

Tax avoidance/evasion and rational expectations

In general, individuals and companies desiring to avoid/evade taxes have created an extremely lucrative business area for global banks – and not only those based in Switzerland, which have become notorious for their “secret” numbered bank accounts. In the last week’s article, I had referred to the corporate mergers and acquisitions which had no economic justification other than saving on taxes. Initiating such ideas with corporate managements and helping in their execution has proved to be an extremely lucrative business for global banks. So has the business of helping non-corporate individual clients to evade taxes: a few years back, Swiss banks alone paid \$ 5.5 bn in fines to the US government for helping US clients to evade taxes.

In the last article I had also referred to the existence of a General Anti-Abuse Rule (GAAR) in the UK tax regulations which considers arrangements aimed only to avoid/reduce taxes as an abuse of the laws and regulations and considers it tantamount to evasion. Interestingly, many of the tax havens are British off-shore territories. To give one example, the Panama Papers referred to something like 214,000 companies, half of which are domiciled in the British Virgin Islands – BVI itself has something like half a million companies registered there. The true ownership is generally hidden through nominee directors, who get fees for their services. In short, there are a number of middlemen feeding on the gravy train: lawyers, chartered accountants, nominee directors, other professionals, and, of course, banks.

In the popular mind, it is the Swiss banking system most closely identified with banking secrecy, money laundering and helping clients evade taxes. (To be sure, even banks like HSBC which, at one time, advertised itself as the “world’s local bank”, has a Swiss subsidiary in which many Indians were having accounts.) One reason is the very strict Swiss banking laws which prohibited details of any bank account in Switzerland being disclosed. Interestingly, the basic rationale for the law was laudable, when it was passed in 1934. At that time, the Nazis had come into power in next door Germany and were persecuting Jews and confiscating their businesses. The Jewish population of Germany found it easy to cross the porous border into Switzerland and deposit their money in Swiss bank accounts – banking secrecy laws were passed to protect the anonymity of such account holders. Later of course it became very useful for citizens/residents all over the globe to hide their wealth from their tax authorities.

Such services were not only lucrative by themselves but benefited Swiss banks in another way also: at least at one time, Swiss laws allowed deposits unclaimed for 'x' years to be transferred to the bank's profit and loss accounts. By their very nature and purpose, most account holders kept the details with themselves. Once the original depositor expired, in too many cases, nobody even in his family knew about the account, let alone the details. Surely, the amount of unclaimed deposits would have been large and so would the credits to the profit and loss accounts of banks. To be sure, in recent years, Switzerland has moved away from its traditional culture of bank account secrecy – and the authorities and the banks are co-operating with other countries to a much greater extent than was the case earlier.

The whole issue of tax evasion, particularly by individuals, leads to a more fundamental question: what does it say about the assumption of rational expectations on the part of all economic agents and the law of diminishing marginal utility, on which are based most of the mathematical models used in economics? (One example: the Dynamic Stochastic General Equilibrium (DSGE) model used by central banks to frame monetary policies is based on rational expectations of economic agents.) One of the corollaries of the assumption of diminishing marginal utility is that when supply of a commodity goes up, its price/value falls; conversely, rising prices reduce demand.

This is broadly correct when the commodity is a consumable. But is it equally true in the asset market? The rising price of a share (or currency) often attracts more buyers. Tax evasion is a game which only the wealthy play: surely for them the marginal utility of the money saved through such activities is practically zero. Why do they still indulge in quasi-criminal activities – even at a time when tax rates in most countries have come down significantly from their levels 50 years back, even in socialist India?

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