point of view of the US. The share of US company profits, relative to the GDP of the countries where the profits were reported, was 645.7% in Bermuda, 546.7% in the Cayman Islands, and similarly large shares in other small islands listed as tax havens. The shares were also fairly large in some countries not listed as tax havens. For example they were 18.2% of the GDP of Luxembourg, 9.8% of that of Cyprus, and 7.6% of the GDP of Ireland. As long as these profits are kept abroad, US tax laws do not tax them. It is obvious that large losses in tax revenue occur to the US because of these reallocations of profits.

A world in which the "world's tax base" (the potential taxable income of the whole world estimated on the basis of existing laws) is fractured into hundreds of jurisdictions, and in which the taxes on personal income are imposed nationally (generally following the residence-based principle), cannot lead to a fair outcome, unless, somehow, there is full transparency in the tax arrangements, full cooperation between jurisdictions in exchanging information, using the information efficiently, and helping one another prevent tax avoidance and tax evasion. Unfortunately, there is often neither transparency in the actions of taxpayers, nor full cooperation on the part of the jurisdictions. It is also an open question as to whether the information obtained is efficiently used.[15]

Tax planners, who are often well paid and clever individuals, are continually probing the defensive walls of tax systems and creating new schemes to facilitate tax avoidance, especially by HNWIs. Furthermore, the tax jurisdictions engage in tax competition to attract investments that might have gone to other countries, and profits earned in other countries that might have been reported elsewhere. By doing so, they derive some economic advantages. The incentives that are introduced by the competing countries tend to create frictions between the countries that lose tax revenue and those that benefit from the tax competition or the tax avoiding activities of the taxpayers. The "world's tax base" tends to become in part a "commons" that can be exploited by the less scrupulous jurisdictions. The ease with which income can now move across jurisdictions facilitates tax avoidance by clever, but less law-

13. J. Guttentag & R. Avi-Yonah, *Closing the International Tax Gap*, in *Addressing the Crisis in Federal Tax Administration* (M.B. Sawicky ed., 2005).
14. Id.
15. *See* Tanzi & Zee, *Tax Policy in Emerging Markets: Developing Countries*, LIII National Tax Journal 2 (2000).

abiding individuals, at times assisted by corrupt national tax administrators.

In past writings, I have argued that a World Tax Organization – an organization that would represent global interests (in the same way as the World Trade Organization does with trade issues), that would hopefully have the resources necessary, and that would focus exclusively on tax matters, exercising surveillance activities over the tax behaviour of individual countries – could help deal more effectively with some of the difficulties mentioned above.[16] Such an organization would obviously not collect taxes. Until the time when the need for such an organization is widely recognized and leads to its creation, countries must continue the fight against international tax evasion using the tools available. That fight is now assisted by offices within existing international organizations that have main mandates that do not directly relate to taxes, and by activities including those of the International Tax Dialogue, the TJN and other similar institutions.

It is important to stress that the fight against tax evasion must start at home, in the countries themselves. No outside help will ever be sufficient for dealing with the growing problem of domestic and global tax evasion. At the national level, the fight must start by making tax systems *more transparent and less complex* than they have become, because tax avoidance problems often begin at home, by exploiting existing complexity. Complexity has become a problem in the tax systems of most countries and has created growing possibilities for tax planning and tax evasion, both domestically or globally.[17]

It is distressing to read that there are today, reportedly more than 70,000 pages in laws and regulations, for the US income taxes. The situation in many other countries is not much better and complaints about tax complexity are common. This complexity is clearly affecting the cost of compliance and the equity of tax systems. For example, the US IRS has recently reported that the average tax rate on the incomes reported by the 400 individuals with the highest adjusted gross incomes fell from 30% in 1995 to 18% in 2008. Much of the fall was not due to statutory rate reduction but presumably to reclassification of income sources.

Transparency and genuine tax equity cannot be achieved when the conditions reported above prevail. Without more tax simplicity at the *national* level, the HNWIs will continue to have an easy time in reducing their tax liabilities, regardless of international actions. The pressures of lobbies and other special interests groups, and the desire on the part of policymakers to accommodate many perceived, personal or corporate special needs with special tax treatments, tax incentives, tax expenditures and so on, make the tax systems opaque, opening possibilities of reinterpretations of laws. Complexity ends up making the systems unfair both horizontally and vertically.

In several countries including the US, there has been continuous talk over the years about the need for tax simplification. However, the talk has not been followed by action, and complexity has continued to grow year after year, because complexity is a cumulative process. The result has been the erosion of taxable bases, for both personal and corporate income taxes and also other taxes. The differences between the economically defined tax bases and the bases that are actually taxed have become large, especially for the incomes of the HNWIs.

At the international level, the fight against tax evasion is being fought with:
– political pressures and threats on tax havens on the part of some powerful governments, such as those of the US and Germany;
– with bilateral agreements (tax treaties) on exchange of information, of which there are now more than 700; and
– with declarations for greater cooperation, made at G8, G20 and at other high-level, political meetings, e.g. the one issued at Cannes on 4 November 2011.

Tax treaties are expensive to negotiate, take a lot of time and effort, and often put officials from highly sophisticated countries who have the assistance of top tax experts, against much less sophisticated and poorly paid officials and experts from poorer countries. This leaves the impression that their results are not always fair, such that there is much skepticism about the usefulness of these treaties and whether they justify their cost.

In negotiating these treaties, the principles are similar to those that arise in bilateral trade negotiations. It would be better to develop a single standard, a template, one that would guide the behaviour of all countries, dispensing with the need for bilateral treaties. That standard should reflect the interests of all the countries and not mainly those of particular countries. A World Tax Organization, if it existed, might find it easier to promote such a single standard. The OECD and the Council of Europe have developed a Protocol for all countries to follow on transparency and exchange of information. However, the limited membership of these organizations is likely to reduce the impact or the acceptability of this Protocol.

Pressures on tax havens and other jurisdictions that make it easier for HNWIs to evade taxes, should be intensified. In recent years, these pressures seem to have generated some positive results. They have also elicited some promises at deeper collaboration. However, much more needs to be done. The results of some these attempts have been published in reports by the OECD and other groups.[18]

16. *See* V. Tanzi, *Taxation in an Integrating World* (Washington: The Brookings Institution 1995); V. Tanzi, *Does the World Need a World Tax Organization?*, in *The Economics of Globalization* (A. Razin & E. Sadka eds., Cambridge University Press 1999); and V. Tanzi, *Globalization, Tax Systems, and the Architecture of the Global Economic System*, in *Taxation and Latin American Integration* (V. Tanzi, A. Barreix & L. Villela eds., Harvard University 2008).
17. *See* V. Tanzi, *Complexity in Taxation: Origin and Consequences* (2010), Paper presented at a Conference at the Law School of Getulio Vargas Foundation, Sao Paulo, Brazil.
18. *See*, for example, OECD Tax Transparency 2011: Report on Progress, Paris.

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5. Concluding Comments

It is not easy to quantify the progress made so far in the areas discussed in this paper. While the attempts made and the official, but still too general, backing that international tax cooperation has received from countries' leaders who attend global meetings such as the G8 and G20 are helpful, it is difficult to ascertain whether tax evasion, an activity that increasingly involves cross-countries actions, is going up or down. The impression that one gets, and it is just an impression, is that tax evasion, often in the less clear form of tax avoidance, may still be going up. As long as tax levels, tax rates, tax structures and the incentives continue to diverge across countries (promoting and facilitating tax competition), the fair taxation of HNWIs and, more broadly, tax equity will remain as a distant and difficult-to-reach objective. Without equity, both market economies and democracies will face future dangers, by losing some of their legitimacy and attraction.

It must be repeated that, while the promotion of tax equity requires greater international cooperation, it also requires specific national actions by all countries, and especially by the larger ones. It may be naïve to expect that the solution to the difficulties discussed will come from outside. Ongoing economic developments in the world are not likely to make the promotion of the tax equity objective any less difficult with the passing of time.

Finally, it is important to stress that the use to which tax revenue is put is also of great importance in reducing the validity of arguments, made by some observers, that while high taxes always produce some disincentive effects and other costs, they rarely generate clearly identifiable benefits for citizens.

It needs to be reaffirmed that tax revenue, if it is used to support efficiently provided and clearly needed public services and if it is collected with reasonable rates and with equity, remains an important tool in the actions of governments. But, obviously, taxes can be not only too low but also too high.

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