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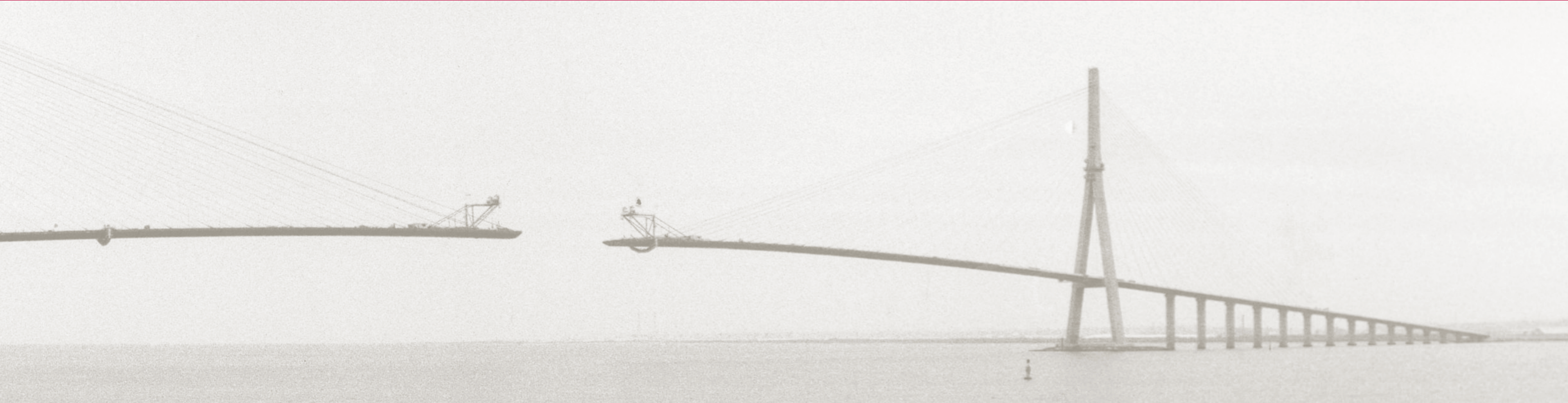


Briefing Paper 13/2019

Financing for Development and Domestic Revenue Mobilisation: More International Reforms Are Needed

Summary

To achieve the Sustainable Development Goals (SDGs) by 2030, developing countries need additional funding. Funding can come from four sources: domestic public resources (or revenues), international public resources, domestic private resources or international private resources. Of these four sources, domestic revenues from taxes and non-tax sources (e.g. profits from state-owned oil companies) are by far the most important. Tax revenues amounted to USD 4.3 trillion in 2016 for low- and middle-income countries alone, which is more than double the amount of international public and private capital these countries received in the same year. Domestic revenues have been growing in a majority of low- and lower-middle-income countries over the last 15 years. However, these increases remain insufficient to cover the financing needs of the SDGs, estimated at USD 2.5 trillion per year for developing countries, according to figures from the United Nations Conference on Trade and Development. In addition, these countries have to deal with the recent decline in financial flows from international public and private sources – a decline of 12 per cent between 2013 and 2016. As a result, many governments are under pressure to mobilise more revenues at home. What options do they have to achieve this goal?

In this briefing paper, we focus on the international dimensions of the issue. We argue that governments need to act multilaterally in three key areas.

First, tax avoidance by multinational corporations (MNCs) remains a global problem, despite important progress in recent years. Though not openly illegal, tax avoidance causes considerable damage to developing countries. Poorer countries depend to a higher degree on corporate taxes than richer countries and are thus more vulnerable to these practices. International initiatives to act upon tax avoidance – for instance, by introducing a minimum tax and by taxing the digitalised economy – should take the taxation rights of poorer countries into account.

Second, fighting illegal tax evasion is another relevant topic. At an international scale, the exchange of tax-related information – for instance, on the beneficial ownership of assets – is a key factor, and developing countries need to participate in this exchange on a broad scale. This will require additional domestic and international efforts to boost capacity and credibility.

Third, governments worldwide should increase transparency on their tax expenditures and dismantle those structures that prove to be either harmful or ineffective in fiscal, social or environmental terms, or create negative spillovers for other countries. As a first step, governments should agree on common reporting standards and start producing regular, public and encompassing reports on the tax expenditure schemes in place.

Evidently, this is not an agenda for individual countries or a call for unilateral action. Current approaches to international tax cooperation – mostly propelled by the Organisation for Economic Co-operation and Development (OECD) and the G20 – need to be broadened and include all countries on an equal footing; they should also be deepened to cover those aspects of taxation that are not yet being sufficiently addressed. It is also clear, however, that the degree to which developing countries will take part in international standard-setting and regulation depends to a considerable degree on their capability to push forward critical governance reforms at the domestic level.

Overview of development finance flows

Domestic revenue mobilisation forms a key action area in the financing for development process, as defined in the Addis Ababa Action Agenda. On average, tax revenues covered between 42 per cent of total financial resources in low-income countries (LICs) and 78 per cent in upper-middle-income countries (UMICs) in 2016 (Figure 1). Another source is private investments (both domestic and international), which average between 13 per cent and 18 per cent of total financial resources in low- and middle-income groups, but the investment levels have been declining over recent years. Remittances are an important part of private financial flows in poorer countries. In addition, international public flows (bilateral and multilateral) are particularly important in least developed countries (LDCs) and LICs, where they cover between 22 and 29 per cent, on average. The global decline in private investments over the past years and a decrease in international public flows to middle-income countries make mobilising domestic revenues even more important for financing the SDGs by 2030 and bringing developing countries onto a sustainable development path.

Tax avoidance

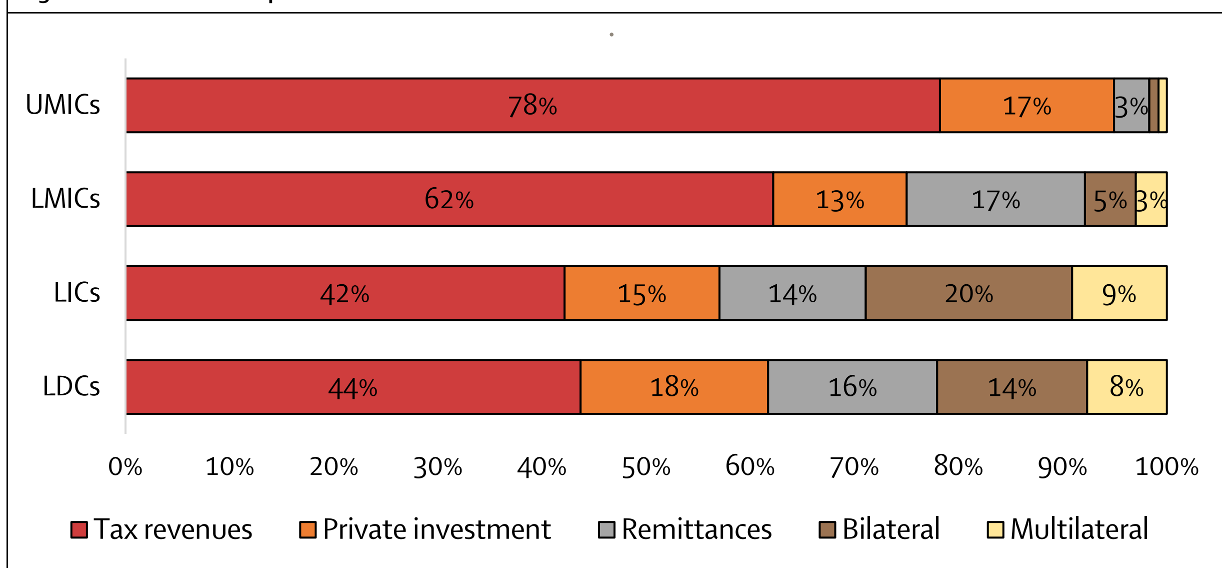
Loopholes in the international tax system allow MNCs to shift their profits and intangible assets from high-tax to low-tax jurisdictions to lower their overall tax burdens (profit shifting). Similarly, MNCs shift their debts from low-tax to high-tax jurisdictions to lower the taxes on interest payments (debt shifting). Profit and debt shifting by MNCs create large losses in corporate tax revenue all over the world, but the problem is more severe for developing countries because taxes paid by large corporations play a more important role for public revenue in this group of countries. On a global scale, estimates indicate that about 40 per cent of multinational profits are shifted into tax havens every year. This behaviour creates average corporate revenue losses of about 10 per cent for public funds.

The growing importance of intangibles in value creation and the digitalisation of the economy make the fight against tax avoidance even more complex. In the current international tax system, each subsidiary of an MNC is treated as a single entity, and profits should be taxed where value is created (nexus principle). The digitalisation of the economy produces new business models (e.g. social media firms such as Facebook, and shared platform firms such as Airbnb) that are hard to tax under the current nexus rules because the location of profits differs from where value is created. In a growing number of cases, value is created without any physical presence of the firm.

The OECD/G20 base erosion and profit shifting (BEPS) project is currently implementing its 15-point action plan, which was set up in 2015 to tackle the problem of corporate tax avoidance. The Inclusive Framework on BEPS, established in 2016, opened up the process to non-OECD and non-G20 countries and was an important step towards more inclusiveness in the BEPS process. As of early 2019, the Inclusive Framework had 129 members, including many developing countries that are committed to fighting BEPS. On the tax challenges posed by digitalisation, a task force was set up and produced a series of proposals for public consultation in early 2019.

Although it is clear that the international community is still at odds regarding specific solutions, a fundamental consensus is beginning to emerge on the need to move beyond the current system in the determination and location of profits at an international scale. A growing number of proposals entail versions of formulary apportionment, which determines the distribution of taxation rights according to a global formula, thus eliminating profit shifting. Governments and international organisations such as the G20 are

Figure 1: Mix of development finance resources in 2016



Note: UMICs = upper-middle-income countries, LMICs = lower-middle-income countries, LICs = low-income countries, LDCs = least developed countries.
Source: Authors; data retrieved from OECD (2018)

discussing global applications of a minimum tax as well as new ways to tax the value generated by users of digital platforms as well as providers of digital services without a physical presence.

Many of the options on the table today could, in principle, lead to granting developing countries new taxation rights. However, their real impact on revenue and foreign direct investment flows is largely dependent on the design of the new rules. In this context, some developing countries want more influence in shaping future international tax reforms and are critical of implementing the pre-defined tax policy agenda of the OECD/G20 BEPS project. In addition, many poorer countries are clearly struggling with implementing new rules and standards due to a lack of technical skills and capacities. This is a field where bilateral development co-operation needs to go hand in hand with international reform initiatives.

Tax evasion

Rich individuals hide their income and wealth in offshore accounts and shell companies in tax havens to illegally evade taxation in their home countries. Global estimations indicate that about 10 per cent of the global financial wealth of households is held in tax havens. In some developing countries, the level of tax evasion among political and economic elites is severe. Resource-rich countries are often particularly affected because of high rent-seeking opportunities captured by the elites. Companies illegally evade taxes through international trade mispricing and misinvoicing. Illicit capital flows stemming from these practices were estimated to have amounted to 20 per cent of developing country trade between 2006 and 2015. It is noteworthy that individuals and companies seeking to evade taxes and companies seeking to (legally) avoid taxes often use the same kinds of services provided by tax havens.

Digitalisation provides both opportunities and solutions for global tax evasion. On the one hand, the spread of cryptocurrencies and blockchain technology could facilitate the anonymous transfer and hiding of wealth. On the other hand, digitalisation can lead to better information-sharing between tax authorities and more transparency regarding the flow of goods, services and capital. The Global Forum on Transparency and Exchange of Information addresses international tax evasion. About 127 countries have committed to exchange automatically the data from the bank accounts of tax residents of member states via the Automatic Exchange of Information agreement. Another line of action refers to beneficial ownership registries, which require asset-holding companies to disclose the beneficial owners – natural persons – of their assets.

The participation level of developing countries in the information exchange is still low – partly because they lack the technical and human resource capacities to effectively implement the mechanisms in their tax administrations. Therefore, building up the required technical infrastructure and expertise is critical. However, credibility in the collection, management and sharing of sensible data is equally important to facilitate the flow of information (Monkam, Ibrahim, Davis, & von Haldenwang, 2018).

Despite progress in international tax transparency and information exchange, a core problem remains: Without pressure from powerful international actors, offshore banks and governments, tax havens have little incentive to comply. Hence, governments of non-haven countries should publish and share data on their financial transactions with tax havens. Bilateral tax treaties with tax havens should be carefully revised in order to ensure that they are not being used as vehicles to evade and avoid taxes. In addition, channelling official development assistance funds through offshore financial centres should also be avoided. The creation of the EU tax haven blacklist was an important step in tackling tax havens, but more transparency and joint actions are needed to make tax evasion less attractive.

Tax expenditures

Tax expenditures are widely used to attract foreign investment and boost economic growth, but they create sizeable revenue losses and their benefits are often highly doubtful. According to a definition of the International Monetary Fund, tax expenditures are "special exclusions, exemptions, deductions, credits, concessions, preferential rates, or deferral of tax liabilities" in domestic tax laws for specific corporate taxpayers or activities. Many countries have no clear view of the real costs and benefits of their tax expenditures. Governments often fail to collect, publish and analyse comprehensive data on the size and type of their tax expenditures. In those cases where some information is provided, revenue losses due to tax expenditures amount to up to 6.6 per cent of gross domestic product in Latin America and 7.5 per cent in Africa.

Tax expenditures can present three types of problems. They can be i) ineffective, in that they do not attract the desired foreign investment; ii) domestically harmful, in that they create negative externalities and welfare losses within a country; and iii) internationally harmful, in that they create negative spillovers to other countries.

As a first line of action, governments should phase out environmentally harmful tax expenditures. Among the most harmful tax expenditures are tax reductions for fossil fuels, which create many negative externalities (Redonda et al., 2018). Second, governments should redesign or renegotiate ineffective tax expenditures. To identify ineffective tax expenditures, cost-benefit analyses should be prepared to compare expected investments and economic growth perspectives with revenue losses. Therefore, governments should commit to publishing annual tax expenditure reports in which they inform on the size (in terms of revenue foregone), type, sector and policy objective of all tax expenditures. Third, negative spillover effects of tax expenditures on other countries need to be assessed and international cooperation should be strengthened so that tax expenditures do not decrease overall global welfare.

Such reform proposals are ambitious and difficult to put into practice, especially for countries with limited administrative capacity. It is noteworthy, however, that many developed countries also do not reveal information about their tax expenditures. This is clearly a topic that calls for concertation in multilateral fora such as the Platform for Collaboration on Tax or the Addis Tax Initiative. Regional tax organisations can play an important role in supporting their member countries to prepare the reports and reduce regional tax competition via tax expenditures.

Inclusive processes are needed

Fighting tax avoidance and evasion and ending harmful and ineffective tax expenditures are key reform areas to mobilise revenue from foreign taxpayers in developing countries. Progress in these areas will critically depend on far-reaching reforms of the international tax system, but it will also require structural changes at the domestic level in many countries.

There seems to be a broad consensus that the international tax system in place today cannot cope with the realities of a globalised (and increasingly digitalised) world economy. This is new: Although important progress has been achieved in international tax cooperation in recent years, it is also fair to say that much of this progress has tried to emulate the complexity of the globalised flows of goods, services and capital, rather than reduce the levels of complexity and transform the system. Also, progress has been driven, above all, by the unilateral actions of a few powerful actors, such as the United States and the European Union (EU), and much less through multilateral deliberation. Above all, the US Tax Cuts and Jobs Act of December 2017 changed the international tax landscape by imposing minimum taxation on US inbound and outbound investments. The EU is also working on shaping the international tax system by defining rules and standards for harmful tax competition and discussing ways to tax the digitalised economy. The EU Code of Conduct group published the first blacklist of the world's largest tax havens in 2017. Within the EU, the idea of a common consolidated corporate tax base (CCCTB) is being discussed, though with uncertain outcomes. A CCCTB could help to solve EU-wide profit shifting by sharing the consolidated taxable profits of MNCs between EU countries following a formulary apportionment rule, which determines how much tax an MNC pays in each operating country.

From a developing country's perspective, seizing the opportunities for additional tax reforms – as they present themselves now – is important. New initiatives such as the Addis Tax Initiative, the Inclusive Framework on BEPS and the Platform for Collaboration on Tax offer prospects for active participation. No less important, however, is making sure that the interests of poorer countries are considered in the process of defining new rules and taxation rights. It is an open question at this moment whether or not issues such as introducing a minimum tax or taxing the digitalised economy will be determined in a truly multilateral setting. Since governments have an immediate interest in protecting their own tax base rather than promoting a global and long-term perspective on tax fairness, the best – and probably only – way to achieve this is to make the respective processes as inclusive as possible. In this sense, bilateral measures to support policy-making and build capacity in developing countries need to go hand in hand with pluri- or multilateral initiatives that give developing countries and their regional organisations a voice from the beginning.

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