

**CAN STOPPING 'TAX DODGING' BY MULTINATIONAL ENTERPRISES  
CLOSE THE GAP IN FINANCE FOR DEVELOPMENT?**

**What do the big numbers really mean?**

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## SUMMARY

International debates on taxation and development are increasingly informed by a popular narrative that there is a 'pot of gold' for development funding from cracking down on questionable tax practices of multinational enterprises.

But there are reasons for caution in accepting this narrative at face value, as it is often shaped by misunderstandings and unrealistic expectations. These cloud the perhaps obvious reality that while businesses should pay tax on the profits they make, the potential for countries to raise more from taxing international business is limited by actual level of activity by multinationals (i.e. foreign direct investment (FDI)) in each country, and that changes to the effective tax burden may also have impacts on investment.

There are emerging studies which shed some light on the order of magnitude of the revenues at stake from international tax arbitrage, with recent estimates indicating revenue losses of US\$100-200 billion across all developing and emerging economies. This is by no means an insignificant sum of money, but at around 2% of overall tax revenues in the same set of countries (or very broadly some \$20-40 per person on a per capita basis) it should not be assumed to be a huge amount in relation to the scale of the need for investment in modern healthcare, education and infrastructure. Any potential gains are likely to be higher in middle income emerging economies, and lower in the poorest countries, in line with levels of FDI, although extractive industry rents are likely to offer a significant focus for greater domestic revenues in some countries.

The 'big numbers' and the narrative surrounding them have been successful in raising awareness of the potential of domestic resource mobilization for development, and the issues related to international taxation. However actions should be informed by an evidence-based view of the issues and amounts involved and the priorities of developing countries.

Misunderstandings and distortions in the presentation of evidence contribute to a dynamic of polarised attack-and-defence in the debates between NGOs, business, tax experts and policy makers. It is hoped that a clear analysis of the numbers can help as a step towards developing a more constructive dynamic; one that can support learning and evidence-based action. The paper does not make specific policy recommendations but offers a framework and a set of process recommendations to enhance shared understanding of the emerging evidence.

## 1. INTRODUCTION

The ability of states to mobilize and deploy resources to deliver the foundations of infrastructure, rule of law and public services is at the heart of development. Taxation is both the primary means by which they do this, and is critical to the politics of accountability between state and citizen. It provides a predictable and stable flow of revenue to finance public spending, and shapes the environment in which investment, employment and trade takes place.

Issues of international taxation have attracted wider and more intense interest in recent years, in particular boosted by the outrage the tax affairs most notably of US companies such as Apple, Google and Starbucks that have allowed them to built up stockpile of foreign earnings on which they have managed to pay little tax to date.<sup>1</sup> Zucman (2014) estimates that some 40% of the foreign earnings of US multinationals are retained abroad each year, having paid tax rates as low as 3%. The OECD's Base Erosion and Profit Shifting (BEPS) project is focused on identifying workable ways to better align international taxation to the realities of globalised and mobile business. This in turn has been linked to the search for sustainable sources of finance for development. As the UK Guardian summarised in the lead up to the 2013 G8 Summit:

*“Western governments, still suffering the aftershocks of the 2008 financial crisis, need money to repair their public finances. Voters are angry that the likes of Google, Amazon and Apple are minimising their tax payments – perfectly legitimately – because the global tax system has not kept up with the times. But it is developing countries that are the biggest losers.”*

Work done to date on tax and development by campaigners has had notable success despite limited resources. International NGOs have managed to research a forbiddingly technical topic where there is often sparse data, push it onto the public agenda in their home countries; and advocate for policies such as automatic exchange of information. The attention provided by brand-name scandal, and emergence of grassroots movements such as Occupy and UKUncut perhaps provided an opportunistic boost to these campaigns, even if public concerns were more focused on austerity and tax issues at home. But policy debates about the best way forward remain polarized, and there is little robust analysis, let alone broad consensus as to what long-established proposals such as country-by-country reporting could really deliver.

In a field so fiendishly complex, momentum is driven by a popular narrative. It is commonly believed that there are large amounts of untaxed or undertaxed economic activity in the poorest countries, due to the sophisticated tax planning practices of multinational enterprises, and that addressing this would generate enough funding to achieve key development goals. But there are reasons for caution in accepting this narrative as a self-evident truth, as it is often shaped by misunderstandings and wishful thinking. Numbers used interchangeably have become detached from the explanations and caveats underpinning their research, becoming the source of potent ideas, which add to the polarization and confusion of the debates. The lack of common definitions also makes it difficult for campaigners, researchers, tax practitioners, businesses and policy makers to engage constructively to test assumptions and find common ground for workable solutions.

The aim of the paper is to support the foundations for ongoing research, and for constructive engagement and dialogue between experts, practitioners, researchers and campaigners, by providing a

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<sup>1</sup> The US has a global system of taxation in which earnings from international subsidiaries are taxed at US rates, less any taxes already paid. Earnings reinvested outside of the US are able to defer this tax.

review of the existing ‘big numbers’ that are commonly used (and sometimes misused) and clearing up some of the misunderstandings around them, and then setting out a basic review of ‘what we know’ about the issues of concern.

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This is very much intended as a consultation draft and further comments are welcome and should be sent to [hiyamaya@gmail.com](mailto:hiyamaya@gmail.com).

## 2. CLARIFYING DEFINITIONS AND CONTEXT

### ISSUES

This paper is focused on tax losses (mainly in relation to corporate income tax) to developing countries from the behaviour, and associated rules related to multinational enterprises. One of the challenges in understanding issues and numbers in this area is that there is a tendency to aggregate a wide set of issues and tax payer behaviours into a single bundle – popularly labelled ‘tax dodging’ or ‘tax cheating’<sup>2</sup>, or in more formal analysis as ‘tax related illicit flows’ (Hearson, 2014). The concerns that may be included under this heading in practice range from theft of public assets to legally using tax incentives, while the tax payers involved include foreign multinationals, domestic multinationals, domestic companies and state owned enterprises. While there are many legitimate questions and debates about the design of tax policy, and about expectations of corporate responsibility, presenting a wide spectrum of behaviours under a single heading presents an unnecessarily blurred target for understanding the issues at stake, and the potential policies and standards to address them.

Unpicking the bundle, it is generally understood the issues and behaviours occupy a spectrum between illegal and legally condoned behaviour (See for example Beloe, Lye and Murphy, 2006 and Hearson, 2014). While there is broad recognition of the two ends of the range, the middle section is characterised by confusion and disagreement, and in some cases genuine legal uncertainty. Tax law is vulnerable to abuse through the creation of complex corporate vehicles, off-setting transactions, and other elaborate devices to “shelter” income. Accordingly, the courts, tax tribunals or commissions have the power to decide on a case-by-case basis whether a taxpayer is complying with “what the law demands” (Messick, 2014). Some argue that the critical dividing line in determining acceptable behaviour should not relate to whether taxpayer behaviour is in compliance with the law, but whether they are able to ‘play the system’ to reduce their taxes to a level below that which is socially and morally acceptable. However, there as yet no clear and agreed standards to define what this means in practice, and descriptors such as ‘artificial’, ‘against the spirit of the law’ or ‘aggressive’ lack detailed definitions and boundaries (Lewis, 2015). Devereux, Freedman, and Vella (2012) argue that the courts in most jurisdictions give effect to the intention of their legislatures through purposive interpretation and anti-abuse rules. Invoking some kind of ‘spirit’ of the law which goes beyond this to apply the law the revenue authorities or others think should have been enacted, rather than that which was passed takes us into dangerous territory. In that situation, where there is a then there is a defect in the legislation, the most efficient course of action and that consistent with the rule of law is to improve the specific legislation or to improve the general anti-avoidance provisions and principles. Following on from this analysis, Devereux et al distinguish between ‘ineffective avoidance’ which can be prevented, provided it is discovered and ‘effective avoidance’ which cannot be prevented without a change in legislation – this would then fall into the category of tax planning unless the legislation is strengthened to remove the opportunity (Devereux et al, 2012).

While this paper does not seek to resolve these differences or establish universal definitions, it offers a basic a framework of four descriptive categories for the issues of concern, with which to better understand the issues and big numbers which inform this debate:

1. **Evasion/illegality/corruption:** For example hiding payments, underreporting revenues, making corrupt side payments.

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<sup>2</sup> See for example: <http://www.taxjustice.net/faq/>

2. **(Potentially) ineffective avoidance:** Pursuing opportunities to reduce taxes which are at high risk of falling foul of legislation, such as using marketed tax avoidance schemes or setting transfer prices at barely defensible levels.
3. **Tax planning/effective avoidance:** Structuring a business in ways that may have tax advantages, but which remains low risk in relation to legal challenge.
4. **Uptake of incentives:** Pursuing opportunities to reduce taxation that have been explicitly intended by legislation through undertaking the behaviours encouraged (e.g. using capital allowances or setting up a factory in a Special Enterprise Zone).

Within each of the four categories, taxpayer behaviour may involve purely domestic entities and transactions, or cross-border business.

The first category can be defined by its dependence on secrecy; concealing payments and hiding the true nature of business transactions or relationships – businesses may be thought of as ‘ghosts’ (invisible to the tax authorities) or ‘icebergs’ (hiding a substantial proportion of their true size). It may involve complex structures and transactions but can be more straightforward through undeclared cash income, or the complicity of tax officials. The second category of potentially ineffective avoidance does not necessarily entail secrecy, but may involve complex structures (although it can also be quite simple – such as deciding which country to locate a branch in or transferring share ownership to a spouse).

The third involves compliance with tax rules, which while intended by legislation in one country may have negative impacts in another. Many of the fiercest arguments about international tax reforms to prevent ‘base erosion and profit shifting’ thus concern structures and transactions that are in the legal tax planning category.

#### **Box 1: International Corporate Tax Planning: Tools of the Trade**

- **Abusive transfer pricing**—(stretching, violating or exploiting weaknesses in the arm’s-length principle) is often raised as a concern, ranging from potential mispricing of natural resources to the transfer of IP rights to low tax jurisdictions early in their development, when they are hard to value verifiably.
- **Taking deductions in high-tax countries...**—by, for example, borrowing there to lend to affiliates in lower-tax jurisdictions;
- **...and as many times as possible**—passing on funds raised by loans through conduit companies (ones, that is, serving solely as intermediaries within a corporate group) may enable double dipping—taking interest deductions twice (or more), without offsetting tax on receipts—leading to thin capitalization (high debt ratios).
- **Risk transfer**—conducting operations in high tax jurisdictions on a contractual basis, so limiting the profits that arise there.
- **Exploiting mismatches**—tax arbitrage opportunities can arise if different countries classify the same entity, transaction, or financial instrument differently.
- **Treaty shopping**—treaty networks can be exploited to route income so as to reduce taxes.
- **Locating asset sales in low tax jurisdictions**—to avoid capital gains taxes.
- **Deferral**—companies resident in countries operating worldwide systems can defer home taxation of business income earned abroad by delaying paying it to the parent.
- **‘Inversion’**—companies may be able to escape repatriation charges or CFC rules by changing their residence.

[Source: IMF (2014). IMF Policy Paper Spillovers in International Corporate Taxation. Washington DC: IMF]

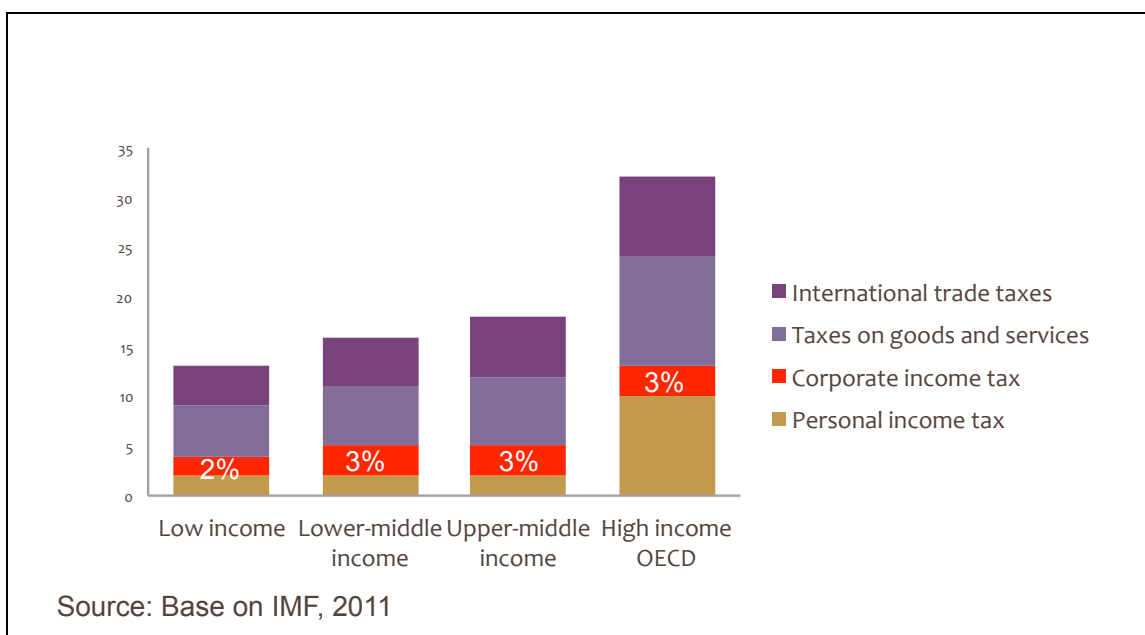
Other issues of legal behaviour include lobbying for and using tax incentives, which while legal, may not be economically effective, offering windfalls to companies that would have invested anyway (Hearson, 2013).

## CONTEXT

Overall domestic revenues are rising in developing countries (amounting to US\$7.7 trillion in total).<sup>3</sup> However for many countries the levels are still far below what would be needed to deliver comprehensive public services (for example annual per capita revenues amount to \$32 in Ethiopia and US\$62 in Bangladesh, rising to \$600 in upper middle income countries like China and Colombia).

While the main reason for low tax revenues is low per capita income, developing countries also tend to have low tax-to-GDP ratios (20% or less compared to upwards of 30% in developed countries), which have risen only slowly despite economic growth. There is acknowledged potential to raise taxation by several percentage points (Le et al, 2012 and Fenochietto and Pessino, 2013). However as the figure below shows, only a small proportion of the difference between developed and developing country tax ratios is due to lower contribution of corporate taxes, with the greatest different being in personal taxation.

**Figure 1: Taxes as proportion of GDP**



Developing country governments tend to rely on a narrow tax base of a few large formal sector business (including multinationals and often the extractive industry). As Action Aid (2013) notes “*In developing countries corporate income tax often represents a high proportion of taxation from a small number of taxpayers: the largest companies*”.

UNCTAD reports that in developing countries the taxes paid by international businesses (including corporate tax, natural resource royalties, trade and property taxes) represent some 23% of taxes on business and 10% of total tax revenues, compared to around 15% and 5%, respectively in developed

<sup>3</sup> There is no single established criteria for the designation of “developed” and “developing” countries, but broadly for statistical purposes the UN officially divides the world into developed and developing regions. Developed regions are Northern America, Europe, Japan, Australia and New Zealand, and everywhere else is considered developing. This overlaps with the World Bank categories of low income, low-middle-income and upper-middle income countries.



countries. (Bolwijn, Casella and Rigo, 2015).<sup>4</sup> This pattern is also illustrated by figures reported on an ad hoc basis for example;

- In Zambia a few large enterprises account for the majority of tax revenue (60-70% of total tax revenue) (Fjeldstad & Heggstad, 2011).
- In Tanzania the 400 largest taxpayers account for 70% of domestic revenues (Katillya, 2011).
- In Rwanda micro, small and medium-sized enterprises make up 98% of tax payers but only provide 3% of the revenue. 70% of taxation comes from multinational enterprises and 0.3% of taxpayers pay 48% of the tax authority's revenue (Rwanda Revenue Authority, 2009).
- Nigeria reported that MNEs represent 88% of the county's tax base (ATAF, 2014).
- Burundi has stated that one MNE taxpayer contributes nearly 20% of the country's total tax collection (North South Institute, 2010).

Ensuring that businesses, including international businesses pay tax is clearly an important part of domestic resource mobilisation. However it is just one of a number of challenges and limitations to raising the level of tax revenues. Other factors include low absolute incomes, large informal sectors and low rates of collection of tax on domestic incomes such as personal taxes on professionals and property owners (Moore, 2013). Furthermore, domestic tax sources are likely to be more robust, give a wider tax base and links citizens to the political process. However broadening the national tax base depends on a difficult process of building institutions, capacity and trust.

The critical question, then, for national governments, and for international cooperation, is how best to raise domestic revenues in ways that are conducive to economic growth, poverty reduction and good governance.

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<sup>4</sup> This overall estimate depends on assumptions about what percentage of individual taxes are paid by multinationals which have been questioned, with the suggestion that UNCTAD may have been overgenerous in their assumptions (Cobham, 2015).

### 3. UNPICKING THREE IDEAS

Multinational corporations should pay tax on their economic activities in the places where they do business. There are good reasons to tax corporate profits: corporation tax was originally designed as a down-payment on the taxation of investors, to prevent people avoiding or deferring their personal incomes through incorporation. It also does double duty as a tax on location-specific economic rents in the places where a company does business. Corporation tax is an attractive source of revenue, as its sources are concentrated and accessible making it relatively straightforward to administer, and because of the distributional rationale of taking money from shareholders who, while they include ordinary pension-holders nevertheless tend to be amongst the better-off in society. In particular corporation tax applied to the profits of inward foreign investment are seen as a means to effect a transfer from rich-world shareholders to developing country governments (Shaxson, 2015).

However, discussions on the potential for developing countries to collect more corporation tax from inward investors are often underpinned by a set of received wisdoms and popular beliefs which, while based on real concerns and issues, do not reflect the reality of the challenges and dilemmas for tax policy makers, administrators and tax payers. This section looks at three received wisdoms, and considers the extent to which they are oversimplified versions of more complex truths:

1. **Huge amounts** are at stake from addressing tax avoidance, which would be problem-solving in relation to the budgets and development needs of the poorest countries.
2. **Transfer pricing** allows almost unlimited scope to shift profits and avoid paying taxes.
3. Governments of developing countries could raise significantly more tax from existing FDI profits at **no cost to ordinary citizens**.

These statements are of course somewhat stylised, although as the quotes and examples below illustrate they are all often seen as ‘sightings in the wild’. This paper does not take a view on whether they directly reflect the opinion or position held by any particular individual or organization, but nevertheless they are a set of perceptions which are often given and reinforced by the overall flow of media reports, infographics, press releases, case studies and campaign publications on this topic and are influential enough to require clarification.

#### IDEA 1: ‘HUGE AMOUNTS’

***The amounts of money involved in tax avoidance and exemptions by MNEs are problem-solving in relation to the budgets of developing countries, and the development needs particularly of the poorest countries.***

***“If we tackle tax dodging by big business, we can fund free, quality healthcare & education for all.”*** Global Alliance for Tax Justice, Share-graphic 2015.

***“Clearly, massive reductions in existing human rights deficits could be achieved by allowing poor countries to collect reasonable taxes from multinational corporations and from their own most affluent nationals, assuming the resulting revenues were appropriately spent.”*** – Thomas Pogge (2015) How Are Human Rights and Financial Transparency Connected?

*“Multinational tax dodging is the main reason why developing nations stay aid-dependent.” (Interpress Service, 2011)<sup>5</sup>*

There are significant uncertainties and methodological difficulties in assessing the amounts of potential government revenue lost to tax avoidance and tax exemptions. And further difficulty in assessing the potential additional amounts that could be collected through particular policy change, given the costs of administration, as well as the behavioural effects. An emerging cluster of estimates (discussed further in section 4) put the overall revenues at stake, across all developing and emerging economies very roughly at around US\$100 - 200 billion. On a per-capita basis this is around US\$20-40 per person per year, which while it is not insignificant in relation to existing government budgets particularly in the poorest countries, is clearly an inadequate amount compared to the cost of healthcare, education and infrastructure provision.

However, it has often been assumed that the sums at stake are much greater than this; trillions of dollars overall, or that they are concentrated on the poorest countries suggesting a greater impact potential. In part this arises from a mismatch between the popular understanding of the term ‘developing countries’ (which people tend to associate with least developed countries) and the official statistics where newly industrialised countries or emerging economies such as Brazil, Mexico, China and South Africa tend to contribute the largest economic aggregates.

In many cases these misunderstandings are reflected in, and reinforced by more explicit misinterpretations which tend to inflate existing tentative estimates by between 5 and 25 times:

- **Wrong countries** – For example at the Africa Rising Conference in Maputo in 2014, Oxfam CEO Winnie Byanyima said that countries in **Africa lose \$242 billion to corporate income tax exemption and unpaid taxes annually.**<sup>6</sup> This figure was also reported in the African media. This figure appears to be a mistake based on estimates which relate to developing countries as a whole (Hearson, 2013 and Action Aid, 2013), of which perhaps 5% relates to countries in sub-Saharan Africa.<sup>7</sup> Similarly Christian Aid’s estimate of US\$160 billion lost to corporate tax evasion is also widely misinterpreted as relating to the poorest countries.
- **Wrong numbers** – One approach to estimating the lost tax revenue losses associated with manipulations in international trade is to draw on estimates of the amount of profit illicitly shifted across borders. The tax due is then estimated as some fraction of the gross amount of profits shifted. There are methodological difficulties in estimating both numbers.<sup>8</sup> But what is clear is that the larger number should not be interpreted as a tax revenue loss. However often it is. For example one widely reported example is the statement by the Africa Progress Panel in 2013 that **\$38 billion dollars is lost from tax revenue in Africa due to profit shifting.**<sup>9</sup> In fact this was a misunderstanding of an estimate of gross illicit flows (Forstater, 2013). Many other reports appear to confuse (or allow for confusion) of illicit flows with tax revenue losses (For example see Lomborg, 2014). The report ‘Honest Accounts? The true story of Africa’s billion dollar losses’ (Sharples, Jones and Martin, 2014) reports that **“Africa is being drained of \$58 billion a year, money that could be spent on essential health care, education and clean water for its people”**, reflecting a common conflation between capital flows and public spending.

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<sup>5</sup> <http://www.ipsnews.net/2011/11/europe-developing-nations-lose-billions-to-multinational-tax-dodging/>

<sup>6</sup> <https://blogs.oxfam.org/en/blogs/14-05-30-africa-rising-time-fairer-deal-all>

<sup>7</sup> One element of the total is an estimate of US\$138 of revenue forgone through tax exemptions by developing countries. Of this the original author states that US\$8 billion relates to Sub-Saharan Africa (Hearson, 2013).

<sup>8</sup> See page 20 for discussion

<sup>9</sup> Also see for example <http://www.bbc.co.uk/news/world-africa-23965543> and <https://euobserver.com/social/122484>

- **Wrong tax payers** – Often estimates relating to one area of taxation are conflated with others. The figure that **US\$1 trillion is lost through tax avoidance and evasion in Europe** has been widely quoted by the NGO Eurodad (2013) and the ETUC (2015) and used by Herman Van Rompuy, President of the European Council (2013) , Jose-Manuel Barroso, European Commission President (Euronews, 2013) and as part of a European Commission communications campaign (European Commission, 2014). It is often used to illustrate the scale of the impacts of tax havens, international capital flight and complex tax avoidance, and the unwary reader might therefore assume that this is what it refers to. However the original study from which this number is drawn (Murphy, 2012) mainly relates to *tax evasion* in the shadow economy – such as underpayment of taxes through unregistered cash-in-hand businesses. It only includes a guesstimate of tax avoidance in Europe at US\$150 billion.<sup>10</sup> An equivalent figure – **US\$3.1 trillion** has been calculated at a global level by the Tax Justice Network (2011), and has been similarly misinterpreted in the media as relating to international tax *avoidance* (For example in the Guardian 26.5.15)<sup>11</sup> This is also the case on findings of tax losses related to illicit flows mentioned above, for example the findings of the recent African Union/UNECA report on the High Level Panel on illicit flows from Africa ‘Track it! Stop it! Get it!’ (UNECA, 2014). This uses estimates which relate to trade misinvoicing (by related and unrelated companies, including state owned enterprises) – however it has been widely interpreted as relating squarely to abuse by multinational corporations (see for example Oxfam, 2015).
- **Wrong time period** – Often estimates are aggregated over multi-year time periods to produce impressively large numbers, which are harder to contextualize than annual figures. In some cases these multi-year estimates are then compared to annual spending, creating inflated perceptions of scale (for example see Box 2 below on the recent Action Aid report on Paladin Mining in Malawi).

### Box 2: An Extractive Affair?

A recent Action Aid report ‘A Extractive Affair’ on the tax affairs of Australian uranium miner Paladin Energy in Malawi compared an estimated tax loss to the government from reduced royalties and withholding taxes, with the cost of HIV medication and the salaries of nurses, doctors and teachers:

***“Paladin – just one company cut its tax bill by US\$43.16 million in Malawi.  
In one year this could have paid for one of the following:  
431,000 HIV/AIDs treatments, 17,000 nurses, 8,500 doctors, 39,000 teachers”*** (Action Aid, 2015)

These headcounts of professional salaries are arresting; representing some 3 times the current number of nurses and over 20 times the number of doctors in the country according the Action Aid’s figure.<sup>12</sup> If taxing ‘just one company’ more could deliver so much for education and health provision imagine the potential across the whole economy.

<sup>10</sup> The main part of this estimate involves multiplying tax revenue as a % of GDP by the estimated size of the shadow economy in each country, based on estimates from a World Bank working paper which uses the ‘MIMIC’ model for assessing the size of the shadow economy . However the underlying estimates on the shadow economy are not viewed as not robust. Furthermore, estimates of the scale of the shadow economy appear to be gross volumes, rather than value added, suggesting that the tax implications are overestimated by calculations which assume that this whole amount could be added to official GDP and taxed accordingly. What data there is suggests that the shadow economy largely relates to informal sector; unregistered cash in hand activity.

<sup>11</sup> <http://www.theguardian.com/global-development/2015/may/26/clamping-down-tax-avoidance-unlock-billions>

<sup>12</sup> Author’s calculations based on figures given in the Action Aid report

However these comparisons are easy to misinterpret. Firstly because they compare an estimate for *six years* of tax revenues with *annual* salary costs, but also because Malawi needs funding in all four areas; for doctors, nurses, teachers AND healthcare supplies (as well as other areas of public spending). Comparing six years worth of potential tax revenues with the annual costs of 4 different spending options gives an inflated impression of what it could pay for, by a factor of 24 (6 x4). Notwithstanding the question of whether the US\$43 million figure is meaningful, more realistically it might be thought of as potentially supporting the annual costs of 18,000 HIV treatments, 700 nurses, 350 doctors AND 1,600 teachers. This equates to treatments for 2% of people living with HIV, 0.04 extra nurses per 1000 people (a 10% increase), 0.02 doctors (a 100% increase) and 3 extra teachers per 1000 school age children (potentially reducing class sizes from 130 to 100).<sup>13</sup>

Moreover Paladin's Kayelekera Uranium mine is one of very few large FDI projects in Malawi, rather than the tip of an iceberg. It has been loss-making to date and is currently shuttered as unprofitable due to a fall in uranium prices, suggesting that the idea that it could have easily yielded an additional US\$43 million may be wishful thinking. The presentation of this example contributes to an exaggerated impression of the potential for increasing social spending from taxing FDI profits in Malawi.

Tax loss estimates are often compared to aid volumes or to calculations of development finance needs at an aggregate level, which also tends to exaggerate their scale (see Box 3); giving the impression that potential taxes that relate to the economies of large emerging economies can be applied to the public budgets of much smaller and poorer economies. (Examples include Oxfam's statement that US \$100 billion would be almost enough to get 'every child into school four times over', and the ONE Campaign's statement that 3.6 million deaths could be prevented each year in the world's poorest countries).<sup>14</sup> Similarly at a regional level, wide estimates are compared to the development finance needs of the poorest economies within them – for example Oxfam calculated US\$11 billion of tax losses in Africa and compared this to the healthcare funding gap in Sierra Leone, Liberia, Guinea and Guinea Bissau (Oxfam, 2015) – in fact this estimate largely relates to Nigeria, Egypt, South Africa and Morocco.<sup>15</sup>

The tendency to rhetorically apply estimates of potential tax revenues mainly for large emerging economies to the public budgets of least developed countries is not confined to NGOs. Most recently World Bank's MD Sri Mulyani presented UNCTAD's estimate of US\$100 billion lost to tax avoidance through thin capitalisation across all developing countries with these examples:

***"For the schoolchild in Haiti, the new mother in Malawi, or the farmer in Bangladesh, these losses have a real impact: They result in classrooms that are overcrowded, health clinics that are never built, and water that is never delivered.***

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<sup>13</sup> Author's calculations based on figures given in the Action Aid report

<sup>14</sup> Another methodology which appears to inflate development impacts of projected tax gains, without simply applying sums from larger countries to the budgets of smaller countries, is the child mortality analysis used in Christian Aid's Death and Taxes report (2008), which found that trade related tax evasion 'costs the lives of 1,000 children a day'. The methodology uses a fixed effect regression to calculate the correlation within countries between tax/GDP and mortality rates. However as tax/GDP ratios reflect the general administrative capacity of the state and have tended to rise slowly, at the same time as GDP levels have been rising rapidly it seems a stretch to conclude that this regression captures the impacts of tax/GDP as an independent variable which could be applied to a small tax rise achieved through an international policy shift.

<sup>15</sup> <http://www.cgdev.org/blog/talking-about-tax-taxing-pretending-it-simple-will-hurt-poor>

*People's opportunities are being stolen from them – because tax revenues are not collected.*<sup>16</sup>

Collectively these misunderstandings have the result of presenting broad, general and fairly modest economic estimates as if they represented specific, concentrated large amounts available to the poorest countries. Such unrealistic expectations cannot be sustained by any program of action, and as mental benchmarks undermine the ability of the public, media and civil society organisations to evaluate real proposals and progress in achieving domestic and international tax reforms, as well as in considering implications for other aspects of development finance.

**Box 3: 'Three Times More than Aid'**

*Tax dodging by multinational companies costs developing countries 3 times more than they receive in aid (Action Aid Fact File).*<sup>17</sup>

One of the most widely quoted figures on tax and development is that *“developing countries lose to tax havens almost three times what they get from developed countries in aid.”* This comes from a Guardian op-ed written by the OECD's Angel Gurría in 2008. It is seen as authoritative because of the source, although there are no further details about way that it was calculated. A statement by Jeffrey Owen, then Head of the OECD Centre for Tax Policy and Administration gives some clarification indicating that it was intended to relate to tax losses from citizens holding undeclared assets offshore, not to corporate accounting practices at all; *“many citizens of developing countries now have easy access to tax havens and the result is that these countries are losing to tax havens almost three times what they get from developed countries in aid”* (Owens, 2009).

As with other aggregate figures it appears to be based on a comparison between an estimate of tax avoidance related to all developing and emerging economies, and aid receipts which are concentrated on a subset of these countries (for example China in 2012 received around 0.1% of international aid according to OECD DAC statistics, but as the world's second largest economy will tend to contribute a large amount to any measures based on economic aggregates). It would be a mistake to assume that from this ratio that for individual aid dependent countries there is a sum that is three times greater than aid at stake from taxing FDI or offshore assets.

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<sup>16</sup> <http://www.worldbank.org/en/news/speech/2015/04/17/speech-wb-md-coo-sri-mulyani-event-tax-evasion-development-finance>

<sup>17</sup> <http://www.actionaid.org.uk/tax-justice/ftse-100-tax-haven-tracker-the-new-data>

## IDEA 2: TRANSFER PRICING IS TAX DODGING

***Transfer pricing rules allows MNEs to import goods at hugely inflated prices and export commodities at a fraction of their true value: Addressing transfer mispricing by multinationals would generate large volumes of public revenues in both their home countries and the places where they do business.***

***“Many multinational corporations launder profits earned in developing countries by importing goods at hugely inflated prices and exporting commodities at a fraction of their true value. They do this through paper subsidiaries in tax havens, providing them with a significant tax advantage over their nationally based competitors and fleecing governments of tax revenue”.***

Christian Aid (2005)

Transfer pricing is perhaps the most widely misunderstood concept in international tax debates. It is often described (perhaps as a shorthand) as being synonymous with pricing fixing, and abusive profit shifting. For example Paul Collier (2013) describes it as ***“a well-established method of avoiding paying tax”***, James Boyce and Léonce Ndikumana (2014) define it as ***“the manipulation of prices assigned, for accounting purposes, to intra-firm trade in goods and services so as to park corporate profits in low-tax (or no-tax) jurisdictions.”*** Tax Justice Network report highlights with concern that in a survey assessing the economic practices of multinational corporations, ***80 per cent acknowledge that transfer pricing remains central to their tax strategy*** (Tax Justice Network Africa, 2011).

Engaging in transfer pricing is a compliance obligation for businesses that have branches, subsidiaries or other connected companies in more than one country. Taxation rules in OECD countries, as well as most emerging and some developing countries require that companies apply a fair price for goods, services and interest when making transactions amongst its different entities. Usually the standard applied is some version of ‘arm’s-length pricing’ (i.e. the price that would be paid if the company was buying or selling on the open market).

As global value chains have become increasingly complex, the tension between source and residence taxation (i.e. between taxation accruing to the government in the place of business, or in the source of capital) has multiplied, as many different places of business (R&D, extraction, manufacturing, management, brand management, marketing) contribute to the ultimate realisation of profits (Devereux and Sørensen, 2006). Even in a domestic context it is not always easy to price goods and services. Allocating costs across products, or cost centres, is more of an art than a science. There can be considerable scope in practice for companies to structure their operations, management of IP and borrowing costs to allocate costs and revenues in a way that reduces their taxable profit overall (KPMG, 2008). Even if not actively reducing tax, companies tend to respond to the disparity in transfer pricing expertise and capacity between the revenue authorities of different countries by taking care to avoid the risk of transfer pricing disputes with the most aggressive and powerful revenue authorities, which can lead to companies apportioning greater profits to developed countries, even if it doesn’t reduce their tax bills overall.

Concern about transfer pricing focuses on both home and source countries. For example the NGO Citizen’s for Tax Justice in the US views the low tax rates paid by companies such as Apple, Google, Nike, Pepsico as taxes lost to the US treasury (Phillips et al, 2014) while in the UK Vodafone and Barclays have faced criticism that they are not paying enough UK tax on overseas profits. At the same time it is also argued that multinationals are dodging taxes in source countries; such as criticisms raised of SAB Miller in Ghana, Google in the UK, McDonalds in Europe and Associated British Foods in Zambia.

While there are real issues here, it appears that often inflated expectations of the levels of undertaxed profits within value chains. A hypothetical worked example provided by the Tax Justice network highlights this thinking; assuming that any difference between export and import price is pure profit: *“Let’s say it costs a TNC \$1 to produce a bunch of bananas in Ecuador. It can sell it for \$10 in Germany. Here’s how the TNC cuts its tax bill. The Ecuador affiliate sells the bunch to an affiliate of the TNC in a tax haven for \$1. The tax haven affiliate sells it to the TNC’s German affiliate for \$10. The German affiliate sells it to a German supermarket shop for \$10, the true market price in Germany. So what happened here? The Ecuador subsidiary had costs of \$1 and sold at \$1, so its profits – and therefore its tax bill – are zero. The German subsidiary bought at \$10 and sold at \$10, again for zero profits and zero taxes. But the tax haven subsidiary bought it \$1 and sold at \$10, for \$9 profit. But the tax haven doesn’t tax profits, so the tax bill is zero there too!”*<sup>18</sup> Sikka and Willmott (2010) also use the banana supply chain (with more realistic numbers drawn from an investigation by the Guardian) to argue that activities carried out by subsidiaries in tax havens are without economic substance and therefore represent profits shifted out of either producer or consumer countries. However, while the reported location of those activities might create tax benefits, it cannot simply be assumed that the activities themselves; financing, marketing, ripening, quality control, transport and insurance in the case of the banana trade are fictitious costs in getting bananas to market in good condition.

There are legitimate and contentious questions about where the profits generated within more complex international value chains should be taxed. For example it might be argued that Apple should be making more retail profit in Europe, its second largest region for sales, or more manufacturing profit in China where it assembles its products, or more entrepreneurship profits on its international business in the US HQ where it designs its products, raises finance and manages strategy. But it should not be assumed that the profits to be divided amongst these jurisdictions can add up to more than overall economic margin on the business of inventing, producing and selling iphones.

However this is precisely the expectation that has underpinned some of the most often cited cases of large-scale endemic transfer mispricing. For example a study by Christian Aid (Hogg et al, 2010) found that despite Zambian copper prices being in line with the London Metals Exchange prices **“if Zambia had received the price for its copper that Switzerland declared on re-exporting the exact same copper, then Zambia’s GDP would have nearly doubled”**. This was seen as an example of the scale of corporate trade mispricing driven by tax avoidance, and has been quoted widely (for example it features in the film *Stealing Africa*). However the methodology is unreliable as it extrapolates prices declared on even very small re-exports which are way above world prices for logistical reasons (such as a single shoe box full of copper ore posted from Switzerland) as evidence of the ‘true price’ of much larger shipments which are sold at world prices (Forstater, 2014).<sup>19</sup>

Another example, where a product with a known low value is assumed to hide a much higher level of profit shifting is the ‘US\$973 bucket’ a case illustration that is often presented as representing a clear cut case of tax abuse by a particular multinational firm. It seems to indicate that the gains from addressing transfer mispricing are several times greater than the economic profit that could be possible from considering the underlying value of a basic export product.

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<sup>18</sup> <http://www.taxjustice.net/topics/corporate-tax/taxing-corporations/>, a similar example is included in ‘The Dark Side of Transfer Pricing: Its Role in Tax Avoidance and Wealth Retentiveness (Sikka and Willmott, 2010).

<sup>19</sup> Alex Cobham and co-authors have recognised these problems with the methodology, also used for the wider analysis *Swiss-ploitation? The Swiss Role in Commodity Trade* (Cobham, 2013). and have withdrawn their initial conclusions from it <http://www.cgdev.org/blog/how-much-are-developing-countries-losing-commodity-mispricing-really>, however Christian Aid maintain that despite this it ‘provides a stark illustration of the potential damage of mispricing’ <http://www.christianaid.org.uk/pressoffice/pressreleases/comment/christian-aid-research-on-commodity-trading-via-switzerland.aspx>



#### Box 4: The \$973 bucket and the 50 pence fridge

- “Would you buy any of the following? How about plastic buckets from the Czech Republic at \$973 each.... you won’t find such dodgy prices in your local market, but these are the actual prices charged by some of the world’s biggest multinational corporations, all authorised by some of the best accountants, and by political friends in high places. Their game is to shift the tax burden onto somebody else. It is played through ‘transfer pricing’” – **Tax Justice Network** (Sikka, 2003)
- “*Transfer Mispricing*: Research conducted by Simon Pak and John Zdanowicz found that US corporations used manipulated pricing schemes to avoid paying taxes. For example, one appeared to import plastic buckets from its subsidiary in the Czech Republic for US\$ 972.98” – **Eurodad** (Ruiz and Romero, 2011)
- “A 2002 study by Trade Research Institute [...] found American firms buying plastic buckets for \$973 each and tweezers for \$4,896. By overpaying or overcharging its foreign affiliates, a company can spirit losses and profits from one part of the world to another” – **The Economist** (2005)
- “Examples of mispricing are plastic buckets bought by a subsidiary in a developing country for US\$973 per bucket from another subsidiary in a tax haven. A more realistic price paid on the open market would have been around one dollar. The rest of the price paid is just a way to shift profit to the subsidiary in the tax haven where less tax is paid.” – **Forum Syd** (Fröberg and Waris, 2013)
- “African invoice fraud hampers development of poorest nations[....]It means that importers pretend to pay more for goods than they actually pay and the extra money is slipped into offshore bank accounts. In one notable case an American company invoiced for plastic buckets at \$972 each.” – **The Guardian** (Neate, 2014)

The evidence for the \$973 bucket does not come from a particular business that was caught at mispricing, but from a record in the monthly official trade data looked at by Pak and Zdanowicz (2002). A more parsimonious explanation of the US\$973 bucket and the other similar examples is that they reflect mistakes in recording the quantity of items (for example the price of a shipment of toothbrushes being misclassified as the price of a single toothbrush – see discussion in Eden, 2012).

Another example is given by Christian based on Pak’s analysis that in 2007, over 60 million fridges were imported from China to Spain at a cost of under 50 pence each. This, they believe resulted in €8.08 billion (£5.53bn) being shifted out of China.<sup>20</sup> Carter (2009) provides a reality check on this case, suggesting that it would be highly unlikely that such a huge jump in the number of fridges bought could go unnoticed, given that usually consumers in a country like Spain buy around 1.5 million fridges a year, while China’s main white-goods manufacturer produces around 12 million. He points out that the anti-dumping duties being levied at the same time, on just a few hundred thousand much less steeply discounted fridges from South Korea, are another reason to doubt that such an enormous jump in shipments of massively discounted fridges could go unnoticed.

Examples like the \$973 bucket and the 50 pence fridge have been widely cited as prime illustrations of the behaviour of multinationals (for example Sikka, 2003, Baker, 2005, Christian Aid, 2005, Eurodad, 2008 and Somo, 2008, as well as in the media). What is striking about these cases is that they are so different from the actual transfer pricing cases that make it to court, and yet they are interpreted as signs of massive fraud by multinational companies. Trade data is freely available online and anyone can make these calculations. Yet if they reflect real trade volumes rather than data glitches it suggests a

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<sup>20</sup> <http://www.christianaid.org.uk/pressoffice/pressreleases/march2009/revealed-true-cost-global-tax-dodging.aspx>

total lack of confidence in the ability of national tax administrations to spot and tackle what would appear to be egregious abuse.

Another belief that underpins the perception that addressing transfer mispricing holds out large promise for closing development finance gaps, is the much quoted statement that **“60% of global trade takes place within multinationals”**. This quote has been repeated so often that it has gained the status of unquestioned truth and appears to suggest a massive shadowy underworld of intra-firm trade, with almost unlimited scope for transfer mispricing. The quote is often attributed to the OECD (who have indeed used it), but it seems to be based on a misunderstanding of an UNCTAD report (see box 5, below). Actual estimates put the figure closer to 30% and note that this is mainly concentrated on trade between affiliates within developed countries.

**Box 5: ‘60% of Global Trade is Within Multinationals’**

UNCTAD’s 1999 World Investment Report states that ‘TNCs account for two thirds of world trade’. This includes *both* intra-firm trade, and trade with customers and suppliers – however it has been widely misquoted and repeated as indicating that 60% of global trade is intra-firm trade *within* multinationals.

Patterns of intra-firm trade (i.e which would involve transfer pricing) are closely linked to patterns of foreign direct investment (since it must involve an affiliated company at both ends of the trade), and mainly take place within the OECD where multinational companies’ affiliates are concentrated. Sourcing along supply chains such as in the food, apparel and electronics industries is generally not intra-firm trade, since production is carried out by independent suppliers (intra-firm trade *does* take place in these supply chains between the sourcing and distribution hubs of the firm; such as from a production office or sourcing hub in the Netherlands to a retail operation in the UK– but this does not impact on the taxable profitability of garment manufacturing in Bangladesh or coffee growing in Kenya for example).

A recent report by the OECD says that intra-firm trade accounts for 30% of trade in goods and services in the US and France, mainly with other OECD countries. Canada, Poland and Sweden also have a high share of intra-firm trade (Lanz and Miroudot, 2011). UNCTAD also puts the global share of intra-firm trade at 30% (some US\$6 trillion). Major sectors include pharmaceuticals, automobiles and transport equipment (UNCTAD, 2013).

Emerging economies have lower, but rising levels of intra-firm trade both through foreign invested exporters, inward investment to serve domestic consumers and their own multinationals. In lower income countries intra-firm trade tends to be concentrated in the natural resources sectors such as oil, gas and mining, forestry and in some cases agriculture where there is investment by vertically integrated multinationals.

### IDEA 3: MONEY FOR NOTHING

***Multinational corporations could easily pay more tax at no cost to ordinary citizens either in developed or developing countries.***

***“Tax-sensitive investment is by definition the least useful stuff: accounting nonsense and paper shuffling that does not involve very much employment creation at all”*** (Tax Justice Network, 2015)

Examples of this belief are rarely seen as direct statements but often reflected in the implicit assumptions behind calculations of lost taxes – where it is taken for granted that any changes in the effective tax rate would have no behavioural impact on investment (as in the presentation of the case of Paladin in Malawi, outlined in Box 2 above).

While shocks to corporation taxes on sunk investments are undoubtedly passed on to shareholders, longer run dynamic effects of expected tax costs impact on projections of the ‘net present value’ for new investments. If effective tax rises (or uncertainty about taxation) deter subsequent investment, this reduces wages for workers and potentially also raises prices for consumers. We do not know the exact balance of tax incidence between shareholders, workers and consumers, but estimates suggest that, because capital tends to be more mobile than workers or consumers, a significant portion is shifted to domestic factors – and especially labour, and that this effect is more pronounced for smaller economies (Gentry, 2007; OECD, 2010). Like other aspects of the investment climate, the level of sensitivity to tax rates will likely varies between firms, industries, and locations (World Bank, 2005). Certainly the prospect that effective tax rises will have behavioural effects should not be dismissed out of hand, even if there are large uncertainties in assessing them.

Corporate income tax is generally seen as amongst the most damaging taxes for growth. Looking at the new International Centre for Tax and Development dataset, McNabb and LeMay Boucher (2014) find evidence of negative impact of corporate tax on economic growth in developing countries. Djankov et al (2010) also find a large adverse relationship between corporate tax rate and aggregate investment. Indeed, it has been argued that access to tax havens may have a protective effect, allowing governments to effectively differentiate tax treatment between mobile and immobile activities and allowing them to access international capital at lower cost (Blanco & Rogers, 2011). As the UNCTAD study emphasises, corporate income tax is only one portion of the overall contribution of companies to public revenues – in their study they find that for every US\$1 of corporate income tax paid by multinationals in developing countries there is an additional US\$3 in other taxes and revenues. In seeking to tackle tax avoidance they argue policymakers have to take into account the value of productive investments and the total revenue contributions they generate (Bolwijn, Casella and Rigo, 2015).

Empirical research and ongoing policy debates (such as those surrounding the OECD’s Action 11 on improving the analysis of BEPs) attest to the difficulty of disentangling tax planning from artificial profit shifting. Provisions to defend against profit shifting may deter not only abusive schemes but also real economic investment by raising the risk of double taxation, increasing compliance costs and raising uncertainty. At the same time however, tax rates are not the only factor influencing investment decisions. Infrastructure, law and order, and the education of the workforce can be even more influential, and depend on an adequate tax base (World Bank, 2005). These arguments then, are not reasons to give up on taxing corporations, or necessarily to lower corporate tax rates, but underline the need for tax policy to be supported by economic analysis, rather than based on the assumption that there is ‘money for nothing’.

**Box 6: The Extractive Industry – A particular case**

Taxation of the extractive industry is distinct from other sectors, because it involves the exploitation of immobile, non-renewable sovereign natural resources. While investors should be able to make a fair profit for the risk they take in finding, extracting, refining and marketing minerals and hydrocarbons, the ‘rents’ associated with the value of the underlying resources should go to the country in which they are found.

This is easy to state in principle, but harder in practice, where fiscal arrangements also have to take account of administrative capacity and political pressures. Extractive fiscal regimes tend to involve some combination license sales, royalties on production volumes, taxes on profits and public equity stakes in joint ventures.

As an immobile source of value, natural resources can sustain greater taxation levels without deterring investment. However, both governments and investors face uncertainty about the economic outcomes of extractive industry investments, particularly at the exploration stage. There are many projects which never pay off, and successful projects require many years of large capital investment before profits are returned. Commodity prices are also volatile. Therefore extractive industry revenue systems must be tailored to respond to both good times and bad times of profitability over the lifetime of a project.

**SUMMARY**

This section has argued that these three perceived wisdoms are both caused by and the cause of misunderstandings which risk undermining the debate on domestic resource mobilization. None of this is to deny that additional revenues could be collected, or that the sums involved are non-trivial. But the exaggerations distort understanding of the potential benefits, and may divert effort from areas where it is most needed to areas which are most fashionable (for example to an over-focus on transfer pricing rather than on broader tax administration issues).

In short; a lot of confusion clouds the perhaps obvious point that the potential to raise more from taxation of multinational corporations is limited by the amount of FDI (both inwards and outwards) associated with a country, and that this will come from the pockets of workers, consumers, capital owners or from taxpayers in some other part of the supply chain. There are real dilemmas and difficulties involved in domestic and international tax reforms. Imagining large amounts of ‘money for nothing’ is attractive, but sound policy-making demands a more cautious and evidence-based view.

**Figure 1: Summary of the received wisdom v. the complex truth**

<b>The received wisdom</b>	<b>The complex truth</b>
The <b>huge amounts of money</b> involved in tax avoidance by MNEs are problem-solving in relation to the budgets of developing countries.	Revenue lost through ‘base erosion and profit shifting’ and tax exemptions for FDI are relatively modest in relation to development needs, with the largest sums concentrated in the biggest emerging economies.
<b>Transfer pricing</b> rules allow MNEs to import goods at hugely inflated prices and export commodities at a fraction of their true value: Addressing transfer mispricing by	There are real tensions and dilemmas in where to tax profits in complex value chains, where design, production, marketing, management, financing and currency hedging, transport and insurance are managed in different locations. The challenge of international tax collaboration is that there

<p>multinationals would generate large volumes of public revenues in both their home countries and the places where they do business.</p>	<p>is no single clearly 'right' way to do this; countries at each point in the value chain have an interest in maximising their own tax revenues.</p>
<p>Multinational corporations could easily pay more tax at <b>no cost to ordinary citizens</b> either in developed or developing countries.</p>	<p>Tax policy has impacts on the incentives for investment and employment and therefore on growth and jobs. Policy makers have to pursue not only revenue mobilization, but also efficiency, distribution and growth-oriented objectives in their tax reforms.</p>

## 4. WHAT DO WE KNOW FROM THE NUMBERS?

### WHAT DO THE NUMBERS SHOW?

Global estimates are only a small part of the evidence base needed to bring together a more constructive conversation about the role of multinational taxation in development. Nevertheless, estimates of the scale of potential revenues and other gains from addressing different problems are helpful in considering the potential costs and benefits of different proposed solutions.

**Tax avoidance** – There are a small number of studies which shed light on the amount of revenue at stake in tackling ‘base erosion and profit shifting’ by multinational companies. However, most studies in this area have been focused on developed countries where researchers have been able to access detailed data. Dharmapala (2014) and Reidel (2014) provide recent reviews of the literature. Riedel reports that estimates for the profits shifted by multinationals from high-tax affiliates to lower-tax entities ranges from 5% to 30% of income earned (of which only the fraction payable as tax is ‘lost’ to the country). Dharmapala stresses that more recent literature gives lower figures than earlier studies, as access to new and richer sources of data has enabled more precise analysis. Tax sensitivity estimates from the 1990s are three times the current accepted estimates. One thing that must be noted is that in most cases these estimates of tax sensitivity do not distinguish between companies shifting paper profits as a result of tax differentials, or shifting actual economic activities.

It is thought that developing countries are more vulnerable to profit shifting lower tax inspection capacity. A few studies have developed estimates of the scale of the tax loss associated with BEPs behaviour in developing countries. They tend to cluster around US\$100 -200 billion for developing countries as a whole.

#### **Box 6: US\$160 billion?**

One of the most often quoted and influential numbers is \$160 billion, developed by Christian Aid in 2008, and which they present as an estimate of the amount of tax lost annually to the developing world from tax evasion by multinationals and other businesses through false invoicing between unrelated parties and transfer mispricing - (Christian Aid, 2008). The number was one of the first estimates in this area and served a role in raising awareness of the issues, and making the case (including within the development community) for greater attention to be paid to multinational taxation issues. However it is clear that it should not be taken as evidence, but as a first attempt at a very rough approximation which hinges on the single estimate that 7 per cent of reported trade volumes are the result of mispricing (based on interviews carried out by Raymond Baker in the 1990s, concerning trade mispricing between unaffiliated companies).

In light of later estimates it appears to be the right order of magnitude for the overall amount at stake, but an overestimate of scale of tax avoidance associated with transfer mispricing of goods specifically.

Janský and Prats (2013) look at company specific data from India. They find that multinational companies with links to tax havens had an effective tax rate 30% lower than multinational companies with no links to tax havens (domestic companies however paid the lowest tax rate). A recent study by UNCTAD (Bolwijn, Casella and Rigo, 2015) estimates that tax avoidance enabled by one kind of tax avoidance (‘thin capitalisation’) through offshore hubs resulted in \$100 billion of annual tax revenue losses for developing countries. A new study by the IMF (Crivelli, Mooij and Keen, 2015) looks at data on tax rates and corporate tax revenues from 173 countries over 1980–2013 and finds that spillover effects, operating through both real investment shifts, and profit-shifting effects (as well as domestic

tax competition policy measures affecting the domestic tax base such as special incentive schemes) matter at least as much for developing countries as for advanced. They make an indicative estimate that developing countries lose somewhere around US\$200 billion of tax revenue through base erosion, profit shifting and tax competition to tax havens. They find that developing countries appear to be two- to three times more vulnerable than developed countries.

These studies provide initial indications of scale but should be treated with care, as there are wide uncertainties in their assumptions and data. Furthermore they should not be assumed to be measures of the potential for recoverable taxes. Nevertheless they confirm that developing countries are vulnerable to tax losses through profit shifting and seem to indicate that revenue losses amount to somewhere in the region of 20-100% of current corporate income tax.

**Tax exemptions** are a separate channel for tax loss (although may also be partly captured in some of the BEPs calculations above), and one that can be directly targeted through domestic policies. Both developed and developing country governments award tax exemptions to individual companies, industrial sectors or companies located in a specific geographical areas. While tax exemptions may be economically justified as part of economic and industrial policy they should be clear, transparent and assessed. Often they are instead politically motivated and opaque, and may be granted in exchange for broad political support, personal or political funding. Conversely, the threat of a special tax audit can be used as political tool to intimidate actual or potential political opponents and those unwilling to provide political contributions.

A tentative study suggests that tax exemptions amount to an average of 24% of current corporate taxes or 0.6% of GDP, indicating that potentially US\$ 138 is 'given away' in tax exemptions (assuming that none of them are effective or justifiable as part of industrial policy) (Hearson, 2013). Action Aid also quote a more conservative overall total of US\$100 billion based on the ICTD Tax Revenue database, and assuming a 22% "corporate tax gap" through profit shifting (US\$49.8 billion) and 24% of revenue foregone revenue due to tax breaks (\$55 billion) (Action Aid, 2015).

**Trade misinvoicing** – Trade statistics are based on the declared price of goods imported and exported and are a vast stock of freely accessible data which have held out great promise as potential sources of primary evidence of where and when trade quantities, values or quality are being inaccurately reported by exporters and importers (a practice known as 'misinvoicing' which can be used for capital flight, tax evasion, bribe paying or money laundering). A number of researchers including Kar & Cartwright Smith (2010), Ndikumana & Boyce (2012) and Mevel, Ofa & Karingi (2013) use anomalies in reported international trade data to come up with large numbers (over US\$700 billion in 2012 according to Global Financial Integrity) for laundering of illicit flows through trade misinvoicing. These are gross flows, and there have been some efforts to estimate the associated tax loss implications. however there are serious methodological difficulties with both the overall and the tax loss estimates.

### Box 7: Measuring Illicit Flows – methodological issues

Trade statistics are notoriously prone to errors in reporting and there are significant concerns with the reliability of estimates of illicit flows, and the resulting tax revenue implications based on them.<sup>21</sup> Methodologies struggle to differentiate between mispricing and gaps in the data or legitimate price deviations due to exchange rate fluctuations, forward contracts, triangular trade or difference in quality.

A major determinant of aggregate estimates is the methodological decision of how to deal with apparent inflows as well as outflows, since trade records tend to show both underpriced and overpriced flows of both imports and exports and it is impossible to tell which country is losing out on any apparently mispriced trade. Methodologies tend to be applied one-sidedly to generate results of interest. For example when looking for profit shifting out of the US Simon Pak looks at *overpriced imports* and *underpriced exports* but when looking for evidence of profit shifting *into* the US from other countries he only counts *underpriced imports* and *overpriced exports*. The GFI methodology ‘gross excluding reversals’ only looks at mispricing out of developing countries (i.e. underpriced exports and overpriced imports from developing countries) and discounts any apparent inflows, on the basis that there is no such thing as ‘net crime’. In Pak (2012) the implied capital inflows and outflows from mispricing in all four directions are added together to arrive at a total of over 110 billion which has ‘disappeared’ in the international oil trade.

The ‘**price filter**’ methodology used by Simon Pak in the False Profits report for Christian Aid (2009) tests whether monthly imports and exports between pairs of countries (e.g. tonnes of wheat, dozens of men’s shirts, kilogrammes of copper wire) are over or underpriced against a benchmark range. It assumes that the cheapest and the most expensive products are mispriced, irrespective of quality. As highlighted in relation to the case of the US\$973 bucket, examples which might be simple misrecording of quantities are also counted as evidence of egregious mispricing. Where commodity prices are volatile or seasonal there can be months where the totality of trade at world prices is counted as ‘overpriced’ or ‘underpriced’, because it diverges from the annual middle range.

A second set of methodologies uses ‘**mirror data**’; comparing the exports declared by one country with the corresponding imports by another. This includes the regular assessments of global and country level illicit flow by Global Financial Integrity<sup>22</sup> as well as slightly different methodologies by Ndikumana & Boyce (2012) and) for the High Level Panel on Illicit Flows from Africa.<sup>23</sup> A key challenge with this methodology are gaps or errors in the data, and the effects of volatility and forward contracts which can be impossible to differentiate from genuine misinvoicing.

It should be noted that this methodology is not designed to deliver plausible estimates of scale as with the BEPs methodologies, but to aggregate forensic evidence of individual scams in specific industries, in specific countries and specific years. It is also important to note here that these methodologies are not able to differentiate between illicit transactions involving unrelated companies and licit transfer pricing between related companies where there is triangular trade through import hubs. However, as

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<sup>21</sup> See Feust and Reidel, 2012; Eden, 2012, Nitsch, 2012 and Henry, 2012

<sup>22</sup> For example Kar & Cartwright Smith, 2010, Kar and Spanjers, 2014

<sup>23</sup> Mevel, Ofa & Karingi (2013)



noted above, this distinction is often lost and these figures are assumed to be a measure of multinational tax avoidance. In fact they are likely to include, as well as noise in the data, money laundering, proceeds of crime, corrupt payments and theft of public assets, which should be stopped rather than taxed. In particular the large scale flows of mispriced oil indicated in many countries could reflect mispriced sales by national oil companies and their agents, with politically exposed persons taking a margin as a hidden offshore payment. This would reflect a 100% loss to the state rather than a margin of tax avoidance.

Despite the difficulty of constructing aggregate estimates it is clear from individual cases, big and small, that misinvoiced trade *is* one means used for paying bribes, misappropriating public money and money laundering (alongside other methods such as simple wire transfers, and old fashioned suitcases of money or gold). This is also confirmed by smaller studies. For example Andersen et al (2013) find that when political institutions are poor, windfall gains from petroleum extraction translate into larger stocks of hidden wealth. They look at BIS bank data and petroleum rents and estimate that around 1.5%-2.5% of petroleum rents in autocracies are transferred to bank accounts in tax havens, with additional funds likely to be stored as other assets such as property. Reuter and Truman (2005) conclude that “It is fair to assume that money laundering is in the hundreds of billions of dollars annually but probably only several, and it is unlikely to be a trillion.”

#### HOW ‘BIG’ ARE THESE NUMBERS?

These numbers indicate the difficulty for developing countries in taxing corporate profits, as well as the broader issue of money laundering and theft of public assets.

As the previous section notes, one or two hundred billion across all developing countries should not be assumed to be huge sums – amounting to tens of dollars per person per year. As a very rough gauge amounts might be something approaching 1% of GDP – however in countries with low levels of GDP this will not fund a large shopping list of potential public services. Nevertheless in a very poor country even a small amount of money can make a difference. However, in practice it should be noted that the potential amounts are likely to be lower in least developed countries, and higher in middle income emerging economies, in line with levels of FDI. Larger economies are also likely to benefit more from international cooperation in taxing MNEs as they have a wider range of specialist staff, and greater economic clout to take advantage of new information flows.

The potential to raise tax by ratios by something approaching 1% of GDP is non-trivial particularly if it can be achieved together with economic growth. However it is not clear that specific tax innovations could lead to short-term major increases in revenue collection in low income countries (Moore, 2013).

One response to the recognition that one or two hundred billion US dollars is not as much as it sounds, is that the estimation methods are still in their infancy, and overall amounts of profit shifting could turn out to be higher. There are two reasons to be cautious of this hope: firstly, for developed countries the experience has been that as data and estimation methods have improved the estimations of the amounts at stake have gone down (Reidel, 2015). Secondly, there is the ratio between the BEPs estimates and existing corporate tax revenues. A US\$200 billion rise in the taxes paid by multinationals in developing countries represents almost a doubling of current levels of tax on FDI profits (UNCTAD, 2015). While the relationship between tax and investment is not clear-cut, at some point seeking to extract more revenue from the same base of taxpayers is likely to become unsustainable.

Estimates of overall tax potential suggest that greater revenues *can* be collected, but from a wider tax base, with potential for some 2-4% of GDP additional overall. For example UNESCAP (2014) estimates that 17 countries in Asia could raise an additional \$440 billion in tax revenues across their whole tax base – (a rise of 70%) of which \$306 billion would be raised in developing countries. The tax base that

is fundamental to increasing tax-to-GDP ratios in a sustained manner is formal sector employment and earnings and private sector spending, while at the same time productivity enhancing investment is critical to raising overall levels of economic output and welfare. As UNCTAD highlight, this creates a dilemma for policymakers; how to “ensure that MNEs pay “the right amount of tax, at the right time, and in the right place” while avoiding excessive tightening of the fiscal regime for MNEs which might have a negative impact on investment” (UNCTAD, 2015).

Other areas, outside the scope of this paper but with high potential, are domestic personal income taxes for professionals and property owners. Legal provisions to tax large-scale agricultural income and personal income from abroad as well as real estate are suggested as underexplored ways to ensure that domestic elites are taxed, but ultimately this is not just a technical but a political question (IMF, 2011). International financial transparency and measures such as automatic exchange of information may help, but ultimately there needs to be the consent and support from amongst the influential elite to both pay more in taxes themselves and to broaden the tax base, which implies more accountable institutions (Everest-Phillips, 2009).

## PROBLEMS AND POTENTIAL SOLUTIONS: TRANSFER PRICING

Transfer (mis)pricing has been a particular focus of concern. Examination of the case studies, revenue potential estimates and arguments reveals that this headline often covers a wide range of issues and tax-payer behaviours which span all four categories of the spectrum.

- **Type 1: Evasion/corruption** – Fake or egregiously mispriced trade shipments, or service transactions used as a cover to illegally shift capital out of a country, attract subsidies, pay a bribe or kick-back into a foreign account and/or avoid taxation (in some cases these are not transfer mispricing since they involve unrelated entities but ‘trade misinvoicing’). This can include misreporting of quantity or quality of the shipment to hide the misreported price: For example in Venezuela fictitious import business have been found to be used to exploit currency controls by obtaining US dollars at official rates from the government to be sold on the black market for a large profit (Neuman and Torres, 2015).
- **Type 2: Potential ineffective avoidance** – There is considerable scope for choosing an arm’s-length price which is favourable to the company, but which can be defended on some basis as being within the arm’s-length standard. This can extend into aggressive avoidance. The basis of these transfer prices may be challenged by revenue authorities based on existing laws, and if found to be an overgenerous interpretation can result in significant adjustments. Examples of this type are seen in the transfer pricing cases which make it to court, such as over the pricing of brand-name pharmaceutical ingredients.
- **Type 3: Tax planning** – these are cases where a company’s transfer prices appear to be within the limits of the arm’s-length standard but nevertheless are seen by some as unacceptable profit shifting and are the focus of reputational challenges and calls for legislative change. Examples here include the SAB Miller case where NGOs believe that the company has unacceptably shifted profits out of Ghana into the Netherlands through charging of royalties for trademarks.
- **Type 4: Incentives** – these are cases where the controversy does not concern whether the transfer price itself is at arm’s-length, but whether the profits it generates are undertaxed through a tax incentive used to attract the mobile part of the business. Examples here include the advance pricing agreements agreed with financial hubs such as Luxembourg, as well as the use of tax incentives such as the UK’s ‘patent box’ scheme.

These four sets of cases, although there is some overlap in the situations, highlight different concerns that are likely to require a different type of solution. The first set involve the hiding of aspects of transactions and ownership (or at least the hiding of them in plain sight, taking advantage of situations of lax enforcement). Although they can have tax loss consequences they are often not motivated primarily by tax evasion, but by theft of public assets, the avoidance or exploitation of capital and currency controls, or to divert funds to pay bribes. The case studies used to illustrate this type of behaviour tend to involve individually privately owned companies, and linkages to state owned entities, officials and politicians. Although there are also cases involving multinational companies (such as BAE and Siemens), this is not the core business of transfer pricing departments in large and well scrutinised publicly listed corporations, but indicates a failure of controls. These are illicit transactions, which if brought to light result in prosecutions that carry not only financial and economic penalties, but criminal penalties. International companies involved in such actions face prosecution under anti-money laundering rules and anti-corruption rules, not only under tax laws. Measures likely to be most relevant to combat this kind of behaviour overlap with those for stolen asset recovery including requirements on collection of beneficial ownership information and whistleblower protection.

The second set involve cases where the company has structured its operations for business reasons, including consideration of tax advantages, but where there is a difference of opinion with the tax authority over interpretation of the transfer pricing rules. They do not involve the kinds of illicit behaviour illustrated in the first set of cases, but genuine technical questions of how to apportion profits along the value chain. These instances of potential mispricing can be challenged. However, disputes are expensive for both companies and revenue authorities and many revenue authorities of poorer countries do not have the resources to pursue them. Companies establishing transfer prices between a country with a track record of pursuing transfer price disputes aggressively and a with weak or no transfer pricing enforcement tend to err on the side of caution in relation to the end of the transfer price calculation with the strongest enforcement, even if this does not reduce their overall tax bill. The key measure proposed in response is for developing countries (with donor support where necessary) to establish transfer pricing rules and build capacity to enforce them. However full implementation of OECD principles, and undertaking transfer pricing audits, is complex and resource-intensive for the tax authority. Other approaches include using simpler alternatives to the standard arm's-length pricing methodologies such as 'safe harbour' benchmarks. Another proposal that has been made is for companies to adopt an active policy of treating transfer price determinations with absolute good faith in relation to the developing countries, even if no challenge is expected (Lewis, 2015). Country-by-country reporting to tax authorities has been proposed here as a risk assessment measure to enable countries to more easily identify potential transfer mispricing.

The third set of cases involve controversies and concerns over the fairness and economic efficiency of outcomes of transfer pricing that are within the current rules. In particular this relates to the ability of companies to legally use IP, marketing and financing hubs to buy and sell commodities across their worldwide operations, manage intellectual property or administrate inter-company loans in lightly staffed offices in low-tax jurisdictions. These effects can be controlled through thin capitalisation and hybrid mismatch rules to some extent. In the last two decades, advance pricing agreements have also been increasingly used to reach agreement with the tax administrations on either side of a cross-border transaction about a fair principle to allocate income and expenses between related parties. Withholding taxes on royalties, interest and dividends are also commonly used to tax these outflows, although companies can often find ways to structure their business through favourable treaty partnerships which reduce these (and countries may encourage this by taking a 'most favoured nations' approach to attracting investment through international tax treaties with hub nations). Even

where prices are deemed to be at arm's-length, some argue that the transfer pricing system is no longer fit-for-purpose because it does not reflect the true nature of multinational corporations (Spencer and McNair, 2012). Renegotiation of tax treaties is one area of policy focus here. Alternative proposals include unitary taxation/apportionment (where profits are allocated according to a simple key based on factors such as sales and staff numbers), or an overall shift in the underlying basis of source vs residence taxation. 'Tax shaming' of individual companies through public campaigns – such as that directed at Starbucks in the UK – tend to be focused on this type of case where transfer prices are within the rules, but the outcome is seen as unacceptable by some stakeholders. Public country-by-country reporting is also advocated here as a means of public scrutiny and pressure of companies and governments (Ruiz and Romero, 2011)

The fourth set involve companies acting in line with legislation, where the legislation itself may be deemed harmful. In this case what is in question is not the transfer price itself, but the tax rate payable on the profit from it in the marketing or finance hub. Questions here concern the role of corporate lobbying in securing preferential tax regimes. However it is important to note in these cases in terms of tax losses it is not the source countries paying interest or royalties that are losing out on tax revenues (as long as the prices are at arm's-length) but the host country of the hub itself, and other countries that it is competing with it to host R&D, high tech manufacturing or finance activities. A distinction is drawn here between tax incentives which aim to attract real investment, and those that only attract 'letterbox' operations, with tax incentives to attract real investment seen as 'fairer' (although the loss of real investment is more damaging to competitor countries).

This is, of course, only a brief discussion of some of the potential policy solutions to addressing problems that come under the broad umbrella of trade mispricing and transfer pricing issues – what is clear however is that different types of problem require different solutions. Often, however, the same numbers are used to represent quite different behaviours.

## PROBLEMS AND POTENTIAL SOLUTIONS: EXTRACTIVE INDUSTRY

In many cases, the largest flows of FDI (and therefore intra-firm trade and lending) relate to the extractive industry. Extractive industry-related revenues are significant for many countries and potential gains from better governance can be hugely significant in some countries. For example national oil sales provide over 60% of government revenues in Nigeria, Equatorial Guinea, Angola and the Republic of Congo (Gilles et al, 2014).

Many of the issues of concern outlined have particular features in relation to the extractive industry because of its relative scale, the relationship between natural resource governance and corruption, and the need for specific fiscal regimes which balance risk between government and investors and can respond to the price volatility and the long investment cycles of extractive projects (energy, telecoms and other utility projects operated as public concessions also share some of the same issues). Again, this is a specific area of policy making with issues that go beyond the scope of this paper, but it is worthwhile unpicking how they relate to the spectrum of tax payer behaviours:

- **Type 1: Evasion/corruption** – Extractive sectors tend to come under high-level discretionary political control and as such, are particularly prone to secrecy and blurring between public, political and personal interests within governments and state companies. Underreporting of the volume or quality of resource produced (such as through biased oil volume measurements or misreporting of ore grade) is recognised as common and is a major concern in many countries, including such high-profile cases as Iraq and Nigeria (McPherson and MacSearraigh, 2007). Corruption can also be involved in the awarding of contracts with advantageous fiscal terms, which may then use misinvoicing to hide the payment of direct bribes or lucrative

service contracts (Le Billion, 2011). These issues affect not only the direct tax and royalty revenues that governments receive but also the important revenues they get when selling products on their own account. For example, several reports, including two commissioned by the Nigerian government, found its national oil company mismanages parts of the oil sales process and has failed to remit billions of dollars in crude sale revenues to the national treasury. In Switzerland, the trading company Gunvor is under investigation for money laundering related to its purchase of \$2 billion worth of crude oil from the national oil company of the Republic of Congo at a discounted price of \$4 per barrel. These illustrate classic cases of 'trade mispricing' where public assets are sold off at low price to companies controlled by politically exposed persons who "flip" cargos on to international companies after capturing a margin (Gillies et al, 2014).

- **Type 2: Potentially ineffective avoidance** – Transfer pricing is often highlighted as a particular problem for taxing extractives, with the perception that companies are selling commodities too cheaply to their affiliates (such as in the Zambia copper case outlined on page 14). However, while regulating transfer pricing is a technical challenge for countries switching from a royalty-based system to one where profit taxes play a greater role, often transfer price abuse is used as an explanation for low taxable profits which are in fact due to large capital expenditures. In Chile for example, six of the ten top foreign owned mining companies paid no income tax from 1991 to 2003, and two only began to pay income taxes in 2003. This was largely because they subtracted accelerated depreciation on new properties. Once the period of accelerated depreciation ended, taxes rose substantially. Similarly, in Peru the new Antamina copper mine paid no more than \$20 million in taxes in 2004, the last year of accelerated depreciation, but paid \$319 million in 2005 (Moran, 2011). These revenue structures, if not well explained and justified by and to parliamentarians and the public can lead to perceptions that mines must be selling off commodities 'for a fraction of their true value' and pocketing the difference.<sup>24</sup>

Regulating transfer pricing of commodity exports is technically relatively straight-forward, compared with the more difficult situations involving intra-firm trade in goods and services with no comparable arm's-length products. While there are administrative challenges in ensuring that amounts and grades are correctly reported, this would also be the case in royalty-based systems. Minerals and agricultural products are easily measurable physical quantities with standardised grades and readily available comparable market prices, including in many cases exchange-based reference prices, so the arm's-length principle is not in itself hugely problematic. For example in Liberia a mineral development agreement initially negotiated by Mittal Steel did not have include requirements for arm's-length pricing, potentially depriving the government of substantial revenues. International experts brought in by President Ellen Johnson Sirleaf amended the contract to reflect the arm-length rule, leaving taxation to be based on the international market price of iron ores of the same grade (Global Witness, 2007).

- **Type 3: Tax Planning** – Another taxation concern in relation to the extractive industry (as well as other key sectors such as telecoms) is about the taxation of capital gains when assets are transferred from one company to another. It is common practice for these to be structured using offshore entities to ensure that no capital gains tax is paid (in some countries these

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<sup>24</sup> For example see the discussion of Transfer Pricing in the Zambian Copper Industry in ICMM (2014).

transactions are specifically exempt). While some regard this as illegitimate and a loss to the country concerned (Hearson, 2014) there is an economic argument that the capital gains on a successful extractive industry project reflect an increase in expected future rents, it may not be necessary to tax them at the point of restructuring if those rents will be adequately taxed.

- **Type 4: Incentives:** Extractive industries generally operate under a separate fiscal regime laid out in legislation and through individual contracts. There is extensive literature and experience of the dilemmas, challenges and best practices in establishing these terms (See for example ICM, 2009). Incentives include accelerated capital allowances, resource depletion allowances and tax holidays, as well as usual provisions for interest deduction and carrying forward of losses. These incentives combine with the tax rate, other payments such as royalties and license payments to determine the overall level of revenue due to the government and the extent to which it is front or back loaded in relation to the production cycle. A key area of concern is that governments are giving too much away through a combination of generous incentives and reduced royalty rates, leading to loss of public revenues (and ultimately to instability for investors). Deals may in some cases be arrived at through a process of political and economic brinkmanship. At worst, concessions can be hastily sold off without knowledge of their value or legislative oversight, with deals facilitated through bribery and collusion, conflicts of interest, bid-rigging and trading of influence (Moran, 2008). Even where contracts are agreed in good faith, there are distinct trade offs between different approaches to the design of the fiscal regime, and the choices can be challenging to explain, and to understand. There is growing recognition that both host country and international investor interests would be served by more active multilateral assistance in the design of extractives legislation and negotiation of contracts. Transparency in the contracting process, to allow for parliamentary and civil monitoring of extractive industry agreements is one key solution to allow trust to develop on all sides and minimize opportunities for corruption. However, this demands capacity building to understand the issues and finances.<sup>25</sup>

## SUMMARY

International taxation and policies for domestic resource mobilization pose complex problems in which the public debate has become somewhat disconnected from the policies. This section has provided only a brief overview of some of the issues and options for action both internationally and domestically.

A basic map of areas of concern, and areas for potential solutions is laid out below as a framework for discussion. The aim is not to provide a single solution, but to offer a way of unpacking the issues and solutions. While there is of course some overlap and potential for synergy between them, different problems are likely to require targeted approaches.

For example some, such as the Independent Commission for the Reform of International Corporate Taxation have called for states to “*reject the artifice that a corporation’s subsidiaries and branches are separate entities entitled to separate treatment under tax law*” and instead treat them as single global firms (ICRICT, 2015). Arguments about unitary taxation are likely to rumble on, but they do not target the immediate core issue of extractive industry taxation where the aim is precisely to tax the value of

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<sup>25</sup> There are several initiatives in this area. For example <http://www.resourcecontracts.org/> and <http://www.open-contracting.org/>

local natural resources. If the problems in this case is weaknesses in negotiation of contracts or inadequate systems for basic reporting of commodity exports, they are more likely to be addressed through domestic administrative strengthening than a root-and-branch redesign of the international tax system. Similarly anti-secrecy measures are likely to have limited impact on legal tax avoidance, which is not dependent on secrecy.

Within such a framework specific solutions may be identified which are easier or harder (both technically and politically), well-established or subject to experimentation. Some will involve legislation; others may rely on corporate responsibility, good practice principles and the power of reputation. Some will involve host country measures, or measures by capital-sending countries, or a combination. Some areas are likely to be particularly attractive for transparency measures, public engagement and oversight, where others depend mainly on the development of stronger administration capacity. There are areas where campaigners, tax practitioners, businesses and policy makers might work together (and indeed already are; such as the long standing Extractive Industry Transparency Initiative and the recent B Team initiative on beneficial ownership), as well as areas where there are different priorities, divergent interests and disagreements about the best way forward.

**Figure 2: Areas of concern and types of solution: a framework for discussion**

Areas of concern	Taxpayer behaviours			Types of solution
	Domestic business (including high income citizens)	International business	Extractive sector	
<b>Evasion/ corruption</b>	Hiding the business Hiding income (offshore) Inflating deductions Not passing on taxes collected Corrupt side payments to reduce taxes Misapplication of tax exemptions (e.g. through bribery, closing/reopening to get new tax holiday)	Misdeclaring trade Invoice fraud Carousel Fraud (VAT) Offshore abusive tax shelters Not declaring taxable offshore income Misapplication of tax exemptions (e.g. through round-tripping)	Bribery and corruption to win concessions Misdeclaring trade Invoice fraud Theft/oil bunkering	<p><b>Law enforcement measures and anti-secrecy</b></p> <p><b>Adequate resources for tax authorities</b></p>
<b>Potential ineffective avoidance</b>	Use of marketed tax avoidance schemes	Overly aggressive transfer prices Thin capitalization/ excessive interest deductions Treaty shopping Using hybrid mismatch arrangements Artificial avoidance of permanent establishment	Transfer mispricing? Thin capitalization/ excessive interest deductions	<p><b>Anti-avoidance and BEPs Measures</b></p> <p><b>Adequate resources for tax authorities</b></p>
<b>Tax planning</b>	Captive real-estate investment trusts Employee share options 'Carried interest' (Private equity) Accelerating/deferring income	Centralised IP and treasury operations by MNEs - transfer pricing, service fees, interest deductions etc.. Advanced pricing agreements with tax authorities	Offshore ownership to avoid capital gains tax on restructuring/sale	<p><b>Updating domestic legislation?</b></p> <p><b>Changes to the basis of international taxation?</b></p> <p><b>Adequate resources for tax authorities</b></p>
<b>Negotiation /Uptake of incentives</b>	Use of general deductions e.g. capital allowances Use of specific incentives e.g. sector based tax holidays	Use of specific tax incentives for FDI – e.g. negotiated tax holidays Advanced pricing agreements with tax authorities known to be generous	Demanding/negotiating overly generous fiscal regimes (including through corruption and secrecy)	<b>Targeting and transparency of incentives</b>



## 5. CONCLUSION

*“Only after journalists and nongovernmental organizations told the story of BEPS in ways that were understandable by people other than tax specialists did sufficient public interest arise to motivate the analysis that currently is being led by the OECD. Unless countries today put in place understandable means of evaluating progress in curtailing Base Erosion and Profit Shifting, the global public might lose its ability to assess political leaders’ progress in achieving international tax reform, endangering the viability of the reform process.”*

Micheal Durst, former Director of the IRS Advance Pricing Agreement Program

Effective taxation depends on both robust technical design and broad consent, scrutiny and support from across society. In a globalized world this negotiation must take place internationally as well as within individual jurisdictions, and must find ways to enlist domestic elites in support of institutions which broaden national prosperity, despite the unprecedented options for international mobility. This historic challenge is taking place through a patchwork of domestic political and judicial processes, business and interest group lobbying, voluntary guidelines, academic and other research, bilateral tax treaties and co-operation through international organisations, and through debates, and public understanding enabled by the media, NGOs (and their funders) and corporate communication.

Important areas of policy should not simply be ‘left to the experts’. But maintaining public and corporate engagement on such complex cross-jurisdictional challenges depends on the debate developing through stages of maturity and learning – from initial campaigns based on weak evidence, met by defensive responses, through messy and difficult processes of organisational learning and collaboration towards more effective problem solving across sectors and national boundaries (see for example Zadek, 2004).

Campaigners have succeeded in getting the complex and difficult topic of international taxation onto the public agenda, and have advanced progress on previously ‘impossible’ solutions such as automatic exchange of information. But in the process they have also contributed to unrealistic public expectations and an appetite for a simplistic narrative about a corporate tax ‘pot of gold’ which may become a liability to future progress.

For citizens in developed countries the behaviour of well-known brands such as SAB Miller, Vodafone, Associated British Foods (owners of Primark), Barclays Bank and others may seem more salient than the technical and political challenges of strengthening tax administration in far away places, but we should not assume that what matters most to us is what matters most.

It would be conveniently wonderful if the gains from taxing big business more in poor countries were really enough to solve the problem of how to raise sufficient public revenues to develop the public services and institutions on which broad-based economic growth depends. But the best estimates reveal the dilemma that the potential gains are both *too small* and *too big* to fulfil this hope – too small to be a gamechanger for public services, and too big in relation to existing corporate taxes to assume that impacts on investment returns will be negligible.

This does not mean that multinational corporate taxation is unimportant for development. It contributes non-trivial revenues, and is accessible to support through legislation in capital sending and financial centre countries. Developed countries therefore have a moral responsibility to ensure that the ‘spillovers’ from their tax policies to not undermine development prospects elsewhere. But corporate tax is only one part of a domestic revenue mobilization strategy.

Moreover a narrative that posits multinational corporations and the accountancy profession as always the ‘bad guys’ ignores the common interest that responsible companies and the tax profession have in

the development of broad, stable tax regimes, enforced through the rule-of-law; where tax risks are manageable and compliant businesses are not out-competed by those practicing tax evasion and corruption in negotiation of contracts. Business leaders argue that investment structured through offshore financial centres can be a legitimate part of this; this has the potential to put pressure of financial centres to demonstrate that they contribute to, and do not detract from broad-based development. This suggests a potential alignment of interests between development-motivated campaigners and tax experts and business.

There will always be a difference between the kinds of statements that can be made in headlines and on social media to raise awareness of issues, and more in-depth analysis and direct engagement. However the gap between these two forms of communication in this case appears to be widening, with a gap between perceptions and analysis which could become a risk to finding ways forward for effective progress in three key areas:

- **Building understanding.** Continued research is critical to developing policies with theoretical rigor and empirical support, and which are able to win international agreement and broad consent. Useful new knowledge and evidence is unlikely to confirm long-standing beliefs based on misunderstandings of current evidence. But the pressure to maintain the narrative could constrain much needed new understanding emerging from research (for example with estimates in the region of a hundred billion across all developing countries to be presented as 'huge sums').
- **Developing coalitions.** There is much emerging common ground between campaigners and business (for example see Lewis, 2015). However, the division of the tax debates into competing sides and movements with unassailable beliefs and advocacy positions precludes more constructive engagement. In particular, confusion and conflation of illicit financial flows and legal tax planning (in particular using estimates drawing on trade statistics) contributes to a toxic debate in which corrupt behaviour and legal compliance are presented as roughly similar morally, technically and economically.
- **Translating transparency into change.** Transparency measures are a key hope for improving public revenues. For example, in the area of extractive industry revenues, hard fought-for 'publish what you pay' regulations are coming online in Europe, Canada, Australia and the US; revenues are published by governments as part of the Extractive Industry Transparency Initiative; and laws are being amended to enable civic monitoring of contract awards and implementation through 'open contracts'. However experience to date is that transparency in itself has had less impact than hoped, and that the critical work of enabling constituencies to use the data to influence reforms is still to be done (O' Sullivan, 2013). International NGOs and donors are likely to continue to play a key role here. Unrealistic expectations and polarised debate could put at risk the potential for meaningful public scrutiny to improve accountability and revenues. Indeed, if public debates drive taxation away from the rule-of-law into capricious reputation and political pressure based approaches, this raises unmanageable tax risks for companies, *perversely* increasing the pressure for tax holidays and other approaches to making long-sunk investments attractive.

As the transparency movement comes of age, facing up to the practicalities and dilemmas of tax policy is just one test case. Can it support people to engage honestly with debates over economic trade offs and widen and deepen the conversation between tax campaigners, tax experts and practitioners, development agencies, the business community and policy makers? Or will the gulf between data and perceptions continue to widen?

Perhaps a reason why there seems to have been a tolerance for exaggerated interpretations and misunderstandings, is that the estimates which do exist are seen as the tip of an iceberg. There are many areas of fraud and corruption which are not covered by existing estimates – such as oil bunkering, outright smuggling, rigging of forex trading and so on. Nevertheless, lack of information in

one area cannot be mitigated by errors and misunderstandings in another. And furthermore, exaggerated expectations of the scale of commercial illicit flows risk making efforts in areas such as recovering stolen assets (where amounts recovered are in the hundreds of millions, see Gray et al, 2014) appear to be paltry, and allows discussion of aid commitments to take place against a background of expectations that there is much larger sum of money just around the corner.

The image of the 'pot of gold from corporate taxation' can perhaps be compared to the use of exploitative and prejudiced imagery in charity appeals and by development organisations. Pictures which stereotype and sensationalise people living in poverty, depicting local people as victims and outside celebrities and aid workers as saviours have been challenged over several decades as damaging and misleading. Yet pictures of teary-eyed children, dressed in rags without visible family or community are undoubtedly effective in raising funds. Nevertheless it has been recognized that the ends do not justify the means. Codes of conduct have been drawn up by international and national associations of NGOs committing them to refrain from using 'pathetic images' or 'images which fuel prejudice' and giving guidance about how to use images of people which respect their dignity and autonomy, and do not confirm prejudices amongst audiences.

This suggests the need for similar active organisational processes within and between NGOs around tax concepts and ideas. Organisations could individually and collectively draw up guidelines and review their research and communication processes to make sure they to:

- **Highlight data weaknesses** in any estimates used.
- **Be clear on the policy challenges** with raising revenues that are estimated to be lost.
- **Be clear on where revenue losses are emerging** from and avoid aggregating estimates between countries and over years in ways that make them harder to understand in context.
- **Consider the area of taxation with the most potential** for mobilising revenues with minimum negative effects.
- **Use broad peer review processes**

Wider collaborative processes could also help to strengthen understanding and to create the space for more constructive engagement between campaigners, tax experts and those concerned with finance for development – both internationally and domestically in individual countries:

- Establishment of broader multi-expert, multi-sector networks to **debate issues**, and strengthen research by **identifying new data sources, collaborating on projects** and undertaking **peer review** (including of campaigning reports) to consider estimates and other research findings.
- Collaboration between tax and development experts to develop **common basic resources of definitions and knowledge** on key issues such as transfer pricing.
- **Teach-ins or seminars** involving tax experts to raise levels of understanding of tax issues amongst development advocates (within NGOs, development organisations and funders).
- **Collaboration to assess the individual clusters of potential solutions** in light of clearer articulation of the evidence of the nature of the problems.
- Establishment of **common principles**
- Collaboration in **piloting the use and understanding of data from country-by-country reporting in the extractive sector**.

The challenge now is in moving the debate beyond the early-stage attack-and-defence mode, to one which can fuel a next phase of collaboration, understanding, experimentation and learning about what works in practice. Positive signs include the focused research by international organisations, the

tentative collaboration between NGOs, tax experts and business representatives (including for example the Martin's in the Fields Group convened by Christian Aid with business representatives from the UK's CBI, the involvement of tax practitioners in Christian Aid's 2014 report on 'Tax for the Common Good', as well as on the discussions that have gone on in the advisory group to this report). Further research will of course be needed, and is welcomed, and can only be strengthened by the development of ongoing conversations and collaborations with renewed energy going forward

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