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Post 2015: The International Battle Against Tax Fraud and Evasion

Summary

Reports on worldwide tax fraud and illicit global financial flows have been appearing more and more frequently in recent times. In spite of the attention which such revelations attract, however, the international community is still far from an effective system of controls. While it is true that the G20, the G8, the European Union (EU), the *Organisation for Economic Co-operation and Development* (OECD) and other international organisations are advocating more international cooperation and control in this area, implementation of the related resolutions has proven to be difficult.

In its first major report, at the end of May 2013, the United Nations "*High-Level Panel of Eminent persons on the Post-2015 Development Agenda*" now proposes that the reduction of illicit flows and tax evasion and the recovery of stolen assets be included in the new global agenda. This initiative deserves support, precisely because many of the poorer countries labour under a disastrous combination of weak national tax and control agencies together with international tax loopholes and regulatory gaps.

Large international companies above all use this constellation to shift their profits with the help of internal transfer prices to countries with particularly low tax burdens (so-called "tax havens"). And it is often much too easy for persons with large private assets to circumvent tax obligations in their own countries. While it is true that no reliable figures are available about the extent to which developing countries are damaged by such behaviour, even the most conservative estimates make it clear that these illicit capital outflows lie on an order of several magnitudes above inflows from official development assistance (ODA), not to mention their negative impacts regarding governance and corruption.

Most of these "tax havens" are found in OECD countries or smaller states and territories which are dependent on them. At the same time, it is the OECD countries which have the market power and public infrastructure to effectively implement controls and plug existing legal tax loopholes. But the major emerging countries too, along with resource-rich developing countries, must be integrated into this effort if actions which have been decided upon are to take effect on a worldwide basis. This topic is thus particularly relevant for a global agenda "*Beyond Aid*".

The new agenda should tackle the problem at several points: in order to increase market transparency, reporting and accounting obligations of companies must be expanded and standardised. It is also of major importance to improve international cooperation and the exchange of information between tax authorities. Bilateral accords like those presently in place are not enough for this; rather, multilateral actions by the international community are required. These may be initiated by individual groups of countries, but must then be implemented on a global scale.

1. Developing countries are hit hardest

For a long time, the public debate on tax fraud and financial outflows concentrated on private assets in OECD countries. This, however, touched only the tip of the iceberg. Many developing countries also make it too easy for those with large assets to circumvent their tax obligations. Members of the elite often use their position to block investigations by national tax authorities. Once the funds have left the country, lax controls in so-called "tax havens" help to conceal the origin of such wealth. As a result, some of the world's wealthiest persons come from very poor (but often resource-rich) countries with bad governance.

In addition, many companies veil their activities by carrying out their operations in part or wholly via "tax havens". This is especially true of the financial sector. In other areas such as extractive industries and the international transportation industry, such patterns of behaviour are likewise common. An important role is played here by transfer prices for goods and services delivered or rendered within a company or consortium on a cross-country basis (*transfer pricing*).

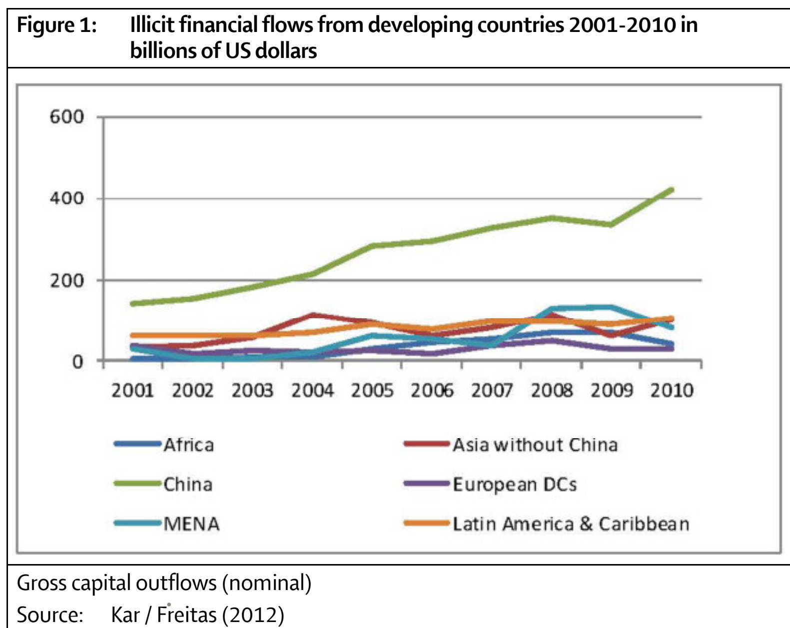
All over the world, tax authorities struggle to monitor transfer prices even for standardized products – not to mention highly specific financial services or internally licensed intellectual property rights. For example, a study carried out by the *United States Congress* in the year 2010 found that the officially documented profits of US American company subsidiaries on the British Virgin Islands were 2.5 times in excess of that country's Gross Domestic Product (GDP). Profits on the Cayman Islands were 4.5 times greater than the local GDP, and even 5.5 times greater in the case of Bermuda. This means that a major share of the value-added of these US companies is transferred artificially to states which levy extremely low taxes.

Poor countries with weak public sectors have even greater problems in monitoring large companies. Here the disproportion between the market power of such companies and the effectiveness of taxation and supervisory authorities is usually especially glaring. As a result, the public hand collects only a fraction of the funds which are actually due to the state.

It is no accident that the above-mentioned figures refer to an industrialized country, the USA. True, research has long focused on the problem of measuring capital drains from developing countries. But whereas industrialized countries often provide data on the level of companies or taxpayers, such detailed information is usually unavailable in developing countries. In its place, macro-economic data (e.g. trade and debt statistics) are used to assess the dimensions of the problem. Even though the methodological problems entailed by this do not permit a presentation of robust results, all available evidence indicates that the problem of negative capital outflows places a serious burden on many developing countries. Depending on the source, taxes lost by the developing countries are estimated to total between one-and-a-half to 10 times the amount of ODA.

To be sure, very diverse circumstances are hidden behind these aggregate figures. If the statements of the international non-governmental organisation *Global Financial Integrity* (Kar / Freitas 2012) are taken as a basis, nearly half of all illicit capital outflows in the years 2001 to 2010 fall to the account of the People's Republic of China. In part, these are circular flows of capital which bleed enormous amounts of tax revenue out of the Chinese State and promote corruption and illegal enrichment in their place. On the other hand, when such outflows are seen in relation to the GDP, other countries – oil exporters like Nigeria, for example – are much more heavily involved. At any rate, the outflows appear to have increased significantly in most developing regions in the last decade (see Figure 1).

Figure 1: Illicit financial flows from developing countries 2001-2010 in billions of US dollars



Gross capital outflows (nominal)
Source: Kar / Freitas (2012)

2. Possible elements of a Post-2015-Agenda

There are signs that the battle against tax fraud and evasion could become a significant aspect of the Post-2015-Agenda. The relevance of this issue is now generally recognized on the international stage. The United Nations as well as the OECD have long been aware that poorly regulated financial markets and illicit capital flows pose hurdles to the sustainable financing of development. The G20 and G8 emphasized the need for better regulation at their most recent meetings. In order to deal with the problems, institutional, regulatory, tax-related and penal reforms are required. These range from combatting tax dodging and eliminating tax loopholes for financial institutions and companies to the restriction of possibilities for acting se-

cretively and an intensified fight against money laundering and corruption.

As a *first* step, international cooperation among tax authorities must be further improved. Automatic exchange of information should become the general norm. In most cases, it has been the rule up to now that information is given out only upon request. In April 2013 the finance ministers of the six largest EU countries (Germany, France, the UK, Italy, Spain and Poland) signalled their readiness to orient themselves to the *Fair and Accurate Credit Transactions Act* (FACTA) of the USA from the year 2003 and to set up an automatic exchange of information on capital income. However, this intensified cooperation in the club of industrialized countries is only an intermediate step, beyond which it is important above all to involve the major emerging powers and resource-rich developing countries. There has been almost no discussion of this to date.

Secondly, the responsibilities of companies regarding bookkeeping, the rendering of accounts, and the presentation of reports must be expanded and harmonised. In order to make internal transfer pricing transparent, mandatory disclosure is under discussion, above all on a project-by-project and country-by-country basis. This is where sectorial initiatives like the *Extractive industries Transparency Initiative* (EITI) play a trailblazing role. The disclosure obligations anchored in the U.S. *Dodd-Frank Act* of 2010 for extractive industries also represent an important step on the road to more transparent financial behaviour on the part of multinational companies. This is all the more true as the EU (Parliament, Commission and Council jointly) launched a comparable directive in April 2013. It binds companies listed in the EU as well as major non-listed companies to disclose all payments of more than 100,000 Euros earned from the production of natural oil and gas and from mining and logging operations and made to public entities worldwide. Once this information has been received, it can be combined with technical assistance targeted specifically to resource-rich developing countries.

Another important step would be to oblige every corporate entity recognized as such by law – including corporations, *trusts* and foundations – to procure and provide information about natural persons who profit from that entity's activities (*beneficial ownership*). The lack of such information is the central business basis of the so-called "tax havens", which advertise that the asset-holder's true identity must not be revealed. This is a point where resistance to reforms (or the gap between formal rules and their effective implementation) is thus especially strong.

Thirdly, additional steps to **harmonize** tax regimes and financial market regulations are required. Large companies often use country-specific rules and diverging interpretations of laws to lower their tax burden. In addition, it is now customary to situate valuable intellectual property with company subsidiaries in low-tax countries so that profits from the use of property rights accumulate there. Such behaviour many be legal in many cases, but is by no means legitimate. An important aspect of harmonization in light of this would be a uniform basis for the assessment of corporate income tax, i.e. a *Common Consolidated Corporate Tax Base* (CCCTB), with the aim that company profits should be taxed at the place where real value added does in fact occur. This instrument has been under discussion for years within the EU, but has still not been implemented. Here too, emerging powers and the developing countries must be integrated as soon as possible in order to prevent rules from being circumvented practically as soon as they are decided upon.

3. Implementation in the framework of the Post-2015-Agenda

Some of the above-mentioned steps are within the area of competence of national governments. In other cases, unilateral actions of individual states or groups of states could quickly have the result of closing international regulation gaps. However, a truly sustainable control of illicit financial flows requires multilateral action within the framework of a global agenda. To be specific:

Actions by national governments: Every state has the responsibility to formulate tax and finance policy regulations and ensure that they are effectively applied. In the poorer countries, however, the capacity gap between governmental agencies and the major companies and owners of assets is particularly wide. As part of the post-2015 agenda, therefore, development co-operation must be more clearly focused on strengthening tax agencies and supervisory bodies in the developing countries. This is already being carried out today to some extent in cooperation with regional associations, above all the Latin American association of tax authorities (CIAT) and its African counterpart (ATAF), which was founded in 2009. To some extent international organisations are also already being integrated, in particular the International Monetary Fund (IMF) with its regional training centres.

The experience of the EITI mentioned above shows that it is possible to provide specifically targeted support to reform-oriented governments relying on a lean, multilateral structure. In this context mechanisms of voluntary self-commitment and accountability are particularly relevant, especially when accompanied by civil society organisations in the countries involved and on the international level.

To a certain extent, **unilateral initiatives** of powerful individual states or groups of states have the potential to bring about changes on the international level (or conversely to prevent them). This is especially true for the USA as the largest national economy. The above-mentioned laws governing the exchange of information regarding capital income (FACTA) and the disclosure of payments rendered in the extractive industries (Dodd-Frank) have probably brought about more progress in the global fight against illicit financial flows than years of deliberations in the EU or OECD. However, even the USA become increasingly aware of the fact that unilateral implementation of power posi-

tions alone will hardly suffice to put an end to illicit flows. Important impulses in this regard are coming from so-called "club governance" structures such as the G8 or the G20. These act as forums for the international concertation of political initiatives, can propose effective measures or even provide international organisations with the mandate to take action in a corresponding manner.

Multilateral approaches: a key lesson learned over the past decade refers to the fact that without the major emerging powers and resource-rich developing countries the problem of tax fraud and evasion cannot be brought under control. In recent years, the OECD in particular has launched several initiatives to fight tax evasion and avoidance, addressing the club of industrialised countries as well as non-member states and developing countries. Examples to be named here are the OECD *Informal Task Force on Tax and Development*, founded in 2010, which works on several of the topics discussed above, and the *Global Forum on Transparency and Exchange of Information for Tax Purposes*, currently with 120 members (including many of the so-called "tax havens"). In addition, the *Financial Action Task Force on Money Laundering* (FATF) which was called into being in 1989 by the G7 strives to promote a stronger involvement of developing and emerging countries through its associated regional groups. Within the UN system, the *United Nations Convention against Corruption*, which took effect in 2005, offers a framework of standards for international cooperation which in turn takes such important aspects as the return of stolen assets into consideration.

On the whole, the conditions for an international monitoring of the behaviour of states and private actors have improved at several points in recent years. However, they are still inadequate to bring about changes on a broad front. The report of the "*High-Level Panel of Eminent Persons on the Post-2015 Development Agenda*" at the end of May 2013 has now proposed the reduction of illicit flows, and tax evasion and the recovery of stolen assets be included in the new global agenda. This proposal is in need of further elaboration. In this, the initiative is dependent on the support of member states and international organisations.

A major opportunity offers itself here for a global agenda "*Beyond Aid*". It is certainly possible to formulate targets which can be applied with equal validity to industrialised, emerging and developing countries. The indicators to be used for monitoring could be identical for all states, e.g. a (weighted) tax ratio, indicators measuring banking secrecy and corruption, and documented proof of active collaboration in selected international bodies and initiatives that serve to improve transparency in financial flows and fight unfair tax competition.

This paper is part of the "Post 2015" series of the DIE. For articles which have already appeared in this series, see www.die-gdi.de.

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