Clamping down on Google's tax avoidance: don't hold your breath

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Outrage over tax avoidance has bubbled up this week with the visit of Google's executive chairman Eric Schmidt, who is speaking at the LSE today. The crucial agreement that has brought criticism of Google is that the sale of a product over the internet is treated just like the sale of its physical equivalent, and therefore taxed in the country where the company is domiciled. ***Martin Hearson*** *argues that the system as it stands now suits countries like the US and UK, which are home to large multinationals that sell services abroad without needing a big physical presence. This is why the UK opposed the proposed changes at a meeting debating international tax rules last year.*

Google's executive chairman Eric Schmidt will stand up to give a talk at the LSE this evening after a week of unprecedented criticism of the search giant. I wonder if he still feels the same way today as he did last October, when he told journalists:

> *"I am very proud of the [tax] structure that we set up. We did it based on the incentives that the governments offered us to operate…It's called capitalism. We are proudly capitalistic. I'm not confused about this."*

Doing no evil: Eric Schmidt
(Credit: Guillaume Paumier, CC-BY.)

Last Thursday Matt Brittin, the company's vice president, was told "I think you do evil" by the chair of parliament's Public Accounts Committee when he made a second appearance to defend what he had openly admitted were the company's tax avoidance activities.

Coverage of a pre-G8 summit meeting for business leaders at 10 Downing Street on Monday, attended by Schmidt, focused on the tax avoidance questions, and whether the company's tax practices had been discussed. David Cameron and Nick Clegg did indeed claim to have challenged Schmidt for his aggressive tax position. Just yesterday, Ed Miliband took the fight to the belly of the beast, throwing the company's own words back at it. He said:

> *"I can't be the only person here who feels disappointed that such a great company as Google, with such great founding principles, will be reduced to arguing that when it employs thousands of people in Britain, makes billions of pounds of revenue in Britain, it's fair that it should pay just a fraction of one per cent of that in tax."*

The political consensus appears to be that the international tax system is broken and needs to be fixed by governments – to change those incentives identified by Schmidt – but also that, in Miliband's words, responsible companies should "*do more than obey the letter of the law."*

Here's the problem with this analysis: the reason that Google (and Amazon, Apple and Starbucks for that matter) pay so little tax in the UK is not simply a matter of exploiting weaknesses in the system. It's also because that's how the system is designed. We've built a set of global rules that define a company's tax liability not by how much stuff it sells in Britain, but by where it locates the business functions that add most value to the things it sells.

And the reason we did this is because we thought it suited us. On the global stage, Britain is a reasonably sized, but not huge, consumer market. But British businesses have a lot of customers overseas. So we figured that we would be better off with a system that's biased towards – in the language of international tax – a multinational company's place of residence, rather than the source of its revenue. It's that bias that allows US companies to sell billions in Britain while incurring a relatively small tax liability here – a liability that they can reduce further through tax avoidance.

What our political leaders rarely mention is that the difficulties that e-commerce would create for our tax system were foreseen as early as 1997, and supposedly resolved as early as 2001 (pdf). The crucial agreement here was that the sale of a product over the internet would be treated just like the sale of its physical equivalent. If I stand on the other side of the UK-French border, stretch my arms across it and sell you a book, I'm running a business in France and my profits are taxed in France, even though you, my customer, are in the UK. The same would be true no matter how many books I sold. Under the rules agreed in 2001, exactly the same rule applies if I sit in an office in Luxembourg and transfer a book to your Amazon Kindle, no matter how far away I am.

At a meeting debating international tax rules last year, the UK and US opposed efforts by India and other developing countries to change precisely this kind of rule. They wanted to be able to tax the profits of foreign companies that sell services into their huge and growing markets without needing a physical presence. The UK said no, outright, because it would be a "fundamental change in the balance of source and residence taxation." The OECD, which is in charge of the current review of international tax rules, says it isn't aiming to change this balance.

The system as it stands suits countries like the US and UK, which are home to large multinationals that sell services abroad without needing a big physical presence. Many companies selling services into developing countries are either British or providing the services from Britain, and our government doesn't want to surrender the right to tax these companies. A side-effect of this decision is that it also means getting less tax from the foreign companies with the biggest consumer presence and visibility here.

David Cameron says he's going to sort the system out, and no doubt there will be some changes that tighten up some of the areas most exploited for tax avoidance. But untangling the costs and benefits of international tax reform is complex, and it's unlikely that the outcome will put an end to all of the counterintuitive tax results.

Note: This article gives the views of the author, and not the position of the British Politics and Policy blog, nor of the London School of Economics. Please read our comments policy before posting.

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