

WHO SHOULD DECIDE WHETHER THE APPLE IS ROTTEN? TAX DISCLOSURE AND CORPORATE POLITICAL AGENCY

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Abstract

Enron-type corporate financial accounting scandals in the beginning of the millennium have given rise to a renewed interest in corporate tax disclosure. Anecdotal evidence suggesting a connection between corporate fraud and aggressive tax planning has motivated academics and policymakers to reconsider tax disclosure as a way to monitor corporate governance and limit tax avoidance. This article offers a different perspective on tax disclosure, tying it to the broader question of how policymakers should monitor the political impact of corporate business activities.

The article claims that policymakers should view corporations' tax planning strategies as part of a broader corporate political impact on social issues. This impact results from the genuine difficulty of bifurcating corporate business decisions from their political ones. This difficulty is a result of many judgment calls required in such decisions, which relate to individuals' moral and political preferences. Tax planning is one of these mixed business-political decisions, and the article advances the notion that policymakers should analyze tax planning not only as a law enforcement issue, but also through corporate governance lenses. To establish this inquiry, the article explains why the investor-shareholder relationship gives rise to political agency problems, which neither traditional nor critical corporate law literatures recognize. It then demonstrates how the costs associated with this type of agency relationship could be reduced via disclosure of information about the impact of corporate activities on issues of political concern. The article uses insights from financial markets theory to explain how disclosure of non-financial information would help to better align corporate actions with the political preferences of shareholders, despite shareholder rational passivity and apathy. It is then illustrated, through the Apple case, how policymakers can use the theoretical conclusions reached through this analysis to formulate a real world policy proposal with respect to corporation tax planning. Through its use of a wide range of interdisciplinary resources, this article aims to reformulate the multi-layered inquiry over the benefits and costs associated with corporate tax disclosure.

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“Apple carefully manages its foreign cash holdings to support its overseas operations in the best interests of its shareholders . . . Apple serves its shareholders by keeping these funds overseas”

(Apple’s Senate submission)¹

“There’s something fundamentally wrong when the wealthiest company in America pays 12.6% in taxes, while [many small businesses]. . . pay a rate nearly three times higher. And it’s not just savvy accounting or a strategic maneuver—Apple’s tax avoidance has a profoundly damaging effect on our whole country”

(Letter from a disgruntled shareholder)²

I. INTRODUCTION

A corporation’s value to society can be judged not only by what it gives, but also by what it chooses to withhold. Nowhere is this more evident than corporate tax policies.³ This article advances this observation by focusing on the idea of greater corporate tax disclosure. It ties together two, seemingly distinct, topics that have attracted considerable academic interest in recent years: public finance interest on the impact of mandatory tax disclosure on tax evasion and avoidance activities,⁴ and business-science interest on the costs and opportunities of corporate social responsibility (CSR).⁵

The article argues that behind the somewhat instrumentalist view of public finance lies an underlying and profound notion about the role of corporate power in society. Therefore, tax policymakers should consider the potential impact and structure of a future tax disclosure regime as part of a broader goal—promoting accountable corporate conduct. The need to promote this accountability arises in business decisions, like tax planning, which reflect certain inherently moral and political preferences about what is a legitimate way to pursue profits.

While the need to limit corporations’ political impact on the electoral process has attracted considerable (tax⁶ and non-tax⁷) academic attention, the actions of corporations

¹ TESTIMONY OF APPLE INC., *Offshore Profit Shifting and the U.S. Tax Code—Part 2 (Apple Inc.): Hearing Before the Permanent Subcomm. On Investigations of the Comm. On Homeland Sec. and Governmental Affairs*, 113th Cong. 2 (written testimony of Timothy Cook, Chief Exec. Officer, Apple Inc.), available at <http://www.hsgac.senate.gov/download/?id=e0a00aaa-f4a1-4fa0-b5b2-563b86a7588a> [hereinafter “Apple’s Testimony”].

² Brian Levin, Op-Ed, *Letter to Apple CEO Tim Cook from a Disgruntled Shareholder*, HUFFINGTON POST, May 21, 2013, available at http://www.huffingtonpost.com/brian-levin/letter-to-apples-tim-cook_b_3311215.html.

³ Mihir A. Desai & Dhammika Dharmapala, *CSR and Taxation: The Missing Link*, LEADING PERSPECTIVES, Winter 2006, at 4 (noting that taxes are the most visible and straightforward contribution that corporations make to non-shareholders and non-employees).

⁴ See discussion *infra* Part III.B.

⁵ See discussion *infra* Part I.

⁶ I.R.C. § 501(c)(3) denies the tax exemption for NPOs; I.R.C. § 501(c)(4) denies charitable relief from contributions made to tax-exempt social welfare organizations that are allowed to lobby. See also Steffen N. Johnson, *Of Politics and Pulpits: A First Amendment Analysis of IRS Restrictions on the Political Activities of Religious Organizations*, 42 B.C. L. REV. 875, 878–80 (2001); Meghan J. Ryan, *Can the IRS Silence Religious Organizations?*, 40 IND. L. REV. 73, 79–80 (2007); Allan J. Samansky, *Tax Consequences When Churches Participate in Political Campaigns*, 5 GEO. J.L. & PUB. POL’Y 145, 156–59 (2007).

⁷ The Supreme Court’s decision in *Citizens United* placed the controversy over the political identity of corporations at the center of the debate about the role of corporate money in democratic elections. See

inevitably have a substantial *political impact* on a wide range of issues, which may not be directly related to elections. There is no one “right” way for doing business, and the decision to pursue one avenue over another cannot be separated from moral, ideological, and political preferences.⁸ Hence, since corporations play an important role in the modern economy, the notion that they do not or should not have a political impact is utterly unrealistic.

Tim Cook’s well-publicized Senate testimony about Apple’s tax planning strategies offers a good example of this difficulty. In reply to questions about parking billions of dollars in subsidiaries not subject to tax in any country, Cook asserted that Apple is an American company of strong values that believes that “to whom much is given much is required.” Apple also claimed that its tax planning was done on behalf of its shareholders—thus failing to recognize the potential variation in its shareholders’ political views about the legitimacy of its somewhat controversial profit-maximizing strategy.

This article tackles this topic head on, aiming to define what comprises *corporate political agency* in modern markets. It uses the example of tax disclosure to meaningfully discuss how problems associated with corporate political agency should be regulated. It explores an aggressive yet perfectly legal tax planning structure employed by Apple, which allowed the company to report and retain its foreign earnings in a tax-free Bermuda subsidiary. It argues that the decision of what comprises legitimate tax planning is, at the end of the day, a matter of moral and political preferences. The fact that it has financial significance should not cloud its political impact or the obligation of Apple, as an agent, to adequately convey this political impact to its principals.

The article’s analysis connects CSR, corporate tax planning and corporate tax disclosure by engaging in an interdisciplinary inquiry that touches upon public finance and business science literatures as well as political philosophy, corporate law, and critical legal theory. The core of the argument is that recent changes in investment patterns—namely the emergence of portfolio investment patterns and the growing importance of institutional investors—have resulted in political agency problems. In conducting ordinary business activities, corporations are required to make judgment calls about issues that are inevitably political, such as what comprises legitimate tax planning. Yet, because of common action problems associated with modern investment patterns, most of the political dimensions of corporate business decisions cannot adequately reflect the preferences of their principals.

The article seeks to make the following contributions. First, it argues that the relevant inquiry is not whether socially responsible corporations should engage in specific tax-planning strategies. Instead, the relevant question is how corporations can best fulfill their political agency when making ordinary business decisions (such as tax planning) that have political implications. In other words, responsible corporations are those that adequately reflect the political preferences of their shareholders. CSR should therefore be understood as an internal standard reflective of shareholders’ aggregated

Citizens United v. FEC, 558 U.S. 310 (2010); Francis Bingham, *Show Me the Money: Public Access and Accountability After Citizens United*, 52 B.C. L. REV. 1027 (2011) (noting that it has been called both a broadside assault on democracy and a victory for free speech and that these extreme reactions suggest the importance of the case); Richard A. Epstein, *Citizens United V. FEC: The Constitutional Right That Big Corporations Should Have but Do Not Want*, 34 HARV. J. L. & PUB. POL’Y 639 (2011).

⁸ The definition of the term “preferences” is beyond the scope of this analysis. This article uses it broadly to include both principles and conventions.

preferences rather than as an amorphous external standard of “social” conduct.

Second, this article argues that recent changes in investment patterns—namely the shift to non-control, intermediated, and retail-diversified portfolio investments—have resulted in political agency problems. Put differently, it argues that while the change in investment patterns has many positive outcomes (namely risk diversification), it also has negative externalities on the political process. These externalities are inconsistent with some basic notions of democratic participation and decision-making.

Third, the article suggests that the negative externalities caused by the change in investment patterns can be corrected by disclosure. The efficient market hypothesis, which justifies financial disclosure, explains why non-financial disclosure would have a significant real world impact on corporations. With respect to financial disclosure, the efficient market hypothesis contends that policymakers should not be concerned with retail investors’ lack of financial literacy. Professional investors, who analyze the disclosed information, are marginal buyers and sellers who correct for mispricing. This is also true with non-financial disclosure. While retail investors are unlikely to change their behavior with more information, sophisticated players (e.g., media organizations, competitors, and NGOs) would. Thus, *even though the shareholders’ apathy results in problematic corporate-political accountability, the remedy should not necessarily aim to increase individual shareholders’ involvement or activism.* In fact, much of the answer to what comprises legitimate corporate conduct will come as a result of the actions taken by well-informed “professional” parties. Hence, *just as in the case of financial disclosure*, the success of a non-financial disclosure regime does not depend on whether it actually changes the *behavior of individual investors, but on how it affects the overall (not necessarily investment) behavior of professional players.* To the extent that corporate conduct on certain issues seems unjustified, non-financial disclosure would generate socio-political reactions, and these costs may alter the corporate cost-benefit equilibrium on this issue.

The article then explains how its new formulation of CSR interacts with the public finance scholarship on tax disclosure. The notion of tax planning is ideal because it reflects corporations’ obligation toward society. Because tax planning is legal, traditional corporate law scholarship suggests that managers have an obligation to undertake legal (yet aggressive) tax minimization strategies to maximize shareholders’ returns. However, many corporations refrain from aggressive measures in avoiding taxes, which is antithetical to what they are “rationally” expected to do to maximize the financial return on their shareholders’ investment. The article addresses this issue by relying on the public finance literature dealing with the impact of disclosing corporate tax returns.

Part I provides an overview of the CSR literature. Part II explains the concept of corporate political agency, the negative externalities of portfolio investments on democratic participation, and why disclosure may help solve some of these problems. It then assesses the strengths and weaknesses of using disclosure to address corporate political agency problems. Part III explains how disclosure could be implemented with respect to corporate tax planning strategies, analyzing how such a disclosure regime would help determine whether specific tax planning strategies, such as Apple’s non-country tax resident subsidiaries, are legitimate tax planning avenues.

II. CORPORATE SOCIAL RESPONSIBILITY IN CONTEXT

The article argues that policymakers should view tax disclosure as a corporate

governance issue that relates to the broader questions of CSR, and not only as a mechanism for promoting tax compliance. This Part provides a synoptic review of the relevant CSR literature. Part I.A gives the background of CSR and the recent academic interest in it. The analysis of Part I.B extracts three core truisms from the CSR agenda: the notion that corporate officers should take into account the externalities of corporate activities; the notion of welfare (not wealth) maximization; and the idea that there is a change in the nature of agency costs associated with the growth of portfolio investments.⁹

A. Corporate Social Responsibility in Context

The traditional corporate law model views corporate managers and employees as agents invested with the fiduciary duty of maximizing the wealth of their principals (that is, their shareholders).¹⁰ This model argues that corporations are more easily monitored when corporate managers have a single class of principals (that is, shareholders entitled to residual benefits) and a single goal (wealth maximization).¹¹ The resulting benefit of this simplified monitoring is a reduction in agency costs, which, in turn, increases the value of the corporate venture.¹²

The CSR movement objects to this traditional view, arguing that it fails to promote an optimal corporate regime.¹³ Theorists, such as Einer Elhauge and Cynthia Williams, stress that shareholder wealth maximization should not be the only principle that governs corporate law. Instead, corporate law should allow managers to undertake activities that do not necessarily increase shareholders' wealth, and also to be held

⁹ See *infra* notes 84–85 and accompanying text.

¹⁰ This principal-agent model, with its sole wealth maximization objective, has been the core of Anglo-American corporate law for centuries and is widely supported by the majority of corporate law scholars, including Frank Easterbrook, Richard Posner, Daniel Fischel, Henry Hansmann, Jonathan Macey and Roberta Romano. See Richard A. Posner, *Economic Analysis of Law* 453–54 (2007); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001); Virginia Harper Ho, "Enlightened Shareholder Value": *Corporate Governance Beyond the Shareholder–Stakeholder Divide*, 36 IOWA J. CORP. L. 59, 71–77 (2010); Cynthia A. Williams, *Corporate Social Responsibility in an Era of Economic Globalization*, 35 U.C. DAVIS L. REV. 705, 711–18 (2002); Milton Friedman, *The Social Responsibility of Business is to Increase Its Profits*, N.Y. TIMES MAGAZINE, Sept. 13, 1970, at 32. The notion that wealth maximization is the dominant view is undisputed, even by its critics. See Margaret M. Blair & Lynn A. Stout, *Specific Investment and Corporate Law*, in CORPORATE SOCIAL RESPONSIBILITY AND CORPORATE GOVERNANCE 99, 101. (2011). See also Miriam A. Cherry & Judd F. Sneirson, *Beyond Profit: Rethinking Corporate Social Responsibility and Greenwashing After the BP Oil Disaster*, 85 TUL. L. REV. 983 (2011).

¹¹ Einer Elhauge, *Sacrificing Corporate Profits in the Public Interest*, 80 N.Y.U.L. REV. 733, 736 (2005) (describing this argument). For one of the most canonic expression for this "traditional" view of corporate law, see FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 37–39 (1991).

¹² Accordingly, corporate law should require managers only to increase shareholders' wealth. Other goals, which may concern the welfare of other parties affected by corporate activity, should therefore be promoted or protected through other means. EASTERBROOK & FISCHEL, *supra* note 11; David G. Yosifon, *The Public Choice Problem in Corporate Law: Corporate Social Responsibility After Citizens United*, 89 N.C.L. REV. 1197, 1200–01 (2011); Ian B. Lee, *Efficiency and Ethics in the Debate About Shareholder Primacy*, 31 DEL. J. CORP. L. 533, 538 (2006). The core assumption is that a bigger pie could serve everybody better. For example, voluntary creditors (e.g., debtors and employees) would be compensated by higher returns on their investment. By the same token, the state would be better off if it took the position of involuntary creditors (e.g., individuals negatively affected by corporate externalities) by regulating these externalities directly or indirectly (e.g., via tort litigation). Goals other than wealth maximization are best promoted through the political arena.

¹³ Andere Crane et al., *Introduction*, in THE OXFORD HANDBOOK OF CORPORATE SOCIAL RESPONSIBILITY 363, 377 (Andere Crane et al. eds., 2008) [hereinafter OXFORD HANDBOOK].

publicly accountable for certain efforts (even if legal) to increase corporate profitability.¹⁴

Despite its intuitive appeal, the CSR agenda raises serious problems that are difficult to reconcile.¹⁵ The most fundamental concern is that it remains unclear how CSR theory, given its public good characteristics, can have any significant effect on corporate behavior.

It can be disputed whether the traditional argument against CSR initiatives, which stresses that these initiatives tend to be managerial pet projects that significantly increase agency costs, is indeed correct.¹⁶ However, it is unquestionable that CSR objectives—e.g., environmental protection, education, and equality—are public goods. In a price-sensitive, competitive market, private actors generally do not supply public goods voluntarily; managers who choose to do so in place of tangible financial benefits would be driven out of the market.¹⁷ Rather, in profit-oriented product markets, financial markets, and managerial markets, decisions are made in response to competitive pressures. These pressures should render the legal articulation of managerial fiduciary duties insignificant, thereby nullifying much of the CSR critique against traditional corporate law.¹⁸

B. The Three Undisputable Cornerstones of the CSR Critique

I begin from a conservative, non-controversial starting point from which I will develop my arguments with respect to CSR. Throughout this analysis I *assume that traditional corporate law theorists are correct* in arguing that corporate managers should be seen only as agents of their shareholders, and not as agents of a more diversified group of stakeholders.¹⁹ Accepting this assumption is not of descriptive or normative value—it *does not suggest that strong-form shareholder centrism is the established law or the desired corporate law framework*. Instead, this assumption is of instrumental value, showing that the Article's analysis, which leads to a very different conclusion from law and economic analysis of corporate law, can align even with this "traditional" framework of corporate law theory.

It is important to stress that traditional corporate law scholars do not claim that wealth maximization is a goal in itself, but merely that it is an efficient means for promoting overall welfare. This article does not deny that wealth is often a proxy for welfare, or that there can be a socially productive division of labor—one that would encourage corporations to focus primarily on their profits and allow other objectives to be pursued elsewhere. However, based on the CSR critique, this article's analysis makes three central observations explaining why wealth maximization often falls short of

¹⁴ See generally Elhauge, *supra* note 11, at 733 (providing a comprehensive review of the various justifications to allow corporate managers to deviate from the wealth maximization principle).

¹⁵ J. Van Oosterhout & P.P.M.A.R. Heugens, *Much Ado About Nothing: A Conceptual Critique of Corporate Social Responsibility*, in OXFORD HANDBOOK 197, 198; Evaristus Oshionebo, *The U.N. Global Compact and Accountability of Transnational Corporations: Separating Myth from Realities*, 19 FLA. J. INT'L L. 1, 22–25 (2007) (noting that the global compact—the leading UN document providing guidelines for MNEs—is intentionally vague).

¹⁶ Lee, *supra* note 12, at 551 (arguing that stakeholder and team-production theories do not specifically address the problem of enhanced agency costs).

¹⁷ DAVID VOGEL, *THE MARKET FOR VIRTUE* 71–72 (2005); Peter Utting, *The Struggle for Corporate Accountability*, 39 DEV. & CHANGE 959, 969 (2008) (reaching the conclusion that voluntary action is not enough).

¹⁸ D. Gordon Smith, *The Dystopian Potential of Corporate Law*, 57 EMORY L.J. 985, 989 (2008).

¹⁹ EASTERBROOK & FISCHER, *supra* note 11, at 90; Ian B. Lee, *Corporate Law, Profit Maximization, and The "Responsible" Shareholder*, 10 STAN. J.L. BUS. & FIN. 31, 38 (2005).

providing an adequate proxy for welfare.

First, to help corporations generate value, a legal regime should force corporations to internalize the various externalities associated with their operation.²⁰ The problem of holding private parties accountable for the externalities of their actions is not unique to corporations and decision-making by their managers. However, in the case of large corporations, the issue of externalities is more significant due to the entities' dominant economic position and the large breadth and scale of their activities.²¹ Additionally, some of the mechanisms that would typically restrain parties from generating negative externalities on their surroundings do not exist in the context of multinational enterprises (or MNEs). The potential separation of corporate decision-makers from shareholders makes the corporate structure more susceptible to externalizing its costs to those who are not directly accounted for in its financial calculus.²² For example, shareholders who would tend to feel socially restrained from imposing certain negative externalities may not feel these pressures (and actually may not be even aware of them) when the same externalities are imposed by the conduct of their corporate agents.²³

Furthermore, the shareholder wealth maximization principle assumes that governments are the most efficient bodies to manage the incentives of actors whose activities impose externalities.²⁴ This assumption may be somewhat weakened by the complexity of the issues at stake, the relative weakness of certain governments, the information-asymmetry problems of government officials with respect to the wide range of implications that different forms of corporate conduct generate, and the time and transaction costs associated with the enactment of government regulations.²⁵

Second, corporate managers, as shareholders' agents, should aim to maximize their *welfare*²⁶ rather than their *wealth*. The wealth maximization principle wrongly assumes an artificial separation between individuals' goals in their capacity as investors—maximizing the returns for their investments—and goals they have in other capacities. Individuals have a range of preferences, including commitments to a wide range of political and ethical issues that are not self-serving; naturally, these preferences

²⁰ BENJAMIN J. RICHARDSON, SOCIALLY RESPONSIBLE INVESTMENT LAW REGULATING THE UNSEEN POLLUTERS 514 (2008) (arguing that the only permissible financial returns should be those achieved while accounting for public costs to the environment and social welfare); R. Edward Freeman et al., *Stakeholder Theory and the Basis for Capitalism*, in CORPORATE SOCIAL RESPONSIBILITY AND CORPORATE GOVERNANCE 52, 67 (2011); Andrew Johnston, *Facing up to Social Cost: The Real Meaning of Corporate Social Responsibility*, 20 GRIFFITH L. REV. 221, 221 (2011) (noting that CSR should not include managers' attempts to increase value for shareholders via green-marketing strategies).

²¹ Yosifon, *supra* note 12, at 1204 (arguing that large corporations have an advantage in promoting their interests in the political arena).

²² Kent Greenfield & D. Gordon Smith, *Saving the World with Corporate Law*, 57 EMORY L.J. 947, 959 (2008).

²³ Elhauge, *supra* note 11, at 756.

²⁴ GEOFFREY HEAL, WHEN PRINCIPLES PAY, CORPORATE SOCIAL RESPONSIBILITY AND THE BOTTOM LINE 9–10 (2008).

²⁵ Lorenzo Sacconi, *Introduction*, in CORPORATE SOCIAL RESPONSIBILITY AND CORPORATE GOVERNANCE, at xv (noting that a Causian account of the CSR issue is that, in the real world, both government and corporate governance suffer from transaction costs); Elhauge, *supra* note 11, at 802.

²⁶ The concept of welfare is amorphous and tricky. This article addresses it in a broad sense to include any type of fulfillment of society's preferences, principles, and conceptions of not necessarily selfish ways to promote the public good. Under this definition, if altruistic preferences are met, then welfare would increase even when society bears a cost.

also relate to business and investment decisions.²⁷ The act of investment does not transform those preferences into one-dimensional decisions that are focused exclusively on wealth maximization.²⁸

Traditional corporate law scholars would argue that the heterogeneity of shareholder preferences requires managers to focus only on the common denominator—the interest in increasing the (risk-adjusted) return on their investments. Nevertheless, even these scholars would concede that most shareholders would refrain from investing in certain highly contested issues (e.g., privately supplied military services,²⁹ legal prostitution, extreme pornography, etc.).³⁰ In these cases, it is clear that *the division of labor, which assumes that allowing corporations to focus only on maximizing their profits will increase shareholders' welfare, breaks down*. Even if such corporate conduct increases shareholders' material wealth, it would undermine the non-wealth related values and preferences that many shareholders have, and may ultimately reduce their overall welfare.³¹ Hence, especially with respect to the extreme issues mentioned above, managers' commitment to maximizing shareholders' *wealth* can lead to a non-*welfare* maximizing course of action.³²

The third and most crucial point that should be extracted from the CSR agenda is the changing nature of corporations due to a massive shift towards non-controlling share ownership. Corporate law is concerned with enabling an institutional framework that can productively use different types of inputs from various contributors.³³ Most importantly, it helps establish a reliable agency relationship that allows contributors of capital to supervise how others manage the business they own.³⁴

During the course of the twentieth century, corporate law regimes and capital markets evolved significantly, changing the patterns of investment. As part of these changes, there has been a decline in the volume of economic activity by family-owned corporations and a rise in MNEs that rely on regulated financial markets as their primary source of capital. On the investment level, there has been an increase in the amount of non-controlled (dispersed) ownership of corporate equity and portfolio investments, in which investors are rationally passive and concerned primarily with diversification to attain (average) market returns.³⁵ Additionally, there has been a radical increase in the amount of assets that are invested through institutional investors—namely pension funds

²⁷ Freeman et al., *supra* note 20, at 53–54.

²⁸ RICHARDSON, *supra* note 20, at 20–27 (providing evidence of shareholders' increased interest in financially insignificant political spending of corporations).

²⁹ PETER W. SINGER, CORPORATE WARRIORS: THE RISE OF THE PRIVATIZED MILITARY INDUSTRY 217–22 (2003) (discussing some of the moral problems associated with the services provided by corporations, such as executive outcome to governments of various developing countries).

³⁰ For further discussion of why individuals would care about these issues even if they do not invest or vote according to them, *see infra* note 73 and accompanying text.

³¹ Lee, *supra* note 19, at 48 (noting that the assumption that shareholders care about the ethical implications of their investment decisions would be idealistic but not unreasonable).

³² Elhauge, *supra* note 11, at 738–39.

³³ Greenfield & Smith, *supra* note 22, at 958.

³⁴ *See supra* note 19 and accompanying text.

³⁵ *See* ZVI BODIE ET AL., INVESTMENTS 378–79, 405 (2005) (describing the rationale behind passive portfolio investment strategies, in which small investors know that it is costly and unlikely that they can achieve higher-than-market returns and instead focus on diversification and indexing the market); Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811, 813 (1992); Michael J. Graetz & Itai Grinberg, *Taxing International Portfolio Income*, 56 TAX L. REV. 537, 542–46 (2003) (describing the growth in portfolio investment even in the international investment context).

managing the retirement savings of individuals in the developed world.³⁶ Like retail investors, institutional investors engage in non-control portfolio investment practices. These changes in investment patterns are all connected—they relate to the need for risk diversification and the difficulty for individual investors and investment managers in generating sufficient expertise in different economic fields.³⁷ The effect of these trends has been amplified by the liberalization of global markets and the risks and advantages associated with investing abroad in a growing but volatile global economy.³⁸

Although the shift to non-control forms of investment (hereinafter referred to as “portfolio investment/ors”) allows more risk-taking, and thereby stimulates economic growth, it has also materially changed the shareholder-manager relationship. Portfolio investor shareholders no longer have an effective way of actively influencing corporate behavior by voicing their concerns. They do, however, have an easy way to execute exit options. Hence, the transferability of shares and the liquidity of financial markets compensate for shareholders’ lack of control and allow them to maintain low agency costs by easily shifting out of investments.³⁹

This state of affairs has two important implications for the analysis. First, it increases the group of equity shareholders *to include almost everyone in society*, because institutional (namely pension fund) investors do much of the portfolio investment on behalf of a wide range of individual investors. This growth in the class of shareholders *blurs the classic distinction between shareholders and other parties associated with the corporate venture* (e.g., consumers).

Second, even though shareholders can elect the board of directors and management team, small retail investors are voiceless and do not have the means to affect corporate conduct.⁴⁰ This absence of a voice for portfolio investors in corporate control is particularly noticeable in the context of investments mediated by institutional investors, especially insurance companies and pension funds.⁴¹ These institutional investors are generally expected to maintain adequate levels of savings, so government regulation and market forces focus managerial incentives on maximizing profits.⁴² Thus, when investing through institutional investors, individual investors’ preferences on non-profit maximization issues remain unheard, even with respect to issues that they greatly care

³⁶ RICHARDSON, *supra* note 20, at 45–46; Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Market*, 95 VA. L. REV. 1025, 1025–27 (2009); Ho, *supra* note 10, at 64. See also Pension Markets in Focus, OECD (Sept. 2012), available at <http://www.oecd.org/daf/financialmarketsinsuranceandpensions/privatepensions/PensionMarketsInFocus2012.pdf> (illustrating the growing role of pension investments in developed economies).

³⁷ RICHARD A. BREALEY ET AL., *PRINCIPLES OF CORPORATE FINANCE* 160–70 (2006) (explaining the importance of risk diversification to increasing investors’ risk-adjusted values); RICHARDSON, *supra* note 20, at 47, 193 (noting that the growth of institutional investment has expanded financial markets and resulted in a parallel reduction of direct family ownership).

³⁸ RICHARDSON, *supra* note 20, at 49.

³⁹ Greenfield & Smith, *supra* note 22, at 954.

⁴⁰ Black, *supra* note 35, at 820–26; RICHARDSON, *supra* note 20, at 265.

⁴¹ Elhauge, *supra* note 11, at 817 (noting that individuals invested with institutional investors are likely to be even more insulated from social and moral sanctions).

⁴² RICHARDSON, *supra* note 20, at 233–34; Elhauge, *supra* note 11, at 733 (noting that managerial incentives toward excessive generosity are constrained by various market forces that limit the ability to sacrifice profits); Lee, *supra* note 12, at 585 (noting that the liquidity of shareholders’ rights and the market for corporate control provide shareholders with protection against agency costs associated with excessively responsible corporate policies).

about.⁴³

The above analysis does not lead to the conclusion that investors' muteness with respect to corporate conduct is a negative outcome. Portfolio investors are not experts, and their excessive intervention in corporate affairs would perhaps have severe costs. As long as there are other market mechanisms that reduce the agency costs of monitoring managers' conduct, this muteness is actually an advantage. Nevertheless, the ubiquity of large corporations in the global economy and the vital role they play (either by action or omission) in contemporary markets merit examination of some additional aspects of this voicelessness.

III. POLITICAL CONCERNS OVER RATIONAL APATHY

Having looked at the context of the recent interest in CSR in Part I, Part II examines the effect of corporate activity on the democratic political process. Part II.A advances this article's main normative argument that while portfolio investment is, by and large, a positive development that enables risk diversification, it has some negative externalities on the democratic political process. These externalities are generated by the unaccountable and non-mandated political agency granted to corporate officers. As the economic power of large corporations (particularly MNEs) continues to grow, this lack of political agency with respect to vital public policy issues should be understood as the core of the CSR critique. Part II.C goes on to suggest that mandatory disclosure with respect to social and financial issues can legitimize corporate agency.

A. The Political Costs of Rational Ignorance

The analysis in this section questions the social construction of corporate agency with respect to shareholders. Corporations are mainly investment vehicles, but, in the course of business, they inevitably interact with many issues that are political in nature. Because corporations are primarily designed to generate profits, traditional corporate law theory focuses on corporations' economic agency, translating it into a fiduciary obligation to maximize shareholders' wealth.⁴⁴ Considerably less attention has been given to corporations' political agency, which, I argue, is a form of accountability that does not follow smoothly from the economic agency practice.

Financial markets and portfolio investment patterns allow investors to limit the cognitive resources they devote to managing their investments.⁴⁵ However, these same attributes come into conflict with the democratic notions that emphasize the role of individuals' informed, responsible decision-making. Therefore, despite—and perhaps even because of—its risk diversification benefits, portfolio investment patterns also result in negative externalities on the democratic political process. Portfolio investment encourages individuals to be morally and politically indifferent to the consequences of their investment decisions. This is contrary to the ideals of a democratic regime that stresses the importance of individuals' informed decision-making as the basis of public policy. It is true that there are different approaches to how a democratic regime should function and that these approaches vary considerably in how they regard the importance of investing resources in order to encourage a broad body of citizens to engage in active

⁴³ Elhauge, *supra* note 11, at 733.

⁴⁴ See *supra* notes 10–12 and accompanying text.

⁴⁵ Victor J. Vanberg, *Corporate Social Responsibility in the Market Economy: The Perspective of Constitutional Economy*, in *CORPORATE SOCIAL RESPONSIBILITY AND CORPORATE GOVERNANCE* 131, 143.

decision-making.⁴⁶ However, at their very core, all democratic societies rely on decentralized, individual decision-making and all of them require some level of active participation.⁴⁷ In fact, one of the main functions of the state in a democratic regime is to facilitate mechanisms of deliberation that will allow informed, individual decision-making to be effective in shaping public policy.⁴⁸

This article does not participate in the longstanding inquiry over what is the “proper” level of active political knowledge and engagement to which a democratic state should aspire.⁴⁹ Instead, it wishes to emphasize why recent changes in the world economy have amplified the concern about investors’ rational apathy. Historically, democratic societies did not regulate businesses solely by law. Rather, regulation involved a combination of explicit government regulation and social norms that reflected both community expectations and individual consumer choices.⁵⁰

All of these mechanisms have become less effective in the increasingly integrated global economy.⁵¹ First, the opening of global markets introduced regulatory-competition pressures, causing states to loosen their regulatory requirements to attract business investments. This created a global atmosphere of weakened state regulatory capacity, which has made it difficult for states to effectively regulate issues related to business conduct within their individual jurisdictions, and even more difficult to effectuate responses to a growing set of issues that currently require coordinated global action.⁵² One of the best examples of this is the very well-documented dynamic of tax competition for MNE foreign direct investments.⁵³ MNEs are sophisticated taxpayers that have access to and awareness of many tax reduction opportunities that are unavailable to other taxpayers.⁵⁴ Corporate income taxation (by the source jurisdiction)

⁴⁶ Liberal theorists tend to argue that political power in a representative democracy is no different from any other type of commodity—individuals and groups invest in society only to the extent that it promotes their interests. Deliberative and republican theorists of modern democracy tend to view active political participation as an act of virtue—participation improves democratic decision-making because it gives a larger role to consideration of the common good. *See generally* Jurgen Habermas, *Three Normative Models of Democracy*, 1 CONSTELLATIONS 1 (1994) (discussing three competing normative visions of democracy and emphasizing the role of deliberative discourse theory which emphasizes active citizenry involvement and communication as a middle path between the liberal and republican vision of democracy).

⁴⁷ For example, no democratic state allows vote buying or proxy voting.

⁴⁸ Joshua Cohen, *Deliberation and Democratic Legitimacy*, in DELIBERATIVE DEMOCRACY: ESSAYS ON REASON AND POLITICS 72 (James Bohman & William Rehg eds., 1997).

⁴⁹ For more on this point, see *infra* note 99.

⁵⁰ Stanley Deetz, *Corporate Governance, Corporate Social Responsibility and Communication*, in THE DEBATE OVER CORPORATE SOCIAL RESPONSIBILITY 267, 267; Elhauge, *supra* note 11, at 756–76.

⁵¹ Deetz, *supra* note 50 at 267.

⁵² Andreas Georg Scherer & Guido Palazzo, *Globalization and Corporate Social Responsibility*, in OXFORD HANDBOOK 414.

⁵³ There is a significant amount of empirical and theoretical economic research that reveals and explains why MNEs’ foreign investments are mobile and tax sensitive. *See generally* JOSEPH E. STIGLITZ, MAKING GLOBALIZATION WORK 188 (2006); Kimberly A. Clausing, *Multinational Firm Tax Avoidance and Tax Policy*, 62 NAT’L TAX J. 703, 705 (2009); Harry Grubert & John Mutti, *Do Taxes Influence Where U.S. Corporations Invest?*, 53 NAT’L TAX J. 825, 825 (2000); Gaëtan Nicodème, *On Recent Developments in Fighting Harmful Tax Practices*, 62 NAT’L TAX J. 756, 756 (2009); Alan J. Auerbach et al., *Taxing Corporate Income* 22 (Nat’l Bureau of Econ. Research, Working Paper No. 14494, 2008), available at <http://www.nber.org/papers/w14494.pdf>.

⁵⁴ They achieve these tax reduction opportunities primarily, though not exclusively, by engaging in tax planning transactions structured to shelter profits in subsidiaries within the MNE groups located in low-tax jurisdictions. *See generally* Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699 (2011) (reviewing the different mechanisms through which MNEs achieve this form of tax reduction).

is the most important factor in determining MNEs' worldwide tax exposure.⁵⁵ This system creates a clear incentive for MNEs to engage in investment-shifting and income-shifting behaviors and further motivates countries to respond to this demand.⁵⁶ Because the tax competition dynamics for both investments and profits operate simultaneously and in an interrelated manner, it is difficult to distinguish between them.⁵⁷ MNEs therefore are thought to have considerable influence on governments' tax policy decisions, which impact their effective and marginal tax rates.⁵⁸

Second, the growing market share of corporate entities (especially MNEs) in the global economy suggests that they are important contributors to the current problems, an idea supported by the widely regarded notion that MNEs have a uniquely strong influence over the global economy.⁵⁹ If policymakers manage to reduce some of the negative political externalities associated with investments in MNEs, this could have a meaningful impact on a range of public policy issues.⁶⁰ For example, it has been argued

⁵⁵ This means that shifting real investments to low-tax jurisdictions and shifting reported profits to them are both legally permissible strategies for increasing MNEs' profitability. See Clausing, *supra* note 53, at 705.

⁵⁶ These two tax competitions—for investment and for profit shifting—intersect at many points. Whereas tax competition for capital investment reduces the effective marginal tax rate on new investments, tax competition for profits reduces statutory tax rates. See Michael P. Devereux, Ben Lockwood & Michela Redoano, *Do Countries Compete over Corporate Tax Rates?*, 92 J. PUB. ECON. 1210, 1212–13, 1231 (2007) (developing and testing a model for such a two-dimensional tax competition—finding that countries simultaneously compete across both margins and that the competition for lower statutory tax rates is best explained in terms of competition over mobile profits); Michelle Hanlon & Shane Heitzman, A Review of Tax Research 38 (July 25, 2010) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1476561 (stating that there is significant evidence that differences in corporate tax rates affect firms' pricing decisions).

⁵⁷ Clausing, *supra* note 53, at 717; Peter R. Merrill, *Corporate Tax Policy for the 21st Century*, 63 NAT'L TAX J. 623, 630–31 (2010) (suggesting that the high corporate tax rates in the United States make it difficult to attract investment and to prevent profit-shifting); Michael Overesch, *The Effects of Multinationals' Profit Shifting Activities on Real Investments*, 62 NAT'L TAX J. 5, 5 (2009); Joel Slemrod, *Location, (Real) Location, (Tax) Location: An Essay on Mobility's Place in Optimal Taxation*, 63 NAT'L TAX J. 843, 861–62 (2010) (suggesting that models that accommodate both tax competition for investment and profit locations are the most promising for future research development); George R. Zodrow, *Capital Mobility and Capital Tax Competition*, 63 NAT'L TAX J. 865, 869 (2010).

⁵⁸ For example, certain (mostly small) countries, typically thought of as tax havens, reduce their statutory tax rates to compete for profit shifting; i.e., to incentivize profit shifting by making it more lucrative. Other countries indirectly compete for investments by allowing MNEs to operate from tax havens when investing in them. By allowing MNEs to shift income out of their jurisdictions, these high tax countries indirectly reduce their effective tax rates. See generally Joel Slemrod & John D. Wilson, *Tax Competition with Parasitic Tax Havens*, 93 J. PUB. ECON. 1261 (2009) (demonstrating that smaller tax countries chose to become tax havens to facilitate income-shifting and that abolishing these havens would improve global welfare). For a different view, see Adam H. Rosenzweig, *Why Are There Tax Havens?*, 52 WM. & MARY L. REV. 923, 948, 951 (2010) (observing that in a world of capital disparities, smaller countries have an incentive to use their tax laws to attract economic activities by exploiting policies adopted by wealthier countries to mitigate double taxation). See also Mihir A. Desai, C. Fritz Foley & James R. Hines, Jr., *Do Tax Havens Divert Economic Activity?*, 90 ECON. LETTERS 219, 223 (2005); Dhammika Dharmapala, *What Problems and Opportunities Are Created by Tax Havens?*, 24 OXFORD REV. ECON. POL'Y 661, 662 (2008); Overesch, *supra* note 57, at 20; Benjamin Alarie, *Price Discrimination in Income Taxation* (January 30, 2012) (unpublished manuscript), available at <http://ssrn.com/abstract=1796284> (arguing that many of the complexities in tax system could partly be understood as an attempt of tax authorities to compete for mobile investments and investors).

⁵⁹ Cynthia A. Williams, *Corporate Social Responsibility in an Era of Economic Globalization*, 35 U.C. DAVIS L. REV. 705, 721 (2002).

⁶⁰ RICHARDSON, *supra* note 20, at 520–22 (acknowledging that, despite his support of direct regulation, it may not be enough given the lack of direct governmental control over MNEs); Patricia H.

that corporate tax avoidance negatively affects the legitimacy of the tax system.⁶¹ When sophisticated taxpayers such as corporations are able to use tax planning devices to reduce their effective tax rate, it generates a feeling that the tax system does not provide private individuals with a fair shake. As a result, this perception of unfairness or inequality legitimizes other avoidance (and perhaps even evasion) tax planning activities by non-corporate taxpayers.

Third, and perhaps most importantly, contemporary investors are exposed to an overwhelming number of ownership “relationships.” Most of these are based on business ventures (a significant number are located beyond their country’s borders) about which the individual portfolio investors know little, if anything.⁶² Much of the effectiveness of social norm pressures, which are present in more localized, domestic economies, simply vanishes in the complex, global production chain. One would expect that this alienation of shareholders from their investments would make the enforcement of non-legalistic methods of control virtually impossible due to common-action problems and, especially, the huge costs associated with shareholder activism.

Corporate business strategy interacts and shapes political realities through the decisions made by corporate managers, who do so on behalf of their shareholders. However, in the context of widespread portfolio investment patterns, it is questionable whether corporate managers should be seen as legitimate political agents for their shareholders.⁶³

The analysis up until this point stresses that the business sphere cannot be clearly separated from the political sphere, and therefore corporate managers act also as political agents because corporations’ activities have an inherent political impact. *Prima facie*, this would not be problematic—democracy does not require individuals to decide on all the political issues that may affect them. Accordingly, while vote buying is indeed forbidden, private transactions (including agency contracts) that have a political impact should not necessarily be subjected to high levels of regulatory scrutiny or approval.

However, the shareholder-manager political agency relationship in public corporations is different from other private transactions in several respects. First, the difficulties for portfolio shareholders of effectively monitoring their investments’ political impact make this political agency relationship unaccountable. Second, corporations, particularly MNEs, are not ordinary private actors, but ones that have an ever-growing role in the modern global economy at a time when regulators find it increasingly difficult to exercise effective governmental control over their actions. Therefore, the shareholder-manager political agency relationship results in a significant democratic deficiency that has considerable implications for public policy (as well as on democratic theory).

This suggests that the traditional CSR inquiry is slightly misplaced. Instead of considering whether the efficiency costs of allowing managers to promote non-profit

Werhane, *Corporate Social Responsibility/Corporate Moral Responsibility: Is There a Difference and the Difference It Makes*, in *THE DEBATE OVER CORPORATE SOCIAL RESPONSIBILITY* 459, 470. (Steve May et al. eds., 2007).

⁶¹ Ilan Benshalom, *Sourcing the 'Unsourceable': The Cost Sharing Regulations and the Sourcing of Affiliated Intangibles-Related Transactions*, 26 VA. TAX REV. 631, 697 (2007).

⁶² Lee, *supra* note 19, at 53 (asserting that corporate nature results in bounded feelings of empathy towards geographically remote victims of corporate irresponsibility).

⁶³ Ilan Benshalom, *The Dual Subsidy Theory of Charitable Deductions*, 84 IND. L. J. 1047, 1086–87 (2009) (discussing this issue in the context of corporate philanthropy).

seeking goals are worth the benefits to society,⁶⁴ the inquiry should be whether managers are adequate political agents of the shareholders they represent. It is clear that managers are better placed than many other stakeholders in identifying the various costs and benefits of corporate conduct to third parties and society in general.⁶⁵ However, this placement does not provide managers with any special moral or political weight when deciding issues such as the fairness of tax avoidance schemes, labor practices or the appropriate balance of sustainable growth against short-term profits.

These types of questions relate to the *goals that should be pursued and not the methods by which they should be pursued*. Therefore, the answers to these questions should be grounded in individual shareholders' preferences on these issues and not resolved solely (or primarily) with deference to managers' expertise.

Framing CSR as a problem of political agency leads to a very different conclusion from that of the mainstream CSR literature. Traditional literature focuses on how policymakers should obligate or incentivize managers to adopt certain desirable policies that could help solve specific problems associated with their business activities.⁶⁶ This article suggests that instead of trying to define what "good corporate citizenship" entails, policymakers should try to make corporations perform their political agency role adequately.

As noted earlier, all of the issues attached to the CSR debate relate to the provision of public goods⁶⁷—how they should be provided, the desired amount, and prioritization relative to other public goods. The reason there are so many CSR approaches stems from the (legitimate) differences in opinion with respect to what accounts for fair or optimal provision of public goods. Neither governments nor markets can determine the "correct" answer to this question, simply because it depends on the aggregation of preferences of all members in a given society. For example, in modern democracies, majoritarian decision-making is one way to determine the public goods that should be supplied by the government. Majoritarian decision-making has its advantages (namely, that it can be applied coercively to eliminate free riding), but it also has its weaknesses (namely, the difficulty of achieving a stable coalition on a great number of issues). People therefore try to promote their ideas about the necessity of public goods in other ways, such as through charitable donations,⁶⁸ volunteering, and their daily business and non-business associations and interactions.

What comprises legitimate tax planning or environmentally conscious business conduct is something that can only partially be agreed upon and advanced through government regulation. Apart from what is illegal, individuals have heterogeneous preferences with respect to this controversial, yet fundamental issue. Correspondingly, they may have different ideas as to how their position could be advanced, and can choose

⁶⁴ See generally Elhauge, *supra* note 11, passim (convincingly arguing that, in many cases, allowing managers to engage in profit-sacrificing behavior to promote non-wealth maximization goals would not result in significant agency costs and would be efficient as a way of improving shareholders' satisfaction by compensating for their lower financial returns).

⁶⁵ Johnston, *supra* note 20, at 234.

⁶⁶ Andere Crane et al., *Introduction*, in OXFORD HANDBOOK 3; Greenfield & Smith, *supra* note 22 (arguing that providing management with more latitude to undertake socially conscious, non-profit maximizing initiatives is desirable).

⁶⁷ See *supra* notes 17–18 and accompanying text.

⁶⁸ See generally Saul Levmore, *Taxes as Ballots*, 65 U. CHI. L. REV. 387 (1998) (arguing that governments can use individuals' donations as a signal of their preferences).

among an almost infinite number of legal and legitimate ways to promote these ideas. Portfolio investment in public companies and MNEs is one of many such ways. The reason it has attracted disproportionate scholarly attention relates to the growing importance of the corporate sector in the modern economy, as well as portfolio investors' insulation and detachment from responsibility.

To summarize, policymakers should refrain from adopting traditional CSR objectives, which focus on how to generate better corporate conduct. Instead, they should place the political agency deficit, which results from individual shareholders' rational indifference to political aspects of corporate conduct, as the main element of concern with respect to the current wealth-maximization ideals of the corporate law model. According to this analysis, a CSR agenda should anchor its efforts in the need to compensate for the negative political externalities that this shareholder indifference imposes on the democratic political process. This compensation requires taking institutional actions that would legitimize the unavoidable political agency of managers, while maintaining the benefits of the corporate structure and portfolio investment patterns. Policymakers should take steps to ensure an active process of reflective equilibrium,⁶⁹ which aims to ensure that corporate actions better correspond with shareholders' preferences.

B. Disclosure: A Remedy?

The above analysis suggests that policymakers need to take actions to conform corporate political agency to democratic perceptions of individual responsibility. This does not require any specific behavior; rather, it requires the establishment of mechanisms that align corporate governance practices with shareholders' preferences. The challenge is not to tell corporations how to act, but to facilitate ways for shareholders to determine whether their investments match their preferences. Democratic states provide tools that citizens can use to assume responsibility for their actions and participate in the democratic decision-making process. Assuming responsibility over the political aspects of their portfolio investments requires, at the very least reliable and accessible information about the social and environmental impacts of corporate activity. Reliable information, which is necessary for democratic deliberation on public policy, is a public good, and private parties are not likely to voluntarily invest resources to provide it. This implies that facilitating mandatory disclosure rules should be the main (or at least preliminary) goal of any government policy intended to enhance CSR.

The first issue that policymakers should address is the choice of topics to be covered by any mandatory, non-financial disclosure regime. In the same way that individuals are assumed to be interested (as shareholders) in generating profits, they could be assumed to be interested (as citizens) in a set of relevant political issues (which could be drawn from existing international legal documents).⁷⁰ As mentioned above, the traditional CSR agenda is concerned with a broad set of issues that are all related to the question of how to best provide public goods, ranging from tax avoidance, anti-corruption policies, and labor and environmental standards, to support of educational

⁶⁹ Reflective equilibrium refers to a process in which beliefs are matched with actions. See Norman Daniels, *Reflective Equilibrium*, in *THE STANFORD ENCYCLOPEDIA OF PHILOSOPHY* (Edward N. Zalta ed., 2011), <http://plato.stanford.edu/archives/spr2011/entries/reflective-equilibrium>.

⁷⁰ Oliver F. Williams, *Introduction*, in *PEACE THROUGH COMMERCE RESPONSIBLE CORPORATE CITIZENSHIP AND THE IDEALS OF THE UNITED NATIONS GLOBAL COMPACT 1, 1–3* (Oliver F. Williams ed., 2008) (devoting an entire book to the U.N. global compact that deals with issues of CSR); Oshionebo, *supra* note 15, at 12–13.

initiatives.⁷¹ These goods differ from other commodities and services because the market cannot effectively supply them, since they involve considerable (negative or positive) externalities. Hence, the optimal provision of these goods requires some type of governmental regulatory structure. While arriving at a full set of issues is impossible, determining a set of issues that would interest reasonable or average shareholders is a feasible task. In addition to the political issues concerning labor relations, human rights, and environmental concerns (discussed above), corporations should report their conduct with respect to other business-related political matters central to the global economy (e.g., tax compliance and relationships with foreign governments), their involvement in controversial industries (e.g., tobacco, pornography, and alcohol), and their own attempts to influence a political agenda (e.g., through campaign finance, charitable contributions, and lobbying activities).⁷² This list of topics is open, and may change from one society to another. The main focus for selecting an issue is that individuals care about it as citizens—even if they do not vote in regard to it.⁷³

Policymakers who determine what a corporation must disclose effectively act as agenda setters, and this power is thus open for abuse. This is a valid concern. However, while there may be disagreement about whether certain issues should be included, others (e.g., political contribution, tax payment, environmental, and labor policies) are relatively straightforward. Moreover, the alternative of disclosing only financial information also manifests a non-neutral agenda-setting with respect to the role of corporations in society.

The discussion over the impact of social disclosure is not new.⁷⁴ Like other disclosure regimes, social disclosure is often hailed as praiseworthy for its light, yet effective, regulatory touch, which can be used to advance an array of objectives.⁷⁵ In supplementing direct regulatory requirements, it encourages moral behavior by relying on the market's "taste" for morality and without hardwiring any moral principles into rigid

⁷¹ Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1201–03, 1275–76 (1999) (arguing that social disclosure should include information about where products are produced, about corporations' environmental effects, and information about their labor practices).

⁷² Lucian A. Bebchuk & Robert J. Jackson Jr., *Corporate Political Speech: Who Decides?*, 124 HARV. L. REV. 83, 85–96 (2010) (explaining why corporate decisions, with respect to their political speech, have special expressive significance for shareholders, because shareholders do not generally sort themselves according to political preferences).

⁷³ The majoritarian democratic decision-making process often makes it difficult to reach stable coalitions over a wide range of issues. Voters and politicians therefore often make decisions based on a limited set of issues (e.g., abortion, taxes, deficits, guns, and same-sex marriage). In a society where preferences over the desirability of public goods vary considerably, many groups would not be able to form coalitions that bring their topic of concern into the agenda. This does not suggest that the democratic, majoritarian decision-making process is undesirable, but only that in some cases it does not adequately reflect the full range of political preferences that individuals have. See Benshalom, *supra* note 63, at 1078–79.

⁷⁴ For some of the leading discussions in the legal literature concerning this issue, see Douglas M. Branson, *Progress in the Art of Social Accounting and Other Arguments for Disclosure on Corporate Social Responsibility*, 29 VAND. L. REV. 539, 678–82 (1976); Williams, *supra* note 71, at 1307.

⁷⁵ Paula J. Dalley, *The Use and Misuse of Disclosure as a Regulatory System*, 34 FLA. ST. U.L. REV. 1089, 1108–13 (2007) (surveying the different regulatory functions of disclosure, including: making markets more efficient, monitoring compliance with standard laws and regulations, providing information for government, and increasing public awareness). *But see* Steven M. Davidoff & Claire A. Hill, *Limits of Disclosure*, GEO. L. J. (forthcoming 2013) (critically asserting that disclosure is too often a convenient path for policymakers and many others looking to take action and hold onto comforting beliefs in the face of a bad outcome).

legislation.⁷⁶

This article highlights a different aspect, and argues that disclosure should not be viewed as a second-best supplement to direct regulation. Instead, due to the growth in corporate activities, disclosure should become an important way of exerting broad civic influence over public policy.

If policymakers require corporations to disclose their impacts on social and environmental issues, some of the negative political externalities associated with investors' rational indifference would be corrected.⁷⁷ The following attributes of the disclosure regime suggest that having widely available information on corporations' impacts would facilitate a shareholder-corporation political agency relationship that better accounts for shareholders' multiple capacities and heterogeneity of preferences.

First, disclosure seems to align with the notion of political agency—it does not require corporations to undertake any specific action but just to be transparent about their choices in acting.⁷⁸ The actual impact of this disclosure, the pressures it would expose corporations to, and the type of corporate responses to them are of less importance as long as its respective audience keeps the information internal.⁷⁹ Second, disclosure requirements bridge the inherent information asymmetry between portfolio investors and managers, providing investors with the possibility of making informed and accountable decisions with respect to the broader social impact of their investment decisions.⁸⁰ Systematic, comparable disclosure is a necessary first step in allowing shareholders to exercise a more sophisticated choice to ensure that their investments conform to their overall preferences.⁸¹ Third, mandatory disclosure accompanied by legal sanctions would significantly reduce problems of fraud and green-washing.⁸² This in turn could help legitimize the political agency relationship by providing an assurance that corporations (as agents) are truthful about their social and environmental impacts.⁸³

⁷⁶ This allows disclosure regimes to fit within the comfort level of liberal democracies and their commitment to a competitive capitalist market. Larry Cata Backer, *From Moral Obligation to International Law: Disclosure Systems, Markets and the Regulation of Multinational Corporations*, 39 GEO. J. INT'L L. 591, 597, 639 (2008).

⁷⁷ Elhauge, *supra* note 11, at 750, 758 (noting that portfolio investors, as well as consumers in general, are too insulated from corporations to either try to obtain information about them or to act on irresponsible corporate behavior upon receiving it).

⁷⁸ Disclosure supports the notion of a free market of ideas by meeting two requirements: the government should not tell shareholders how to conduct their (legal) affairs; but their agents (that is, corporate managers) should be required to explain and justify their conduct and its impacts. David W. Case, *Corporate Environmental Reporting as Informational Regulation: A Law and Economics Perspective*, 76 U. COLO. L. REV. 379, 432–33 (2005) (arguing that disclosure is important because it brings potentially controversial decisions into the open and triggers a process of deliberation with respect to them); Dalley, *supra* note 75, at 1093 (noting that disclosure, as a regulatory tool, aligns well with a pro-market agenda because it allows individual choice without requiring direct, governmental interference); Paul R. Kleindorfer & Eric W. Orts, *Informational Regulation of Environmental Risks*, 18 RISK ANALYSIS 155, 165–66 (1998); Williams, *supra* note 71, at 1296.

⁷⁹ The question of whether the goal of effectively communicating this type of information to shareholders is feasible is dealt with in the Part II.D.

⁸⁰ See Kleindorfer & Orts, *supra* note 78, at 168.

⁸¹ See Joshua A. Newberg, *Corporate Codes of Ethics, Mandatory Disclosure, and the Market for Ethical Conduct*, 29 VT. L. REV. 253, 286 (2005); Williams, *supra* note 71, at 1296.

⁸² Branson, *supra* note 74, at 624–27.

⁸³ By “legitimacy,” this article primarily means normative legitimacy, as the disclosure would align with the notion of agency and reduce political-agency costs. It may (or may not) also change the actual public attitudes with respect to financial markets, but this article does not address this empirical and somewhat

In summary, to be legitimate within a democratic regime, public corporations should have a credible disclosure regime that highlights the way in which policies affecting salient political issues are formed.

C. Assessment of the Proposal

The process of compiling data on corporate social performance would be of a very large scale. Mandatory disclosure requires significant resources for verifying the accuracy of information in order to reduce the risk of liability.⁸⁴ There is a market for information about the social and environmental impact of corporations, which is used by socially responsible (institutional) investors. Hence, those advocating for a shift to a mandatory disclosure regime bear the burden of proving that this information market is not operating properly.⁸⁵ Additionally, as mentioned, financial markets offer a liquid investment environment that is characterized by low exit costs. In such a setting, even low-stake portfolio investors can easily opt out from investing in corporations that do not satisfy their preferences. When exit is easy, there seems to be no need to regulate the shareholder voice. As socially responsible investment funds demonstrate, investors who are interested in non-financial aspects of corporate activities can channel their investments through professional fund managers who take these considerations into account.

There are a number of responses to these concerns. The first is that shareholders wish to correctly price the relative value of assets in which they invest in accordance with the increase in welfare they expect to derive from those assets. In order to make these decisions, they need both financial and non-financial information. The analysis in earlier parts of this article demonstrated that the current (mostly) voluntary non-financial disclosure regime is materially deficient.⁸⁶ In other cases, such as information regarding the different tax positions of corporations, government officials operate under strict restrictions of confidentiality.⁸⁷ These types of restrictions effectively prohibit the supply of such information to investors.

This point questions the assumption that the reason portfolio investors have a cheap exit cost option is to allow them to shift out of investing in corporations that do not satisfy their preferences. The low quality of socially responsible investment practices, which are a byproduct of poor corporate reporting practices, suggests that the information is not available to make a decision based on their preferences. Therefore, the only option shareholders have is to shift out of portfolio investment altogether.⁸⁸ This is a very costly exit option, which individual shareholders cannot be reasonably expected to incur, and, on a broader level, it has a negative impact on the economy, since low transaction cost portfolio investment has many positive benefits.⁸⁹ Instead, policymakers should seek other ways, such as mandatory social disclosure, to minimize the negative externalities of

speculative issue. See Kleindorfer & Orts, *supra* note 78, at 167–68 (making the distinction between empirical and normative legitimacy); Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. REV. 139, 154 (2006) (noting, skeptically, that one of the goals of security regulation is to boost investors' confidence in security markets).

⁸⁴ EASTERBROOK & FISCHER, *supra* note 11, at 276–309.

⁸⁵ Lee, *supra* note 12, at 574–75.

⁸⁶ See *supra* Part II.C.

⁸⁷ See *infra* note 128 and accompanying text.

⁸⁸ See *supra* Part II.C.

⁸⁹ See *supra* notes 35–37.

rational ignorance on the political process.

The second response is that corporations already maintain information about various social aspects of their activities, especially with respect to their tax compliance.⁹⁰ Indeed, tax authorities and other regulatory agencies in developed countries often require corporations to disclose such information to them. Generating much of the relevant information should therefore not be too costly for MNEs operating in developed countries. While compiling it into standardized reports would require some additional resources, it would also reduce some of the costs associated with the multiple standards applied today (by voluntary disclosure initiatives). Furthermore, one could expect that a mandatory disclosure requirement would encourage the development of specialized auditing firms, which would help further reduce some of those costs through economies of scope and scale.

The second line of criticism regarding mandatory disclosure of non-financial information is that it would remain wasteful and distortive even if compliance costs could be reduced to manageable levels. According to this train of thought, as long as consumers, managers, and investors are primarily price-sensitive (a point which even CSR sympathizers acknowledge),⁹¹ any resources invested in disclosure would be better spent elsewhere. It does not matter why all these individuals are price sensitive—whether it is because they fail to care about non-financial issues or because of common action problems that keep them blissfully ignorant and prevent them from effectively pursuing other preferences. Either way, the point remains that the costs associated with a mandatory requirement to disclose non-financial information will not affect individuals' consumption and investment behaviors and they therefore are unjustified. While a market operating with full information is an ideal, there is no point in trying to achieve it if people are unlikely to respond to additional information in any significant way.⁹²

Despite its veneer of empirical correctness, this critique is probably overly deterministic and pessimistic as an empirical matter.⁹³ Moreover, from a normative perspective, it fails to grasp the political agency argument advanced by this article. Specifically, it fails to recognize that competitive, price-sensitive market pressures in corporate stock markets *are only one sphere through which society interacts with corporate power*. Regulation, taxation, organized labor, and civic activism are other potential avenues that could influence the role corporations play in society.⁹⁴ Repeat actors operating in these spheres would probably be more sophisticated and attentive to the disclosed information than the average portfolio investor. Hence, there is a higher probability that they would respond to and make use of credible, easy to compare, and

⁹⁰ See *supra* Part III.

⁹¹ RICHARDSON, *supra* note 20, at 2, 128 (noting that socially responsible investing has a very limited market share and that many of the funds that claim to make socially responsible investment screenings use very broad and questionable definitions); Elhauge, *supra* note 11, at 750–52, 758–59, 805–11, 815, 818; Johnston, *supra* note 20, at 237; Lee, *supra* note 19, at 71.

⁹² Dalley, *supra* note 75, at 1113–19; Langevoort, *supra* note 36, at 1047–50; Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. REV. 139, 144–47, 156–59 (2006).

⁹³ Williams, *supra* note 71, at 1296 (noting that, despite its relatively small magnitude, the demand of socially responsible investment and its growth indicate shareholders' interest in and willingness to act upon such information); Ioannis Ioannou & George Serafeim, *The Consequences of Mandatory Corporate Sustainability Reporting* 29 (Harv. Bus. School Working Paper, Paper No. 11-100, 2012), available at <http://ssrn.com/paper=1799589>.

⁹⁴ SARAH A. SOULE, *CONTENTION AND CORPORATE SOCIAL RESPONSIBILITY* 27 (2009).

easy to access information with respect to corporate conduct on these issues.⁹⁵

This line of argument can be framed in two ways. The first relies on the efficient market analysis, which assumes that sophisticated institutional investors consume financial information disclosed by firms and correct the prices of assets in the market according to this information. This “market efficiency hypothesis” is the essence of modern finance theory. The development of portfolio investment is based on this assumption, allowing investors to be rationally ignorant when investing their capital in the financial markets. The belief that sophisticated actors are able to use the information provided by firms to price assets with reasonable accuracy allows investors to avoid expending resources trying to price those assets themselves.⁹⁶

The same argument should be made with respect to social disclosure.⁹⁷ There is a competitive market for political support of various ideas and initiatives. The success of the non-financial information market with respect to corporate conduct does not depend only on whether individual investors change their behavior according to it in a direct way. As long as there is reliable information cheaply available, sophisticated parties—e.g., NGOs, news organizations, unions, political parties and business competitors—would be able to use this information and translate it into “outrage costs,” which could help trigger political and media reactions to the issue.⁹⁸

While disclosure is unlikely to impact the investment decisions of (rationally ignorant) individuals or (primarily price-sensitive) institutional investors, it would likely impact corporate behavior by imposing pressures in other spheres. Interested parties would use this information to trigger consumer and political reactions to corporate conduct. Chances of manipulation of the disclosed information are low as long as the information provided is reasonably accurate, reliable, and comprehensive. The dissemination of this information would result in a richer and more reflective debate on the various dimensions of what comprises legitimate business conduct.

The notion that social disclosure could only be justified if it is proven that individuals actively consume it and directly act upon it is misleading. Furthermore, this notion stands in deep opposition to the basic assumption that corporate law and finance scholars adopt in their analyses with respect to financial disclosure.

Another approach to this issue could stress how investment decisions are not fundamentally different from voting decisions. As public choice scholars have noted, the general public has minimal incentive to participate in the democratic process, and even less incentive to invest time and cognitive resources in trying to make informed decisions about questions of public policy.⁹⁹ Since politicians can easily manipulate the public, the notion that providing more information would help individuals in improving their choice

⁹⁵ This form does not have to be one that the average portfolio investment shareholder would be able to comprehend.

⁹⁶ See BREALEY ET AL., *supra* note 37, at 337–39; Langevoort, *supra* note 36, at 1052. This notion is generally accepted by the finance and corporate law literature. Nevertheless, it is not free of doubts, even with respect to them. See Davidoff & Hill, *supra* note 75, at 622.

⁹⁷ This article does not endorse or reject the various versions of the efficient market hypothesis.

⁹⁸ See LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 64–70 (2004) (coining the term).

⁹⁹ See generally Russel Hardin, *Street Level Epistemology and Democratic Participation in DEBATING DELIBERATIVE DEMOCRACY* 163 (James S. Fishkin & Peter Laslett eds., 2003) (discussing the difficulty of encouraging individuals in a democracy to invest time and resources in learning the information necessary to make better judgments about public policy matters).

of their representatives—so that those representatives would better advance their preferences—is naïve. In this state of affairs, there is a very low likelihood that individuals could change democratic decision-making; apathy is the most rational behavior.

There is a startling resemblance between these public choice arguments with respect to voting and the criticism against the social disclosure regime. According to both arguments, the attempt to provide relevant information that would help individuals in making informed decisions constitutes a waste of resources. Yet the public choice critique seems to offer only one (pessimistic) dimension of a much more complicated process. For example, according to public choice theory, voting is an irrational behavior because the ability of one voice to influence the result of large elections is negligible. Despite this apparent irrationality, a significant number of people exercise their voting rights in national elections.

In the context of disclosure, public choice would stress the uselessness of almost all disclosure mechanisms. Nevertheless, basically all democratic regimes try to promote transparency of government decision-making and decision-makers. Despite their skepticism about the impact of each and every disclosure initiative, every public choice theorist would most likely (everything else being equal) prefer to live in a country with more governmental transparency (e.g., Finland) rather than less (e.g., Russia). Even though it is difficult to determine the utility of each part of the public disclosure regime, *the whole may be greater than the sum of its parts*. People take the importance of disclosure for granted as part of a broader commitment to a free democratic process. This is not coincidental; the core of the democratic process is premised upon individuals' ability to use their informed judgments to monitor and take responsibility over the actions of elected representatives.

Just as in the case of public sector disclosure, disclosure of information concerning the non-financial social and environmental aspects of corporate activity may be justified out of a broad political commitment to transparency. Policymakers should require corporations to provide information about the political impact of their business activities because transparency promotes proper use of political power. Corporate managers are agents of their shareholders in a way that resembles how elected politicians are agents of voters in a representative democracy. This resemblance results from the growing importance of corporations in impacting issues of public policy in the integrated global economy. Policymakers therefore have justification to impose high transparency requirements on corporate agents even if it is hard to determine the precise costs and benefits of every component of the disclosure policy.

An additional point should be made with respect to the quality of the information disclosed. In financial markets, policymakers can assume that simply providing the information is sufficient because there is efficiency even if the information is understood only by a limited number of professionals. This, arguably, is not the case in the context of non-financial disclosure, where the range of sophistication of parties is much wider. To achieve disclosure that can expose the political impact of corporations to outsider scrutiny, the information should be transparent, and not just technically available.¹⁰⁰ It must be presented in a way that is more than just accurate—disclosure must operate under guidelines that require auditors to illustrate the saliency of the provided

¹⁰⁰ See BEBCHUK & FRIED, *supra* note 98, at 11, 64–70 (2004) (making a similar argument about executive compensation).

information. Policymakers face a difficult dilemma of whether to settle for a relatively light touch disclosure regime, or to try a much more difficult (and costly) regime that promotes transparency. The balance between these two approaches varies from one field to another. Part III provides a single in-depth analysis of what I consider to be the most straightforward application of the analysis: corporate tax disclosure.

In summary, the notion of social and environmental disclosure is an administrable policy alternative that would be effective in promoting normatively legitimate corporate agency. Although far from offering any clear-cut and no-cost solution, the proposal offers a solution that conforms to notions of democratic accountability based on a process of informed decision-making and, therefore, should be considered seriously by policymakers.

IV. THE CASE FOR TAX DISCLOSURE

This Part takes the previous theoretical analysis a step further by presenting the case of tax disclosure as an example of how the deficit of corporate political agency should be incrementally addressed. *The ambition of this article is not to reduce corporate tax planning per se, but only to ensure that corporate tax planning strategies conform with shareholders' (and public) conceptions of what comprises legitimate planning behavior.*

Tax disclosure operates as the ideal case study for demonstrating how the concept of corporate political agency bears concrete results in analyzing CSR issues and for explaining how disclosure can reduce the negative political externalities associated with rational ignorance. By demonstrating that social disclosure would be possible even with respect to such a technical and difficult issue, this article hopes to establish the plausibility and significance of its underlying proposal. To achieve this, the article draws some broad-brush lines between its analysis and recent literature on tax disclosure.¹⁰¹

The first attribute of tax disclosure that makes it an ideal case study is its negligible marginal costs—corporations already produce and deliver the relevant information to tax authorities. The second is its political relevance as an issue of tax policy. The third, and most important, attribute is the seeming gap between shareholders' positions on tax avoidance and the actual conduct of corporations.

A. Corporate Tax Planning: A Clear Case of Political Agency Deficit

Although taxation, particularly corporate and international taxation, is viewed as a complex topic, it is not fundamentally different from other CSR issues involving MNEs' creative compliance strategies. Creative compliance with regulatory requirements is a byproduct of a number of factors, including ambiguity about legal norms, insufficient funding of state enforcement agencies, and corporate access to (typically legal) expertise specializing in reducing the regulatory burden.¹⁰² Even though it is similar to other CSR issues, corporations' tax payment strategies have attracted relatively little CSR-oriented research.¹⁰³ The following analysis demonstrates why

¹⁰¹ See *infra* Part IV.B.

¹⁰² Ilan Benshalom, *The Quest to Tax Financial Income in a Global Economy: Emerging to an Allocation Phase—Taxing Global Financial Institutions*, 28 VA. TAX REV. 165, 174 (2008); Doreen McBarnet, *Corporate Social Responsibility Beyond Law, Through Law, For Law: The New Corporate Accountability*, in *THE NEW CORPORATE ACCOUNTABILITY: CORPORATE SOCIAL RESPONSIBILITY AND THE LAW* 9, 46–48 (Doreen McBarnet et al. eds., 2007).

¹⁰³ John Christensen & Richard Murphy, *The Social Irresponsibility of Corporate Tax Avoidance: Taking CSR to the Bottom Line*, 47 DEV. 37, 37 (2004); Mihir A. Desai & Dhammika Dharmapala, *CSR and*

MNEs' tax planning strategies highlight the problems associated with their lack of corporate political agency and explains how this could be remedied by a better flow of information.

A case study of MNEs' tax avoidance strategies is interesting because managers' ability to minimize corporate tax liabilities goes to the heart of their duty to maximize profits. Traditional (wealth maximization-oriented) corporate law analysis views corporate tax payment as a transfer made by shareholders, as the residual owners, to the government.¹⁰⁴ Hence, because tax planning is not a prohibited criminal activity, minimization of corporate tax liabilities is a permissible way to increase shareholders' return for their investments. At least in theory,¹⁰⁵ it seems as though managers have an obligation to disregard their personal views about tax avoidance and minimize their corporation's tax liabilities via any legal, albeit aggressive, planning option available.

This obligation may strike some as odd, since many shareholders may not support this standard of behavior when it comes to tax planning. Individuals have widely different views about tax avoidance and tax planning. While some view it as a legitimate attempt to minimize tax liabilities, others view it as a distasteful, irresponsible, and immoral practice. Some scholars argue that (with very few exceptions) all tax planning initiatives are negative and wasteful.¹⁰⁶ Other scholars view some corporate tax planning practices more favorably.¹⁰⁷ The existence of the large volumes of literature that consider what comprises legitimate tax avoidance demonstrates the plurality of views on this topic and the difficulty that academics, judges, and lawmakers have in agreeing on how to define it.¹⁰⁸

The relative neglect of corporate tax minimization strategies in CSR literature is surprising because tax payment (and lack of tax payment) has unquestionable welfare consequences on other members of society. Corporate tax planning has the consequence of the government being paid less money.¹⁰⁹ This generally has a negative impact on other members of society, requiring the state to either reduce public provisions, due to its reduced spending capacity, or to increase the tax burden on its members to

Taxation: The Missing Link, LEADING PERSPECTIVES, Winter 2006, at 4; Grant A. Richardson & Roman Lanis, *Corporate Social Responsibility and Tax Aggressiveness* (Working Paper, 2011) (manuscript at 7), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1904002 (noting that CSR research tends to focus on corporations' environmental impacts); Luke Watson, *Corporate Social Responsibility and Tax Aggressiveness: An Examination of Unrecognized Tax Benefits* (Am. Taxation. Assoc. Working Paper, 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1760073.

¹⁰⁴ Reuven S. Avi-Yonah, *Corporate Social Responsibility and Strategic Tax Behavior*, in TAX AND CORPORATE GOVERNANCE 183 (Wolfgang Schon ed., 2008) (noting the different theories over the nature of corporations and tax aspects of the CSR obligations); Desai & Dharmapala, *supra* note 103, at 5.

¹⁰⁵ For different views, see Desai & Dharmapala, *supra* note 103, at 5; Christensen & Murphy, *supra* note 103.

¹⁰⁶ David A. Weisbach, *Ten Truths About Tax Shelters*, 55 TAX. L. REV. 215, 222–25 (2002).

¹⁰⁷ In particular, some scholars have noted that various corporate tax planning strategies are responses to intentional governmental attempts to attract large corporate investments via non-transparent methods of tax price discrimination. See Mihir A. Desai et al., *Do Tax Havens Divert Economic Activity?*, 90 ECON. LETTERS 219 (2005); Benjamin Alarie, *Price Discrimination in Income Taxation* (Jan. 16, 2012) (unpublished manuscript) (available at <http://ssrn.com/abstract=1986272>).

¹⁰⁸ For two recent examples of this literature, see Leandra Lederman, *W(H)ither Economic Substance?*, 95 IOWA L. REV. 389 (2010); Shannon Weeks McCormack, *Tax Shelters and Statutory Interpretation: A Much Needed Purposive Approach*, U. ILL. L. REV. 697 (2009).

¹⁰⁹ MYRON S. SCHOLES ET AL., TAXES & BUSINESS STRATEGY (4th ed. 2008).

compensate.¹¹⁰ In fact, as some important public finance scholars have noted, corporate tax payments—especially income tax payments—are the most visible and straightforward contribution that corporations make to non-shareholders and non-employees.¹¹¹

However one views tax avoidance, individuals clearly have diverse preferences on the issue. This diversity has some real world consequences. Individuals or companies with higher “tax morals,” or (as economists would frame it) higher subjective costs, are less likely to engage in tax planning, and are in turn exposed to higher tax rate burdens.¹¹² While aggressive tax planning can have significant financial and reputational costs,¹¹³ there is little empirical indication that these costs play any role in determining share prices.¹¹⁴ Hence, differences in tax morals and professional ethics can help explain why corporations exhibit such great variances in their tax planning and, specifically, why allegedly rational corporate managers are willing to overpay taxes that they could avoid by investing in tax sheltering activities. All of this demonstrates that what constitutes legitimate tax planning behavior remains an open question, and one that cuts to the very essence of what comprises ethical business conduct.¹¹⁵

Members of society have clear and tangible incentives to “free ride” by letting others pay taxes without doing so themselves. In this context, the reasons that determining what constitutes legitimate tax planning is such a highly controversial political and ethical topic are clear. Taxpayers have a right to structure their transactions in any way they choose, and it is difficult to determine if any one structure serves a reasonable objective or is primarily an attempt to free ride off of other tax-paying members of society. The fact that the question is unsettled provides the reason for mandatory disclosure, so that shareholders can make a determination according to their own political preferences. As discussed in Part III, comprehensive and readily comparable public disclosure of corporate tax payment information may trigger responses in other spheres.¹¹⁶

Current shareholder wealth maximization financial reporting requirements do not require specific details with respect to corporate tax planning strategies. Therefore, a tax planning device used by a corporation should be reported only if it can substantially affect its income projections. In doing so, the current requirements require corporations

¹¹⁰ See Richardson & Lanis, *supra* note 103, at 6 (discussing the negative character of aggressive corporate tax planning).

¹¹¹ Desai & Dharmapala, *supra* note 103.

¹¹² See generally Philipp Doerrenberg et al., *Nice Guys Finish Last: Are People with Higher Tax Morale Taxed More Heavily?* (IZA Discussion Paper No. 6275, 2012) (providing an economic model that illustrates this point).

¹¹³ Jeffrey P. Owens, *Good Corporate Governance: The Tax Dimension*, in *TAX AND CORPORATE GOVERNANCE* 9, 10 (Wolfgang Schon ed., 2008).

¹¹⁴ John Gallemler et al., *The Reputational Costs of Tax Avoidance* (2012) (unpublished manuscript) (available at <http://ssrn.com/abstract=1986226>).

¹¹⁵ If asked, shareholders would presumably provide different answers to what is the optimal balance between the desire to increase the financial returns to their investments and the tax ethics. In the context of small, closely held businesses, where shareholders can communicate their aggressive tax preferences to managers, there should be no political agency problem on this issue. However, the same does not follow in the context of large, public corporations, especially MNEs.

¹¹⁶ This may also include reputational costs associated with consumer pressure on corporations that are perceived as aggressive tax avoiders or political pressure on politicians to improve the tax system. See David L. Lenter et al., *Public Disclosure of Corporate Tax Return Information: Accounting, Economics, and Legal Perspectives*, 56 NAT'L TAX J. 803, 803 (2003); Joel Slemrod, *The Economics of Corporate Tax Selfishness*, 57 NAT'L TAX J. 877, 886 (2004).

to provide the type of information that “rational” investors and creditors interested only in increasing their wealth would demand—that is, only information that impacts a given corporation’s financial stability.¹¹⁷ In fact, the information provided by public corporations’ financial statements is generally not sufficient to isolate and compare even very basic information such as annual tax liabilities and payments in a given year.¹¹⁸

From a social perspective, shareholders’ general lack of knowledge and ability to comprehend the conduct of corporate agents is far from optimal. Given the powerful arguments that tax planning has little, if any, positive social welfare effects on society, this seems to be a relatively straightforward case in which the rational ignorance among shareholders encourages corporate managers to engage in behaviors that have negative social welfare effects overall. The relatively smooth operation of modern self-reporting tax systems is possible because of individuals’ reluctance to maximize their financial returns by exploiting tax loopholes and evasion opportunities.¹¹⁹ Because sanctions alone are insufficient in deterring aggressive tax planning behavior, tax authorities also have to rely on the social norms of ethical tax compliance among sophisticated corporate actors. In this context, the detachment of shareholders from knowledge and accountability makes corporate tax compliance more difficult to achieve. Put differently, current wealth maximization-oriented corporate law and financial disclosure regimes encourage corporations to turn their tax departments into “profit centers.”¹²⁰

These incentives to turn tax minimization into a business strategy may strike some as odd since large corporations, particularly MNEs, are not ordinary taxpayers; rather, they are the ones responsible for most of a country’s corporate income tax revenue.¹²¹ Furthermore, MNEs, as taxpayers, have a large number of tax reduction opportunities because they operate in multiple jurisdictions, employ economies of scope and scale, maintain considerable lobbying power, and have access to tax planning expertise. Unsurprisingly, the result of tax planning by these large corporate taxpayers is extremely costly in terms of foregone revenue.¹²² This result is neither neutral nor reasonable from a social perspective. Nevertheless, it is a predictable outcome, given the rational response of managers to the incentives that current financial disclosure rules provide.

B. Tax Disclosure: From Theory to Practice

This subpart provides a basic summary of the literature dealing with tax disclosure, describing some of the key strengths and weaknesses of public disclosure of corporate tax information. It then turns to examine this article’s analysis about the negative political externalities of non-disclosure. The next subpart contextualizes these conclusions by explaining how tax disclosure would operate with respect to a recent, well-publicized tax minimization strategy employed by Apple.

Tax disclosure has been employed in the United States in the past,¹²³ and is still

¹¹⁷ Gary A. McGill & Edmund Outslay, *Lost in Translation: Detecting Tax Shelter Activity in Financial Statements*, 57 NAT’L TAX J. 739, 743–44 (2004).

¹¹⁸ See Lenter, *supra* note 116, at 822.

¹¹⁹ See Weisbach, *supra* note 106, at 243–47.

¹²⁰ See Slemrod, *supra* note 116, at 885.

¹²¹ Ilan Benshalom, *How to Live with a Tax Code with Which You Disagree: Doctrine, Optimal Tax, Common Sense, and the Debt Equity Distinction* 88 N.C.L. REV. 1217, 1239 (2010).

¹²² See Christensen & Murphy, *supra* note 103, at 39–40 (suggesting that reliance on the offshore economy has become an important component of many globalized sectors); Slemrod, *supra* note 116, at 880.

¹²³ See Lenter, *supra* note 116, at 807–10 (describing the U.S. experience with tax disclosure rules).

employed in various (primarily Scandinavian) countries, where taxpayers are required to report their tax liabilities.¹²⁴ Historically, the tax disclosure debate has revolved around a somewhat different axis than that presented in this analysis—namely, whether it can help improve tax compliance.¹²⁵ The idea was that wealthy people would be afraid to disclose the fact that they make low tax payments that do not correspond with their financial abilities and living standards. The issue re-emerged at the beginning of the millennium in the aftermath of several corporate-accounting scandals.¹²⁶ When Enron collapsed, news coverage revealed that it and other fraudulent corporations reported enormous financial accounting profits to their shareholders but little taxable income to the government. Hence, the renewed interest in public disclosure of tax information sprang from the notion that large corporations were engaged in too much tax sheltering, and that this was a symptom of a greater problem in the business ethics of corporate America.¹²⁷

It remains difficult to determine which taxpayers should be covered by tax disclosure requirements, and what information they should disclose. Disclosing tax return information is obviously in conflict with the notion of taxpayers' privacy protection. Today, taxpayer privacy is such an important principle that the Internal Revenue Service (IRS) is restricted even from providing tax return information to other government agencies.¹²⁸

There seems to be agreement that full disclosure of corporate tax returns is undesirable.¹²⁹ First, while public corporations do not have a right to privacy in the same way in which individuals do, there is a fear that tax disclosure would force them to disclose sensitive proprietary information to their competitors. Second, full disclosure would require corporations to disclose an enormous amount of information and would provide them with an incentive to dilute the quality of the tax information in a way that would obfuscate, rather than highlight, their relevant tax planning strategies.¹³⁰

On the other hand, it is clear that a tax disclosure regime that only provides crude, aggregated information—such as total tax liability and effective tax rate—is also insufficient. A tax disclosure regime that relies only on such data would reveal more information than what is currently available, but would not enable shareholders to grasp the nature of corporate tax reduction activities. Furthermore, the idea that the disclosure

¹²⁴ *Id.* at 811–12.

¹²⁵ On this issue, see Joshua D. Blank, *What's Wrong with Shaming Corporate Tax Abuse*, 62 TAX L. REV. 539 (2009); Lenter, *supra* note 116, at 820; Ronald A. Pearlman, *Demystifying Disclosure: First Steps*, 55 TAX L. REV. 289 (2002); Makoto Hasegawa et al., *The Effect of Public Disclosure on Reported Taxable Income: Evidence from Individuals and Corporations in Japan*, (Working Paper, 2012), available at <http://ssrn.com/abstract=1653948>.

¹²⁶ Lenter, *supra* note 116, at 804–06.

¹²⁷ *Id.* at 804–06.

¹²⁸ James N. Benedict & Leslie A. Lupert, *Federal Income Tax Returns—The Tension Between Government Access and Confidentiality*, 64 CORNELL L. REV. 940 (1979) (describing the 1976 act that limited non-IRS government officials' access to tax return information); Lenter, *supra* note 116, at 811–12 (noting that tax confidentiality is very strong and backed with criminal liabilities).

¹²⁹ See Lenter, *supra* note 116; McGill & Outslay, *supra* note 117, at 753–54. See Joshua D. Blank, *Overcoming Overdisclosure: Toward Tax Shelter Detection*, 56 UCLA L. REV. 1629, 1655–71 (2009) (engaging in a somewhat similar analysis and explaining why current disclosure rules with respect to listed transactions are overly inclusive).

¹³⁰ See Joshua D. Blank, *Overcoming Overdisclosure: Toward Tax Shelter Detection*, 56 UCLA L. REV. 1629, 1655–71 (2009) (engaging in a somewhat similar analysis and explaining why current listed transaction rules are overly inclusive in a way that provides aggressive and conservative taxpayers with incentives to disclose too much information from what the IRS can reasonably handle).

of aggregated data is sufficient rests on the assumption that there is a clear social norm with regard to lowering one's tax rates. However, in our political-legal culture, there is widespread ambivalence about whether paying fewer taxes is, indeed, antisocial behavior.¹³¹ Corporations that reduce their tax liabilities are often considered sophisticated, especially since governments intentionally provide many of these tax reduction opportunities. Indeed, as mentioned, the problem with tax planning lies in the fact that there is not one clear and agreed upon answer as to what comprises legitimate behavior.¹³²

The above analysis does not deny that any tax disclosure regime that wishes to foster political agency with respect to corporate tax payment would need to include aggregated data (e.g., taxes paid at effective tax rates on domestic and foreign incomes). However, aggregated data would also need to include some information that provides a stronger signal for controversial, tax planning behavior. Such controversial information should include levels of investment and engagement in tax sheltering transactions, penalties paid to the IRS, the amount of money saved through authorized tax minimization strategies, and explanations for every major difference between tax and financial accounting figures.

This type of information would be more intrusive and, therefore, more expensive (and politically difficult) to generate. However, it is important to recognize that the vast majority of this information already exists, and is already provided to the IRS.¹³³ This suggests that the costs of generating the information are only those costs associated with detaching relevant information from the rest of the tax return and "translating" it into a format that is easier to read and comprehend.

Within the limited framework of this case study, it is impossible to review every technical aspect of such requirements. However, it is important to note that this regime could be made more effective through a set of simple procedures. These would include penalties for over or misleading disclosure, a list of safe haven elements that do not require disclosure, and a requirement to provide a written description of corporate strategies and tax planning transactions.¹³⁴ The next subpart provides a real world example that contextualizes the analysis.

C. The Open Debate about Apple's Stateless (and Tax-Less) Subsidiaries

This section will consider a tax-planning device that recently received considerable public attention: Apple's "stateless subsidiaries."¹³⁵ For simplicity, this article focuses on the first component of this multistep transaction,¹³⁶ which allowed

¹³¹ For such an approach, see the opinion of Judge Hand in *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934).

¹³² See *supra* notes 102–08 and accompanying text.

¹³³ Blank, *supra* note 129, at 1635–42 (describing the current listed transactions, mandatory disclosure regime that requires corporations to report every time they engage in transactions that are considered "suspicious").

¹³⁴ *Id.* at 1672–86.

¹³⁵ Memorandum from Sen. Carl Levin, Chairman, and Sen. John McCain, Ranking Minority Member, Permanent Subcomm. On Investigations, to the Members of the Subcomm. on Investigations (May 21, 2013), at 17-37 available at <http://www.levin.senate.gov/download/?id=fc514a8c-5890-47c4-ba7c-149e4a8474c2>.

¹³⁶ See Edward D. Kleinbard, *Stateless Income*, 11 FLA. TAX REV. 699, 706–13 (2011) (skillfully describing a similar transaction involving Google).

Apple to shift its intangibles to a subsidiary incorporated in Ireland.¹³⁷

With the authorization of the IRS, Apple initially injected equity capital into a subsidiary incorporated in Ireland, which otherwise had very little activity. This capital was then used by the subsidiary to purchase a share in intangible assets, which had been developed by the U.S. parent, mostly through the human capital of its American employees. The transaction was complexly engineered to allow the income earned by the subsidiary to be shifted outside of Ireland, in essence allowing the subsidiary to become stateless; i.e., for tax purposes, it was located nowhere. Instead of paying the ordinary Irish tax rate of 12.5%, Apple “negotiated [with Ireland] a special corporate tax rate [for its stateless subsidiaries] of less than 2%.”¹³⁸

Despite the overall complexity, the core of the transaction was relatively simple. Apple, a corporation operating mostly from Cupertino, California, raised capital and invested it in innovative R&D activity.¹³⁹ In the process of doing so, it probably deducted most of its R&D and finance costs from the parent’s domestic tax liabilities. Then, with a stroke of a pen, it capitalized what eventually became a stateless subsidiary with equity capital. This equity investment was used by the subsidiary to purchase ownership rights in the highly profitable, intangible assets of the U.S. parent corporation (a purchase that probably triggered some type of tax liability). Almost immediately after this capital arrived in the subsidiary’s bank account, it re-crossed the Atlantic to the parent’s bank account. Over the years, the subsidiary made subsequent payments under the cost sharing agreement financed through its vastly accumulated (and modestly taxed) retained earnings, which, despite Apple’s modest physical presence in Ireland, accounted for two thirds of its profits.¹⁴⁰ Given that Apple controlled 100% of these stateless subsidiaries, all these actions amounted to no more than paper shuffling—moving money from one corporate pocket to another.

Even though the United States taxes MNEs on foreign earnings, the accumulated earnings of Apple’s stateless subsidiaries were unlikely to be taxed. Following the general rule that earnings are only taxed when realized, the Apple parent would only pay taxes on these earnings once they repatriated as dividends in the United States.¹⁴¹ Hence, absent serious earnings or liquidity shocks, Apple has no incentive to repatriate those earnings, and thus subject them to a 35% corporate income tax rate in the United States.¹⁴²

Apple is a unique MNE. It is among the most profitable corporations in the world

¹³⁷ Memorandum to Members of the Subcomm. On Investigations, *supra* note 135, at 25-31. See Ilan Benshalom, *Sourcing The “Unsourceable”: The Cost Sharing Regulations and the Sourcing of Affiliated-Intangible Related Transactions*, 26 VA. TAX REV. 631, 651-67 (2007) (providing an overview of how MNEs use cost-sharing arrangements as a license to migrate profitable, intangible assets to low-tax jurisdictions).

¹³⁸ Memorandum to Members of the Subcomm. on Investigations, *supra* note 135, at 20-21.

¹³⁹ See *Offshore Profit Shifting and the U.S. Tax Code – Part 2 (Apple Inc.): Hearing Before the Permanent Subcomm. On Investigations of the Comm. on Homeland Sec. and Governmental Affairs*, 113th Cong. 35 (testimony of Timothy Cook, Chief Exec. Officer, Apple Inc.), available at <http://www.gpo.gov/fdsys/pkg/CHRG-113shrg81657/pdf/CHRG-113shrg81657.pdf>.

¹⁴⁰ Richard Harvey Jr., *Apple Hearing: Observations from an Expert Witness*, 139 TAX NOTES 1171, 1174 (2013).

¹⁴¹ However, dividend payments are discretionary; the Irish subsidiary is not obligated to make them, and the controlling parent company, wishing to defer or avoid the tax, is not likely to force it to do so.

¹⁴² The earnings of the subsidiary appear in Apple’s financial statements and Apple (probably) uses its control over them in a productive way (e.g., borrowing against them, reinvesting them in its own activities, and investing them in other enterprises).

and its business relies on the production of highly profitable intangible assets. Furthermore, its multinational scope allows it to undertake tax-planning opportunities unavailable to purely domestic corporations. It is, at the same time, a corporation that invests a lot in its brand name and reputation. Most importantly, as a widely held public corporation, it is likely that the vast majority of American taxpayers are Apple shareholders (either directly or indirectly, through pension savings accounts).

Apple's actions were taken to maximize its shares' value.¹⁴³ They were all legal and, to a certain extent, authorized by the IRS. Nevertheless, the public exposure of this tax reduction technique triggered a large-scale, sophisticated debate in all major news organizations about the taxation of MNEs, in which a wide array of views were presented.¹⁴⁴

The debate revealed that there is no single agreed upon answer to whether Apple's behavior was right or wrong.¹⁴⁵ The answer to this question depends on many factors, including personal political preferences and the extent to which other corporations employ similar strategies. Due to the ambiguity surrounding the question of whether this is a legitimate tax planning practice, a tax disclosure regime will not necessarily reduce the use of this type of planning device. Instead, such a regime would require Apple and other companies to disclose this strategy, as well as other tax reduction strategies, not only to the IRS, but also to shareholders, which, in the case of Apple, *are the general public*. Certainly, there is only a low probability that revealing this would affect investment decisions. It would more likely trigger a better-informed debate among a broader circle of (non-tax expert) citizens in the general public. This type of debate may induce tax policymakers to reconsider the limitations that should be placed on such corporate tax reduction opportunities.

The current information about public corporations does not provide shareholders with sufficient information to make judgments on these issues. Instead, this information is made available primarily through sporadic news coverage and is thus generally anecdotal and in and out of the public agenda. This state of affairs is undesirable considering shareholders' different preferences with respect to tax planning. For example, some shareholders may think corporations should pay more taxes and that Apple's actions were plainly unfair. Others may think corporations like Apple should be rewarded directly for creating high paying jobs in the United States and not indirectly

¹⁴³ Apple's Testimony *supra* note 1, at 3 & 15.

¹⁴⁴ See Editorial, *Apple's Taxes Expose a Rotten U.S. Code*, BLOOMBERG, May 21, 2013, <http://www.bloomberg.com/news/2013-05-21/apple-s-taxes-expose-the-rotten-u-s-code.html> (noting that corporations' complicated tax maneuvers allow them to legitimately avoid taxes); Editorial, *No Replacement for Corporate Taxes*, N.Y. TIMES, May 31, 2013, <http://www.nytimes.com/2013/05/31/opinion/no-replacement-for-corporate-taxes.html> (arguing that the corporate tax should not be replaced because it is a progressive element and stating that "disclosure and exposure have a role to play in changing corporate norms [because for MNEs like Apple] their image is part of what they sell"); Editorial, *The Apple Tax Diversion*, WALL ST. J., May 21, 2013, <http://online.wsj.com/article/SB10001424127887324102604578497263976945032.html> (noting that the Apple case offered nothing new and that if anything it should prompt Congress to enact a lower "ideally zero" corporate income tax rate to promote investment and growth); Editorial, *Apple is Shifting its Tax Burden*, WASH. POST, May 22, 2013, http://articles.washingtonpost.com/2013-05-21/opinions/39419357_1_tax-burden-corporate-tax-reform-u-s-tax-code (noting that Apple's "stunning tax strategies" stress the price Americans pay for the failure to promote tax reform).

¹⁴⁵ See *Biting Criticism*, THE ECONOMIST, May 21, 2013, <http://www.economist.com/blogs/schumpeter/2013/05/apples-tax-arrangements> (noting that the issue is bound to continue to be relevant and controversial).

through tax reduction opportunities that involve moving intangibles to stateless subsidiaries abroad. Others still may think Apple applied a legitimate self-help strategy that was a competitive necessity in the dynamic, globalized information technology market.¹⁴⁶

It is highly probable that the full spectrum of these views could be found among Apple's shareholders. However, the purely internal mechanism through which these types of decisions take place today avoids the political and moral debate altogether by relegating the essentially moral and political question of what comprises free riding in the context of tax planning to Apple's CEO, CFO, tax executives, and (to a limited extent) its board of directors. Contemporary financial disclosure rules give corporate decision-makers incentives only to increase the financial returns of their shareholders, which make their decisions to undertake tax-planning strategies easy to understand. This state of affairs is not "natural" or neutral—it is one that can and should be changed. Requiring public corporations to incorporate more nuanced information about their tax minimization strategies, as outlined above, would facilitate the emergence of a more informed public debate about these issues.

Tax planning is but one of many issues in which disclosure can promote a more accountable corporate political agency. The low costs of producing relevant information and the salience of tax policy issues in contemporary political debates make corporate tax disclosure the easiest to implement and the most straightforward avenue to promote such accountability. All thousand-mile journeys start with a single step, and corporate tax disclosure offers the first step in this one.

V. CONCLUSIONS

The article's proposal aims to better reflect upon corporate tax planning behavior through the lens of political agency. Increased or mandatory tax disclosure would encourage a more sincere and accountable public debate about the impact of corporations' tax-planning activities and, more broadly, about the role of corporate power in a democracy. This article does not encourage controversial behaviors such as tax avoidance and does not offer a substitute for direct methods of tax enforcement regulation. Instead, it provides the framework upon which complicated tax and non-tax political-regulatory decisions could adequately and transparently be made in recognition of an inherent corporate political agency.

This article's main argument is anchored by the notion that, in a democratic society, political decisions should be made by a *well-informed and accountable* body of citizens. The alienation of non-control shareholders from their investments creates political agency costs that conflict with this notion of democratic decision-making. Current corporate law allows portfolio investors to distance themselves from their responsibility over the impact of their investment activities, resulting in managers using the people's money to make political decisions that affect the people. These agency costs have been overlooked by the corporate law and public finance scholarship dealing with tax disclosure.

This article refrains from offering a solution that aims to solve all of these related issues. Instead, it focuses on addressing the problem of corporate political agency by advocating mandatory disclosure, taking the position that what the eye does not see, the heart does not feel. The main objective of this solution is to provide relevant and

¹⁴⁶ Especially given that other companies employed similar strategies. *See supra* note 136.

accessible data to investors (mediated by “professional” actors) about the impact of their investments. The article’s proposal aims to better reflect upon corporate tax planning behavior rather than achieving any specific result. The solution encourages a more sincere and accountable public debate about the impact of corporate tax planning strategies. Therefore, the article’s proposal should not be viewed as legitimizing tax planning or as a substitute for more direct methods of confronting abusive tax planning strategies. Instead, it provides the public debate framework upon which these complicated political-tax decisions could transparently be made.