Seeing Like A Taxman

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The world of international financial regulation and taxation is in turmoil. New initiatives from the United States, the OECD and the European Union seek to reign in tax avoidance and evasion through a wide array of measures. These include the US FATCA, the OECD's base erosion and profit shifting (BEPS) initiative, and EU tax harmonization measures. As Richard Gordon and I have argued elsewhere, these measures were generally adopted without regard to whether the benefits they might yield in revenue collection are worth the costs they impose.[1] Why then do they continue to appear?

One advantage academics have in such circumstances is to bring to bear ideas from outside a narrow field that can help make sense of events by providing a framework for analysis. Two books by James C. Scott, a political scientist and anthropologist at Yale, offer a perspective on anti-avoidance and anti-evasion measures that can suggest where things might be headed. In *Seeing Like a State: How Certain Schemes to Improve the Human Condition Have Failed* (Yale 1998), Scott drew on his work in Southeast Asia to analyze why many ambitious development projects failed. In *The Art of Not Being Governed: An Anarchist History of Upland Southeast Asia* (Yale 2009), he looked at the history of

upland people who avoided incorporation into pre-colonial and colonial states by running away. We can use Scott's analysis as an opportunity to rethink how governments are approaching tax avoidance and tax evasion. In doing so, I am stretching Scott's analysis well beyond where he deployed it. Nonetheless, the analogy between Southeast Asian societies and modern tax avoidance and evasion is a powerful one.

Scott offers four big ideas that shape his analytical framework. First, he argues that a fundamental need of a state is to make its population "legible." In essence, a legible population is one in which the relevant characteristics for state purposes are defined and known. Second, he contends that by doing so, the state changes the nature of the activities the population carries on, the culture, and the society as a whole. In other words, you get more of what you measure. Third, he attributes social engineering projects in part to what he terms "high modernist ideology," in which scientific and technical models are uncritically applied to societies, encouraging government actors to believe they can significantly change societies through administrative fiat. Fourth, when this ideology is married to a state with significant coercive power and civil society lacks the capacity to resist, the state does considerable harm by forcing an agenda on society without considering all the costs. Let's consider each.

Legibility

In Scott's survey of Southeast Asian societies, he examined governments' efforts to make things "legible" to the state, so that revenue could be collected based on what the state could find and count. Not surprisingly, both good and bad governments prefer things that are easier to count, since both benevolent and malevolent rulers need revenue. For precolonial Southeast Asian states, the people living in the hills were not legible, while wet rice growing valley people were. Governments thus sought to maximize the "state-accessible product" rather than the gross domestic product. As Scott notes in *The Art of Not Being Governed*:

> "State-accessible product and gross domestic product are not simply different; they are, in many respects, at odds with each other. Successful state-building is directed toward the maximization of the state-accessible product. It profits the ruler not at all if his nominal subjects flourish, say, by foraging, hunting, or shifting agriculture at too great a distance from the court. It similarly profits the ruler little if his subjects grow a diverse suite of crops of different maturation or crops that spoil quickly and are therefore hard to assess, collect, and store. Given a choice between patterns of subsistence that are relatively unfavorable to the cultivator but which yield a greater return in manpower or grain to the state and those patterns that benefit the cultivator but deprive the state, the ruler will choose the former every time. The ruler, then, maximizes the state-accessible product, if necessary, at the expense of the overall wealth of the realm and its subjects." (pp. 73–74)

We can see this in the reaction to tax avoidance (as distinguished from tax evasion). For example, the discussions of Starbucks' and Amazon's tax avoidance measures that reduced their British taxes rarely mention the increase in consumer welfare these companies produced in the UK (as revealed by consumers' choice of their services and products over prior alternatives), focusing solely on the loss of tax revenue to the British government. It might be the case that paying more in UK tax would lead to productive investment of those revenues by the British authorities, but it might also be the case that the government would squander the additional revenue on waste and fraud or political patronage. It would take some analysis to demonstrate that one outcome was more likely than the other.

Changing Society

In *Seeing Like a State*, Scott uses the example of Prussian forests to explain how the criteria used to make something legible to the state changes reality. The Prussians focused on counting the revenue-producing trees (and even the parts of those trees that produced revenue). By requiring reports on those, and not on other trees (or parts), and rewarding forest managers who produced more of what was being counted (and so more revenue), Prussian forests went from diverse ecosystems to organized, regimented monocultures. A terrific result for the state treasury; not so wonderful for the environment. Scott also points to the impact of the French door and window tax (which was not abolished until 1917):

> "Its originator must have reasoned that the number of windows and doors in a dwelling was proportional to the dwelling's size. Thus a tax assessor need not enter the house or measure it but merely count the doors and windows. As a simple, workable formula, it was a brilliant stroke, but it was not without consequences. Peasant dwellings were subsequently designed or renovated with the formula in mind so as to have as few openings as possible. While the fiscal losses could be recouped by raising the tax per opening, the long-term effects on the health of the rural population lasted for more than a century." (pp. 47–48)

Again, a great result for the tax authorities (lower administration costs), but not so good for the health of the citizenry (who got less fresh air).

The same effect is at work today in creating the international business structures that so concern tax authorities. By counting income recognized by entities located in a jurisdiction, tax codes created incentives for attorneys and accountants to devise structures to relocate income to lower tax jurisdictions. U2 didn't put its song copyrights in the Netherlands because their accountant happened to be Dutch. The band put them there because global tax rules recognize income from intangible assets as accruing where the entity that owns them is resident. That intangible property flows to the Netherlands as a result should be no more surprising than that the Prussians ended up with monoculture forests made up of trees in perfect rows.

Unhappy with the effects of their earlier choices, tax authorities now are trying to rewrite the rulebook. But today's efforts to constrain tax avoidance are likely to have similarly unanticipated impacts just as yesterday's choices did – and those impacts need to be considered before massive, costly base erosion or beneficial ownership schemes are mandated. We've already seen increases in the number of US taxpayers giving up their US citizenship in response to FATCA's costs. The key is that what regulations count as important will be affected differently than what they ignore.

High Modernism

In *Seeing Like a State*, Scott defines "high modernism" as "a particularly sweeping vision of how the benefits of technical and scientific progress might be applied – usually through the state – in every field of human activity" (p. 90). This ideology is not limited to either the left or the right, but is present across the political spectrum.

> "Three countervailing ideas and institutions tempering high modernist schemes. The first is the existence and belief in a private sphere of activity in which the state and its agencies may not legitimately interfere. … the idea of the private realm has served to limit the ambitions of many high modernists, through either their own political values or their healthy respect for the political storm that such incursions would provoke." (p. 101)

The second is the "liberal political economy" which established the notion that "the economy was far too complex for it ever to be managed in detail by a hierarchical administration" (p. 102). Finally, the most important obstacle is "the existence of working, representative institutions through which a resistant society could make its influence known" (p. 102).

High modernism is at work in current efforts to combat tax avoidance by creating administratively determined prices to combat profit shifting and in the idea that an accurate, up-to-date beneficial ownership registry on a global scale could be created.

Coercive Power And Lack Of Capacity To Resist

When societies lack the capacity to resist high modernist programs, Scott suggests that the programs are more likely to cause unintended consequences. We can see the absence of those countervailing ideas and institutions in the current debate over financial regulation. Financial affairs are no longer the subject of legitimate expectations of privacy, at least in the eyes of the IRS, the UK Treasury, the OECD, and the various pro-tax campaigners like Christian Aid and the Tax Justice Network. Complexity no longer requires leaving things to the marketplace but instead more highly paid bureaucrats earning tax-free salaries at the OECD headquarters in Paris. And the clever shift of anti-avoidance campaigns from national governments to multinational institutions such as the OECD and the FATF moves the debate further from democratic debate and into the hands of high modernist experts.

Putting The Elements Together

Although Prof. Scott derived his analysis from pre-colonial states in Southeast Asia, his work offers some important insights for understanding the current debates over tax and financial regulation. First, it is critical to adopt the perspective of a state to understand how state actors behave. Much of the drive for additional anti-avoidance measures today is a quest for legibility of assets and actors by tax authorities. Beneficial ownership registries and base erosion/transfer pricing regimes are ultimately about making asset ownership transparent to regulators.

Moreover, we can see how we got to where we are by using Scott's analysis. As tax rates rose over time, the decision on how to measure business and personal income incentivized businesses and individuals to change their behavior to reduce their tax burden. Just as the hill people of Southeast Asia fled to non-state spaces to escape taxation and corvée labor, so companies and individuals took their assets to low tax jurisdictions. Just as those escaping the valley states adopted subsistence lifestyles built around hard-to-tax root crops, so firms shifted their assets into intangible forms that could be held in offshore entities.

Importantly, initiatives like the OECD's BEPS project and the massive fines imposed on banks around the globe will have their own effects on the regulated entities' behavior, just as the Prussian forest tax and French window and door tax shaped the development of Prussian forests and French houses. Some of those effects will be difficult to foresee, but some can be predicted. Multi-billion dollar fines on financial institutions will make those institutions much more careful about getting anywhere near the point at which they can be fined. Incentivizing them to avoid illegal behavior is a good thing, but the size of the fines is likely to make them less entrepreneurial and less likely to lend in developing countries where financial regulations are less developed. It will make them more likely to adopt costly and bureaucratic systems that document compliance efforts. As a result, we risk turning banking into a version of the US Transportation Security Administration – an expensive and inconvenient system with few benefits and many costs.

Avoiding the problems a high modernist approach brings to tax and financial regulation requires some humility and appreciation for the complexity of the world economy. Instead of attempting the impossible task of ensuring that no one anywhere ever pays less than the maximum tax or uses the global financial system for an illicit activity, regulators might use cost-benefit analysis to balance their proposals against the need for an efficient financial system that facilitates economic growth around the world. For example, before signing on to an initiative like the OECD's BEPS project, perhaps governments should ask whether there is evidence to suggest that the additional revenue collected will be worth the costs to governments and firms. Before starting down the road to a beneficial ownership registry, governments might make an effort to quantify the revenue such an effort will produce and compare it to the costs of the registry. Given the dismal record of predictions of additional revenue from prior efforts like the EU Savings Directive and other anti-avoidance measures, it would be reasonable to move ahead only if there is strong evidence of a net benefit.

ENDNOTES

1 Richard Gordon & Andrew Morriss, "Moving Money: International Financial Flows, Taxes, & Money Laundering," *Hastings International and Comparative Law Review* 37(1), Winter 2014 (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2348144).