

**German Bundestag
Finance Committee**

**The Effects of Tax Avoidance and
Evasion on Developing Countries**

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1. There are three issues to consider here

- Tax avoidance
- Tax evasion
- Tackling these issues

2. Tax avoidance

- This is the issue that has attracted most attention in developed countries.
- This may have been appropriate from a developed country perspective:
 - It is likely that most of the avoidance in developing countries is by multinational companies based in developed countries;
 - This is the case because taxes on corporate profits are much more significant in developing than developed countries;
 - In developing countries such taxes often account for up to 20% of total revenues;
 - In developed countries they frequently account for less than 10% of revenues now;
 - Whilst the scale of losses to tax avoidance from these companies in developing countries cannot be ascertained with certainty estimate in the range of US\$100bn to US\$200bn a year are now commonplaceⁱ. My own peer reviewed work for the World Bank suggested that this scale of loss was within a plausible range of outcomesⁱⁱ;
 - Refining the estimates may not now be of much immediate benefit. Tackling the issue is more important and I note ways to do that, below.

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3. Tax evasion

- The scale of losses to tax evasion is much higher in every economy I have ever looked at than the losses to tax avoidance:
 - I would, for example, suggest EU losses to avoidance may not be more than 15% to 20% of the total tax gapⁱⁱⁱ;
 - Evidence from the UK, where most work has been done on this issue, confirms this view, whether the opinion of HM Revenue & Customs^{iv} or my alternative work on the subject is consulted^v;
 - Given the size of the shadow (black) economy in many developing countries tends to exceed that in developed countries it is likely that this scale relationship may well still be true in those countries even though the proportion of taxes on corporate profits, where avoidance is a bigger issue, is higher in those countries^{vi};
 - If this is the case then it is likely that tax evasion is a much bigger problem for developing countries than is tax avoidance;
 - My 2011 work on this issued suggested that maybe one third of worldwide tax evasion took place in Africa, Asia and South America and that the cost might be \$1.1 trillion a year, about 79% of annual health care costs in those continents^{vii}.
- The risk from tax evasion - which is largely a domestic issue – has been ignored for too long and needs to addressed:
 - I make some detailed suggestions on this issue below;
 - Note that without in any way diminishing the efforts to tackle tax avoidance a change of focus to look at tax evasion may also now be wholly appropriate in developed countries as well.

4. How to tackle the issues

a. Tax avoidance

- The OECD BEPS process is a good technical start in tackling the issue of tax avoidance but it has massive limitations within it:
 - It assumes we can tax individual companies as if they are independent of other companies in the group of which they are a member. If this was ever true it is not anymore: the arm's length pricing method of determining the allocation of profits between companies under common control assumes that such prices can be found in reported market transactions. When more than 60% of world trade is now undertaken on an intra-group basis this is just not true. As a result the whole of international tax policy is based on a falsehood - or a fantasy, if you wish. This is that there are markets that can and do indicate prices for goods and services that cross international borders when this is simply not true. As a result nothing the OECD can do to

tackle tax avoidance will be of much use whilst it remains dedicated to this inappropriate basis of taxation;

- The OECD arrangements for CBCR do not go near meeting the promise made to developing countries by the G8 in 2013 when it was said they would get access to this data. The reality is that the data will now only go to parent company jurisdictions and there is no guarantee at all that they will share it with developing countries with whom they do not have a double tax agreement, and DTAs are often not in the best interests of developing countries as currently drafted meaning that an impasse has been reached where many countries will be excluded from the data that it was said was being produced for their benefit.
- The technical answer to the flaws in the OECD BEPS process is to adopt unitary taxation - with a specific allowance in any formula for the extractive industries:
 - The EU CCCTB is a technically sound starting point for discussion on this issue.
- We also have to realise that in the extractive industries there may well be very good reason why taxes other than those on profit may be of best benefit to developing countries:
 - Tariffs, royalties and export taxes are all very effective in this sector and policy moves against such charges over recent decades have undermined the tax capacity of developing countries. We need to permit these countries to have tax systems that suit their current state of economic development, and to those that are designed to achieve best results for developed countries.
- The biggest change required is not, however, technical but behavioural. All tax systems eventually work by encouraging the highest degree of compliance possible. This is best achieved in this area by requiring public country-by-country reporting. Nothing will change corporate tax avoidance behaviour more than this:
 - Public CBCR would put on public record the OECD template data on this issue prepared by multinational groups (for which the definition needs to be widened);
 - This template reveals:
 - Third party sales;
 - Intra-group sales;
 - Profit before tax;
 - Tax liability accrued;
 - Tax paid;
 - Equity capital;
 - Retained earnings;
 - Number of employees.
 - This is likely to reveal as a result:
 - The proportion of genuine trade in a jurisdiction;
 - Where tax risk is high (indicated by the intra-group sales element);

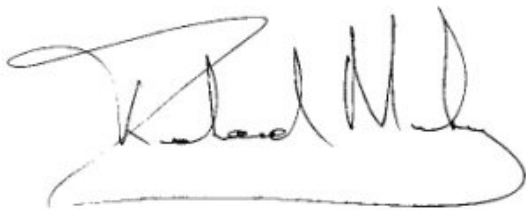
- What proportion of the third party sales of the group take place from a country;
- What proportion of total staff are based in a country;
- What part of total capital is located in a country;
- These three factors are the pre-requisites of real trade: knowing them helps suggest the proportion of total profits likely to be really attributable to a jurisdiction.
- Using this data it is quite easy to estimate what the likely profit attributable to a jurisdiction might be (this is done by weighting the attribution of one third of profit to jurisdictions on the basis of each variable noted but in the case of the extractive industries some variation to allow for a return to land may be needed):
 - Given that companies will know this is possible and will know that they will have to explain variances between these sums and the profits actually allocated to a place the pressure to reduce artificial reallocation of the tax base in ways that cannot be economically justified will be very high and so rates of tax avoidance should decrease;
 - I should make clear my bias on this issue: I created country-by-country reporting.
- My own contacts with large companies suggests that some are already working hard to simplify and justify their group structures and profit allocations:
 - This is happening amongst those who think public CBCR most likely;
 - To extend that behaviour requires that publication of CBCR take place and that the definition of a group that has to publish be extended so that many more groups of companies are covered;
 - I believe there is nothing that will have more impact on tackling tax avoidance than publications of CBCR data.
- Publication of CBCR data would overcome the problem developing countries have with accessing this data. In that way the weaknesses in the OECD / G8 process will be addressed.

b. Tax evasion

- Tax evasion is both domestic and international.
- International evasion:
 - This only happens with the assistance of tax havens and the bankers, lawyers and accountants who service them;
 - The tax haven issue has not been resolved by the OECD Common Reporting Standard (CRS) and by automatic information exchange (AIE) because:
 - The USA has not signed up to the CRS and looks very unlikely to do so;

- States like Switzerland and Luxembourg are already undermining the CRS by deeming the USA CSR compliant when it is not, making the USA the preferred tax haven of choice in the world now;
- The data needed to deliver AIE does not exist because:
 - Very few countries have functioning registers of beneficial ownership and the USA has no intention of producing one;
 - Those that do, like the UK, are putting on an appearance of compliance when in practice hundreds of thousands of companies do not supply the data required of them by law and penalties are almost never imposed;
 - The UK has backed off from demanding reform from its tax havens;
 - The result is we have what might best be called 'transparency in secret' and it is not going to deliver any of the expected benefits.
- And many developing countries are excluded from CRS anyway and so for them it is wholly ineffective.
- The solution:
 - First, the CRS has to be changed for developing countries. It is vital that they get data without being able to reciprocate;
 - Beneficial ownership registers have to become at least an EU issue and must be put on a consistent basis;
 - Countries must invest in AIE internally as well as externally as a mechanism for tackling internal tax gaps as well as those with tax havens. The yield from tackling this issue will be high in terms of tax revenue raised domestically in developed countries and at the same time the spillover effect will be massively enhanced data to developed countries and the ability at the same time to put pressure on tax havens to comply with the demand for beneficial ownership registers in future by proving that such registers are possible;
 - Countries must publish the extent to which they use AIE: if people do not know it is being used then the behavioural impact of it is lost and in many ways this is its most important future.
- Domestically
 - Tax gaps must be properly appraised: the failure to do this is hindering all efforts to recover tax. No one can be sure what the goal of tackling tax abuse is if the sum that it is thought needs to be chased has not been reasonably estimated so that progress can be assessed;
 - There has to be serious support for developing country tax authorities to collect tax by providing them with additional resources whether from their own governments or by international grants;

- The paper based design of a great many developing country tax systems needs to be re-thought. Such systems may work in developed countries but do not work well in developing countries. The idea of transaction taxes based on spending through mobile phones does, for example, need to be considered as an alternative to many aspects of VAT in developing countries. Rethinking taxes based on land use, financial transactions and energy use may also be required whilst in an era when information exchange makes wealth taxation possible such taxes need to be on the agenda of developing countries, but work on how to achieve this goal has to be undertaken.



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ⁱ See, for example <https://www.imf.org/external/pubs/ft/wp/2015/wp15118.pdf> from the IMF that supports this estimate.

ⁱⁱ Page 265 and following here

<https://openknowledge.worldbank.org/bitstream/handle/10986/2242/668150PUB0EPI0067848B09780821388693.pdf>

ⁱⁱⁱ See <http://www.taxresearch.org.uk/Documents/EUSocialists.pdf>

^{iv} See

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/470540/HMRC-measuring-tax-gaps-2015-1.pdf

^v <http://www.taxresearch.org.uk/Documents/PCSTaxGap2014Full.pdf>

^{vi}

http://www.tackletaxhavens.com/Cost_of_Tax_Abuse_TJN%20Research_23rd_Nov_2011.pdf

^{vii} *ibid*