

BRIEFS

International Tax, Transparency, and Finance for Development: A Short Guide for the Perplexed

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In the search for sustainable sources of finance for development, the potential for developing countries to collect more domestic revenues from taxation has risen to prominence in recent years. International tax evasion and avoidance and the role of tax havens have been raised as critical barriers, and transparency is often advocated as a key solution. This briefing offers a short outline of the key issues, terms, and numbers involved. [\[1\]](#)

What Do the Terms Mean?

Taxpayer behavior occupies a spectrum between illegal (“tax evasion”) and legal (“tax compliance”). Because of the complexity of taxation systems, there are sometimes genuine gray areas of legal uncertainty that depend on interpretation by the courts. The amount of tax due nevertheless is defined by law. [\[2\]](#)

- *Tax evasion* is the illegal nonpayment or underpayment of taxes, usually by making a false declaration or no declaration to tax authorities; it entails criminal or civil legal penalties and depends on secrecy and concealment.
- *Tax abuse* is the use of contrived, artificial transactions that serve little or no purpose other than to produce a tax advantage. Such schemes are at high risk of legal challenge (resulting in the transactions becoming “failed avoidance” or “ineffective avoidance”). They do not rely on secrecy but may take advantage of lack of awareness of the scheme, which can give scheme users a temporary advantage before the loophole they exploit is closed.

- *Tax planning* concerns choices in the commercial structuring of a business; these choices are compliant with the law but have an impact on the resulting tax payable.

Concerns may be raised about taxpayer behavior in each area, but they are different and require different remedies. Tax evasion calls for strengthening enforcement of existing laws and tax abuse for tightening anti-abuse measures and closing specific loopholes where there are weaknesses in the law. Tax planning might make a case for broader changes to the tax system.

- *Avoidance*, as generally used in debates, is an ambiguous term covering a wide range of situations, from legal tax planning to arrangements that are unlikely to survive a legal challenge. [\[3\]](#)

Further Areas of Concern

Policymakers confront other complicating factors:

- The granting of tax incentives may be justified as part of industrial policy, but the incentives should be clear, transparent, and assessed. Often they are instead opaque and poorly targeted, and they may be given in exchange for political support and funding.
- Tax policy itself may be skewed toward special interests. In many countries (both developed and developing), policymaking on taxation may be undertaken with insufficient debate and scrutiny. While business is a legitimate stakeholder and should be consulted, its access and influence may be unbalanced, with large companies having undue influence on policy.
- Theft of public assets is a broader problem. Examples include outright theft of oil and sales of public assets, such as mining concessions or commodities, at deeply discounted prices to politically connected associates.

International Aspects

This fairly simple view becomes more complex when companies or individuals operate across borders and across the tax systems of several jurisdictions.

- *Tax treaties* seek to allocate taxable income between “residence” jurisdictions (where individuals or corporate headquarters reside) and “source” jurisdictions (where economic activity takes place), while avoiding double taxation. Companies often are required to submit individual tax returns in each country where they have a permanent establishment, using a system of “transfer pricing” to account for internal transfers among subsidiaries of goods, services, financing, or the licensing and use of technology and intangible assets.
- *Tax havens* are generally thought of as places where the interaction between local tax rules, tax treaties, and other jurisdictions’ rules can be used to reduce tax bills. No satisfactory common

definition has been developed that clearly differentiates between a country acting as a tax haven from one acting as a financial center providing legal frameworks and a tax-neutral base for international investment. There are also concerns about tax haven secrecy enabling tax evaders, criminals, and money launderers to hide income and assets from the authorities.

The underlying basis for allocating profits among jurisdictions is a conceptual rather than an enforcement issue. For example, where should the profits be taxed when an iPhone is designed in California, assembled in China from parts made in Indonesia, Malaysia, and Thailand, distributed in Europe through a hub in Ireland, and ultimately sold from a store in the United Kingdom? Proposed alternative taxation systems, such as residence-based only or formulary apportionment, would deliver different answers. [\[4\]](#)

Conversations on tax avoidance and tax evasion sometimes become very confused. For example, individuals seeking to evade tax may use corporate structures (i.e., trusts and privately held companies) to hide assets, a practice sometimes confused with bad behavior *by corporations*. Corporate tax avoidance is sometimes illustrated by examples that would, if true, constitute large-scale, egregious tax evasion (such as declaring internal prices for refrigerators at 75 cents each or transferring copper across international borders at much less than market value). Often these cases have turned out to be anomalies in the trade data rather than evidence of actual commercial practice.

International Issues and Estimates of Scale

There have been attempts to estimate the amounts of tax revenue at stake in relation to three separate international issues often bundled together under the heading of “tax dodging”:

- *Tax evasion*, particularly by high-net-worth individuals using the cover of offshore secrecy to avoid declaring taxable income. Tax evasion is the most difficult category to estimate, since it is secretive. One estimate is that US\$7.6 trillion is held offshore globally, the majority by residents of rich countries, and that this results in tax losses in the region of \$190 billion a year. This estimate is highly uncertain and based on strong assumptions. [\[5\]](#)
- *Base erosion and profit shifting (BEPS)* by multinational businesses using legal tax planning strategies that take advantage of mismatches and gaps in tax rules to shift profits to places where they attract little or no taxation. A number of studies have estimated the scale of the tax loss associated with profit shifting. [\[6\]](#) All of these are tentative estimates based on statistical observations, and they are not measures of potential revenues that could be recoverable by particular policies. The Organisation for Economic Co-operation and Development (OECD) has given a core global estimate of \$240 billion for BEPs. [\[7\]](#) Other studies, however, suggest that developing countries alone may be losing as much or more than this:
 - The United Nations Conference on Trade and Development (UNCTAD) estimates that effective avoidance enabled by thin capitalization results in \$70–\$120 billion of annual tax revenue losses for developing countries. [\[8\]](#)
 - The International Monetary Fund (IMF) makes an indicative estimate that developing countries currently lose somewhere between \$100–\$300 billion of tax revenue through

base erosion, profit shifting, and tax competition to tax havens. [\[9\]](#)

- *Provision of tax exemptions and incentives by governments* . A tentative study suggests that tax exemptions amount to an average of 24 percent of current corporate taxes in developing countries, or 0.6 percent of GDP. The study therefore estimates that tax exemptions for businesses in developing countries amount to \$138 billion. [\[10\]](#)

These estimates indicate that developing countries are vulnerable to tax losses through international evasion, profit shifting, and incentives, and that the scale is not insignificant (overall domestic resource mobilization by developing countries is estimated to be \$7.7 trillion). [\[11\]](#) Nevertheless, the estimates are by their nature highly uncertain and are not an indication of the amount that could practically be recovered. [\[12\]](#)

What about the “Trillions”?

Illicit flows has recently become a popular term. It spans a wide range of behavior, from hiding the proceeds of crime, corruption, and theft of public assets to illicit movement of privately held assets to evade capital controls. The largest estimates are based on anomalies in published trade data. Yet there are significant challenges in interpreting this data. [\[13\]](#) What is clear is that these figures (such as \$1 trillion for developing countries or \$60 billion for Africa) are not estimates of losses of public revenues but rather of gross capital flight. [\[14\]](#) Nor do they identify flows related to tax avoidance by multinational companies or transfer pricing.

What Do the Big Numbers Mean for the Poorest Countries?

These estimates of the amounts lost by developing countries are often compared broadly with the order of magnitude of international aid. In some cases relatively large sums have been attached to individual countries; for example, it is often argued that Zambia is losing several billion dollars from tax avoidance by multinational companies. [\[15\]](#)

Such statements tend to inflate perceptions that revenue gains would be concentrated in low-income countries. In practice, the vast majority of international economic transactions remain among high-income countries, and within developing countries, they are concentrated among upper-middle-income individuals. For example, the majority of offshore wealth is held by citizens of OECD countries, followed by citizens of major emerging economies such as China, Russia, South Korea, Brazil, Kuwait, Venezuela, Indonesia, and Saudi Arabia. [\[16\]](#) Similarly, the potential for developing countries to increase the amount of tax they collect from multinational corporations is limited by the actual level of activity by multinational corporations within each jurisdiction. For example, foreign direct investment (FDI) stocks in Denmark amount to \$24,000 per capita; in Malaysia they amount to approximately \$5,000 per capita, and in Kenya, they total less than \$100 per capita. [\[17\]](#)

Given the pattern of distribution of multinational investment, aggregate comparisons with aid figures are of limited usefulness and should not be assumed to reflect the balance of financial flows at the

national level. Nor should large shifts in effective tax rates on business be assumed to be possible without considering impacts on investment.

Transparency Solutions

A key focus of international action to support domestic revenue collection has been on mechanisms for greater transparency, primarily aimed at making more information available to tax authorities and law enforcement agencies:

- *Automatic exchange of information.* Standards and agreements among tax authorities can generate automatic reports on dividends, interest, and other income received by foreign tax residents to their home jurisdiction. Automatic exchange of information is largely focused on preventing *tax evasion*.
- *Registers of beneficial ownership/ending of anonymous shell companies.* Governments are developing rules requiring companies to provide information on beneficial ownership (i.e., on who ultimately controls the company) in order to make this information available to competent authorities. Registers of beneficial ownership seek to uncover *money laundering, bribery and corruption, insider dealings, tax fraud, terrorist financing, and other illegal activities*, and they are also promoted as means to enable stakeholders to demand accountability for local environmental impacts (e.g., finding out who owns a polluting facility).
- *Country-by-country reporting.* Governments are developing requirements for companies to report to tax authorities disaggregated details of investment, employment, revenue, profit, and tax in each jurisdiction where they do business. This is considered by governments to be a *risk assessment approach* enabling revenue authorities to identify and tackle profit shifting, such as through thin capitalization or overly generous transfer pricing.

Some also argue for country-by-country reports to be made public, suggesting that they could deliver a large fiscal boost for developing countries through multiple channels of impact (including tax compliance efforts and moral suasion and consumer pressure for corporations to pay more taxes than required by law). By highlighting corruption risks, such reports would encourage policymakers to change the tax system and enable investors to identify risks. [\[18\]](#)

Conclusion

Domestic resource mobilization is increasingly recognized as critical to securing stable and sustainable sources of finance and building accountable states. Technical assistance to build administrative capacity, cooperation on exchange of information, and development of international agreements and frameworks are therefore important strands of the agenda for development cooperation.

Tax practices by global companies are headline grabbing but only one part of the domestic resource mobilization challenge. Domestic issues such as the capacity of tax policymakers and revenue

authorities, the structure of natural resource taxes, and the lack of taxes on assets such as land may be equally if not more important.

By implementing cross-border transparency measures such as automatic exchanges of information, developed countries can make a critical contribution supporting the accountability of governments, firms, and institutions in developing countries. Yet gains from greater transparency also depend on domestic policies and politics.

Aggregate estimates of revenues should be handled with care, since they can be misinterpreted as suggesting a large “pot of gold” for development in the poorest countries.

The fundamental question of international taxation remains how to allocate taxation rights among jurisdictions. There is no clear principle that delivers a single “right” answer. That such allocation remains an open question of research and policy debate suggests that although there may be limited “compliance-plus” expectations for responsible business practices on taxation (such as complying with the arms-length principle even in countries where there is low capacity for enforcement), it is not reasonable to expect that moral instincts can determine a “fair” amount of taxation differing from that determined by the law.

Organizations promoting transparency and accountability will need to address these tensions as part of the overall challenge to translate more information into more informed public debate, build support for development-enabling policies, and hold governments and international businesses to account.

[1] This briefing is based on a longer paper: Maya Forstater, *Can Stopping Multinational Tax Dodging Close the Gap in Finance for Development?* (Policy Paper 15/69, Center for Global Development, Washington, DC, 2015). Also see, for example, Martin Hearson, *Tax-Motivated Illicit Financial Flows: A Guide for Development Practitioners* (Bergen: Chr. Michelsen Institute, 2014)..

[2] Some argue that there is a further gray area that relates to contravening the “spirit of the law.” In general, however, the courts already seek to give effect to the spirit of the law, so it does not make sense to talk of a separate “spirit of the law” that cannot be discerned by the judiciary.

[3] Michael Devereux, Judith Freedman, and John Vella, “Tax Avoidance” (paper, Oxford University Centre for Business Taxation, Oxford, 2012).

https://www.sbs.ox.ac.uk/sites/default/files/Business_Taxation/Docs/Publications/Reports/TA_3_1

[4] Alex Cobham and Simon Loretz, “International Distribution of the Corporate Tax Base: Implications of Different Apportionment Factors under Unitary Taxation” (ICTD Working Paper 27, Information and Communication Technologies and Development, University of California, Berkeley, 2015).

[5] Gabriel Zucman, “Taxing across Borders: Tracking Personal Wealth and Corporate Profits,” *Journal of Economic Perspectives* 28, no. 4 (2013): 121–148. The \$190 billion figure is based on the assumption that 80 percent of assets held in offshore accounts by individuals are unreported, and that these secret accounts are earning 8 percent interest.

[6] See, for example:

Dhammika Dharmapala, “What Do We Know about Base Erosion and Profit Shifting? A Review of the Empirical Literature” (CESifo Working Paper 4612, CESifo Group, Munich, 2014). Nadine Riedel, “Quantifying International Tax Avoidance: A Review of the Academic Literature” (ETPF Policy Paper 2, European Tax Policy Forum, 2014).

[7] Organisation for Economic Co-operation and Development, *Measuring and Monitoring BEPS, Action 11 – 2015 Final Report* (Paris: OECD, 2015).

[8] United Nations Conference on Trade and Development, “International Tax and Investment Policy Coherence,” Chap. 5 in *Reforming International Investment Governance*, World Investment Report (Geneva: UNCTAD, 2015).

[9] Ernesto Crivelli, Ruud A. de Mooij, and Michael Keen, “Base Erosion, Profit Shifting and Developing Countries” (IMF Working Paper, Fiscal Affairs Department, International Monetary Fund, Washington, DC, 2015).

[10] ActionAid, *Give Us a Break – How Big Companies Are Getting Tax-Free Deals* (Johannesburg: ActionAid, 2013).

[11] African Development Bank/Asian Development Bank/ EBRD/European Investment Bank/ Inter-American Development Bank/International Monetary Fund/World Bank Group, “From Billions to Trillions: Transforming Development Finance Post-2015 Financing for Development: Multilateral Development Finance” (April 2, 2015).

[http://siteresources.worldbank.org/DEVCOMMINT/Documentation/23659446/DC2015-0002\(E\)FinancingforDevelopment.pdf](http://siteresources.worldbank.org/DEVCOMMINT/Documentation/23659446/DC2015-0002(E)FinancingforDevelopment.pdf).

[12] For a discussion of the methodological issues see, for example: Clemens Fuest and Nadine Riedel, “Tax Evasion, Tax Avoidance and Tax Expenditures in Developing Countries: A Review of the Literature” (report, Oxford University Centre for Business Taxation, Oxford, 2009).

[13] See:

Volker Nitsch, “Trade Mispricing and Illicit Flows,” in *Draining Development: Controlling Flows of Illicit Funds from Developing Countries*, ed. by Peter Reuter (Washington, DC: World Bank, 2012); Maya Forstater, *Can Stopping Multinational Tax Dodging Close the Gap in Finance for Development?* (Policy Paper 15/69, Center for Global Development, Washington, DC, 2015).

[14] Global Financial Integrity publishes annual estimates of illicit financial flows.

[15] For a discussion of the Zambia estimate, see <https://hiyamaya.wordpress.com/2015/10/28/zambia-copper-again>.

[16] Henry (2012), as discussed in note 3.

[17] Based on CIA Factbook data.

[18] Joint Civil Society Statement, “Why Public Country-by-Country Reporting for Large Multinationals Is a Must: Questions and Answers” (Various Publishers, 2015).

http://www.transparencyinternational.eu/wp-content/uploads/2015/05/Joint_Civil_Society_QuestionsAnswers_Briefing-on-Public-CBCR_04_05_2015.pdf.

