

## Working Paper Number 196

### International Tax Cooperation and Innovative Development Finance

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*Abstract.* For low and middle income developing countries globalization means that effective taxation has become an issue of international development cooperation rather than simply one of domestic economic policy. This paper examines the underlying issues which make effective taxation of foreign companies and their own residents' overseas assets so problematic for developing countries. Initial estimates of the scale of undeclared expatriated profits and assets held overseas, and the income tax that does not accrue to developing countries therefrom, are large in relation to other forms of development finance. International tax cooperation for development (ITCD) essentially involves information exchange between jurisdictions – the full application of existing tax codes – and would not require new institutions (other than for norm setting and monitoring) or tax rate coordination. None the less ITC has potentially fundamental implications for the relationship between rich and poor countries. As a potential source of “innovative development finance” (IDF) based on an expanded global tax base (not new taxes or increased rates) ITCD could represent a much more sustainable and equitable system than forms of IDF based on the traditional donor-recipient relationship.

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## 1. Introduction

A central theme of current debates on economic development and poverty reduction is the need to generate new resources to support the provision of public goods – otherwise known as “innovative development finance” (Atkinson, 2004). This paper argues that to tap new resources on a significant scale requires the strengthening of international tax structures, which currently allow citizens and firms of (or in) developing countries to avoid, evade and defraud national tax systems. Cooperative arrangements among sovereign jurisdictions could offer the possibility of increasing public revenues in many countries. This could potentially allow some countries to exit from the international aid system altogether, so that funding could be shifted towards the poorest countries.

This paper is thus about tax *cooperation* rather than tax *coordination* – in other words, it is about the collection of tax presently evaded and the allocation of the resulting funds, and not about the results of international tax differentials as such. Tax competition is a serious issue for developing countries (UNCTAD, 1995; OECD, 1998; FitzGerald, 2002). Many developing country governments have been competing with each other to offer lower rates of taxation on multinational corporations operating within their borders. The objective of attracting more foreign direct investment flows thus comes at the expense of losing taxable income generated by the foreign firms—often referred as a “race to the bottom”.

However current international taxation arrangements pose an even greater threat to development finance for two reasons: first, the difficulties in acquiring the potential fiscal resources generated by both foreign and domestic trans-border firms; and second, the consequences for both capital flight and social equity of the inability to tax residents’ overseas assets. To put this point another way, the problem is not only one of the tax *rate* applied, but also – and more importantly – of the tax *base* to which these rates are applied.

Globalization involves increasing freedom of capital movement: both for firms from industrialized countries investing in developing countries, and for financial asset owners in developing countries themselves. Standard principles of international taxation suggest that the tax burden should fall most heavily on those factors of production which are least mobile, in order to maximise government income and minimise the disincentives to economic growth. There has been a corresponding shift in the incidence of taxation from capital to labour as governments have tried to maintain levels of both fiscal revenue and private investment.

From the developing countries’ point of view there is in addition to revenue needs a severe income distribution problem that requires redistribution of wealth (and thus capital taxes) in order to reduce poverty and increase social cohesion. In addition, much of the most productive assets in the economy belong to non-residents, while much of residents’ wealth is held abroad. So capital income taxation cannot be ignored as a central development policy issue (FitzGerald, 2012).

The effective taxation of illicit capital flows (that is the transactions of both residents and non-residents that are not reported to or recorded by the national authorities) would provide not only a major resource to support effective public provision of the type outlined above. It would also increase the incentives for the private sector to invest locally, and reduce enormously the “protection” afforded to international criminal transactions by the “cloud” of tax evasion transactions going through offshore financial centres (Barrett, 1997; FitzGerald, 2004; Slemrod & Wilson, 2009). However, while developed countries in general (and the OECD in particular) have made considerable progress in tackling this problem of tax cooperation between themselves over the last decade, developing countries have achieved little – even though they stand to gain more (at least in proportion to their own resources) from such an initiative.

The paper is structured as follows. Section 2 examines the scale of the resources potentially available from the taxation of illicit capital flows out of developing countries. The issues around implementing automatic information exchange systems are discussed in Section 3. Section 4 then addresses the governance implications of tax cooperation on this scale between rich and poor countries. The drivers for change in international tax cooperation are discussed in Section 5. Section 6 concludes.

## **2. Estimating the scale of tax revenue lost to developing countries**

The OECD sums up the current state of knowledge as:

20. Offshore financial centres, broadly defined, reduce revenue available to developing countries where they act as a destination for income streams and wealth protected by a lack of transparency and show a refusal or inability to exchange information with revenue authorities who may have taxing rights in respect of that income or those assets. Data on revenues lost by developing countries from offshore non compliance is unreliable. Most estimates, however, exceed by some distance the level of aid received by developing countries—around USD 100 billion annually. (OECD 2010, p. 6)

It is worth noting in this context that the large proportion of assets held in these OFCs is not only a tax issue but a regulatory one as well – for bank and securities regulators cannot oversee the activities of financial intermediaries booking their transactions through them. It is widely agreed that this (large) gap in the international regulatory framework contributes to global financial instability.

Despite the evident value policy value of a plausible estimate of the sums involved in international tax evasion, and thus an idea of how much might be gained from improved intergovernmental coordination, none of the relevant international agencies – such as the IMF

or the OECD – with analytical resources and data generation capacity, have not so far undertaken the task. The reasons for this lack of quantitative policy research are unclear. It is of course true that the macro-level data from balance of payments statistics is far from reliable, while micro-level data from corporate accounts is by definition lacking in this field.

The only published estimate of the revenue losses due to offshore holdings of financial assets is TJN (2005, 2009). TJN combines estimates of global wealth published by banks and major consultancy firms with data on financial assets held offshore from the Bank for International Settlements to reach an estimate of \$11.5 trillion in assets held offshore in 2005. Assuming an average return on these assets of 7.5 percent and a tax rate of 30% yields an estimate of global tax revenue loss of \$ 255 billion in 2005 (TJN, 2005).

A number of studies examine profit shifting by corporations (both foreign and domestic) in developing countries through transfer pricing, leading to tax losses for the government. Global Financial Integrity (funded by the Ford Foundation) estimates illicit financial flows of the order of \$350bn a year on this basis for all developing countries for 2002-6 (GFI, 2009). The method only uses trade mispricing, on the grounds that other unrecorded capital outflows would not be taxed anyway; and applies statistical filters to eliminate anomalous data. Pak (2007) takes a slightly narrower approach by using US import data only, with the advantage that this allows transfer pricing to be distinguished from quality differentials in import unit value data, and estimates that \$202bn of profits were shifted out of developing countries in this way in 2005. GFI (2010) then goes on to estimate the implied tax loss from these implicit flows by applying the relevant country corporate tax rates to this data and finds that the average tax revenue loss in developing countries was \$98bn annually 2002-2006.

Faust & Reidel (2009) provide an interesting critique those that try to identify profit shifting by analysing international trade prices, for not taking into account quality differences within a product group. There is some merit in this critique for early work in the field; but Pak (2007) overcomes these problems by using micro-level import data and GFI (2009) by checking trade against balance of payments data on a country-by country basis. But the authors are correct to argue that simply multiplying results for income shifted out of developing countries by statutory corporate tax rates neglects the existence of investment incentives which mean that part of this income, even if declared, would be taxable at lower rates. A corollary of this point is that income shifting takes place for many other reasons than tax evasion – such as political instability and regulatory arbitrage.

In order to gauge the correct order of magnitude of these losses, and to help construct a rather more robust methodology for analysing the aggregate flows, it is necessary to take into account both dimensions of the problem: *first*, the tax lost on the illicit outflow of profits (whether by foreign companies or domestic residents) in any one year; and *second*, the tax lost due to the income arising abroad from the accumulated assets owned by residents only. For consistency we thus need estimates of both flows *and stocks* on the same basis.

In principle, to the extent that tax has been paid in other jurisdictions on these flows, there may be claims by other governments on the revenue; but this we shall ignore for the purposes of estimation at this stage on the grounds that (i) we are interested in revenues to developing countries; and (ii) the sum is unlikely to be large. None the less, this would be an issue once the flows are ‘legalised’ and thus should be considered as a future cooperation issue (see Section 4 below).

Ideally we would also want to allow for effect of higher effective tax rate on activity levels (i.e. investment and growth) in developing countries, feeding back into modified tax income on both domestic and international activities. There is no reason to assume that this effect would be negative, because the reduced overall profitability of capital would be balanced by the increased incentive to invest domestically. Further, it would be desirable to include the impact of the additional government expenditure as well on not only growth (e.g. through infrastructure provision) but also social objectives such as poverty reduction. This would of course require a CGE modelling exercise which lies far beyond the scope of this paper.

We thus define the potential tax revenue ( $T$ ) for a year in the following way:

The tax base ( $Y$ ) is composed of two components

- The unregistered (‘illicit’) outflows of profits (‘capital flight’) in any one year ( $F$ )
- The undeclared annual income ( $R$ ) from overseas assets ( $X$ ) held by residents

Flows ( $F$ ) and stocks ( $X$ ) are clearly related, but stocks are not a simple sum of past flows because

- Only a fraction ( $a$ ) of the flows ( $F$ ) are attributable to residents and thus enter into the stock ( $X$ )
- The accumulated asset value ( $X$ ) should also take into account the reinvested portion ( $b$ ) of earnings ( $R$ ), net of tax, inflation etc

The potential tax revenue ( $T$ ) from this tax base ( $Y$ ) depends therefore on the rate of return ( $r$ ) on overseas assets ( $R = rX$ ) and the effective corporate or income tax rate ( $t$ ) applicable after incentives, deductions etc.

$$T = tY = t(F + rX)$$

$$\Delta X = aF + brX$$

The best approach would be to use the global network of bank regulators and tax officials to make informed estimates (the UN/CTED being a key precedent). None the less, comprehensive mobilisation of the data and skills of developing country tax authorities, combined with sound estimates of international financial stocks and flows, would allow a good estimate to be made. There are established methodologies for estimating capital flight (that is, unregistered and thus untaxed flows) which are accepted by international financial institutions (Ajayi, 1997; Beja, 2005). Computable general equilibrium modelling would also

allow second-order effects of higher effective tax rates on capital flows (and, ideally, investment and growth) to be made; as is done in estimating trade gains (and losses) to developing countries from recent global trade rounds (Devarajan & Robinson, 2005).

Absent the above, loss of tax base can be estimated by drawing on estimates of ‘illicit capital flows’ ( $F$ ) from developing countries trade and balance of payments data and then calculating the accumulated stock. IMF’s Direction of Trade Statistics-based Trade Mispricing model, which compares partner country trade data, is the usual source. The World Bank Residual model, which estimates the gap between a country’s sources and uses of funds as the sum of the change in the stock of external debt and net foreign investment, minus the current account deficit and the change in net stock of foreign reserves; is also used. Schneider (2003) contains a useful discussion of these methods.

In the absence of a data base specifically constructed for this purpose which covers all developing countries, we use the best one available at present, which is GFI (2009). This gives the flows ( $F$ ) by geographical region for 2002-6 but not the stocks. The stocks are imputed by extending the linear trend values back for a further decade; which is clearly a very conservative estimate as it excludes earlier flows and accumulated earnings. We assume that one half ( $a = 0.5$ ) of this stock is owned by residents in developing countries; again probably an underestimate; and that it earned 7% rate of return ( $r$ ) in 2006. The GFI estimate for tax losses (GFI, 2010) does not take into account overseas assets, but just current flows ( $F$ ). It also assumes that the official ‘headline’ corporate tax rate in each country (averaging around 30 per cent) is in fact the effective rate, which is unrealistic. So for this estimate This we call *Model A*.

A rather different, yet potentially complementary approach is to approach the issue of financial assets held overseas by developing country residents. These unofficial estimates of the scale of asset holdings in tax havens have recently been confirmed by comprehensive IMF data set on these ‘small international financial centres’ (Lane & Milesi, 2010) which indicates that their external assets (and liabilities) in 2008 totalled some \$15 trillion. We use these estimates of asset stocks in OFCs (IMF, 2010) allocated to source country by GDP share. This gives us the stock figure ( $X$ ) with which to generate implicit untaxed revenue flows ( $Xr$ ) and an estimate of capital flows ( $\Delta X$ ). As in Model A, we have used a value for  $t$  of 20 %. This we call *Model B*.

The results of these calculations for Model A are shown in Table 1 below. Modifications in the assumptions would clearly change these results, but they can be taken as a conservative estimate of the orders of magnitude involved. The overall potential yield to developing countries is of the order of \$200bn a year; but half of this is attributable to Asia (and half of this in turn to China) and relatively little to Africa. This in fact is what would be expected in view of the relative regional contribution to world trade and production, but the GFI estimate for Africa does seem too low – a point we correct below.

Table 1 Estimated potential tax yield to developing regions: Model A (US\$ billions in 2006)

	Flow (F)	Stock (X)	Tax base (Y)	Potential Yield (T)
Developing Countries	859	3060	1073	215
SSAfrica	11	80	17	3
Asia	399	1532	507	101
Europe	186	529	223	45
MENA	165	453	197	39
LAC	97	466	129	26

Sources: author's own calculations (see text) on GFI data.

The total tax loss as a proportion of developing countries' GDP is of the order of 2.5 %, which is considerable and of a similar order of magnitude to total private capital inflows. In terms of tax revenue, the loss represents about 10 per cent of revenue in developing countries; but a much larger proportion – probably one third - of corporate and income taxation revenue.

The overseas asset stock (X) estimate in Table 1 is equivalent to about one-third of financial market capitalisation in developing economies; which seems to be about the right order of magnitude. In this context it is worth noting that the IMF estimate of offshore assets in Table 2 below would be equivalent to about 10 per cent of global market capitalisation (IMF *Global Financial Stability Report 2005*) – suggesting that tax havens are even more of a problem for developing countries than for industrialised ones.

Table 2 below shows the result of applying Model B to the IMF estimates of assets held in small island financial centres (SIFCs) in 2006 (Lane & Milesi, 2010). The allocation of these across regions is, as explained above, estimated by allocating these in proportion to GDP. Although this allocation method is highly arbitrary, it does produce results that are similar to those in Model B and thus acts as a form of confirmation that the estimates are not grossly inaccurate.

Table 2 Estimated potential tax yield to developing regions: Model B (US\$ billions in 2006)

	Asset Stock (X)	Potential Tax Yield (T)
World	18454	692
Developing Countries	5788	217
Africa	285	11
Asia	2531	95
Europe	1035	39
MENA	660	25
LAC	1277	48

Sources: author's own calculations (see text) on GFI data.

We have seen that our estimates on the basis of GFI flow data give very low figures for Africa in view of other evidence (e.g. Ajayi, 1997). Fortunately there is an excellent recent study by Ndikumana and Boyce (2008) who calculate unregistered outflows ('capital flight')

on the World Bank method but add in trade misinvoicing; and also estimate the resulting asset stock. Their method thus come closest to Model A in this paper.

It is widely believed that sub-Saharan Africa has the highest ratio of private capital held abroad in the form of capital flight of any developing region: Collier, Hoeffler & Pattillo (2004) claim that about 40 per cent of African private capital was held abroad at the turn of the century, that capital flight increased in the 1990s compared to the 1980s and that Africa leads other regions in capital flight. Indeed Fofack and Ndikumana (2010) argue that the potential gains from capital repatriation are so large that if only a quarter of the stock of capital flight was repatriated to SSA ‘the sub-continent would go from trailing to leading other developing regions in terms of domestic investment’.

However, although Ndikumana & Boyce calculate a realistic reinvestment rate to convert flows into stocks, they do not seem to distinguish clearly between domestic and foreign (i.e. MNC) owners of the assets. In consequence, we have applied the same share ( $a$ ) as in the previous calculation in order to estimate the net stock. Table 3 shows the results of this calculation, applying the same values of the other parameters ( $r$ ,  $t$ ) as in Table 1.

*Table 3 Estimated potential tax yield to Sub-Saharan Africa from Model A (US\$ billions in 2004)*

	Flow ( $F$ )	Stock ( $X$ )	Tax base ( $Y$ )	Potential Yield ( $T$ )
Total	8.8	303.4	30.0	6.0
of which				
Nigeria	5.8	120.4	14.2	2.8
S. Africa	11.7	8.8	12.3	2.5
Ethiopia	1.8	11.2	2.6	0.5
Cote d'Ivoire	0.5	27.0	2.4	0.5

*Sources: authors own calculations (see text) and Table 1.*

The difference between the estimates in Tables 1 and 3 is mainly due to the revision of the overseas asset figure ( $X$ ) to a more realistic level. The main gainers from recovering the lost tax revenue would be, as expected, Nigeria and South Africa. None the less, in absolute terms the gains to countries such as Ethiopia, or Cote d'Ivoire would still be considerable. In relation to output, the \$6bn yield in 2004 was equivalent to about 2 per cent of regional GDP; but considering that corporate and income taxes only generate 4 per cent of SSA GDP (Keen & Mansour, 2009), this would represent a proportionately large increase.

In conclusion, the tax loss for developing countries was probably of the order of \$200-250bn a year in the mid-2000s – double the OECD estimate. It is likely that the figure has increased since that date due to growth in the world economy and increased financial integration. While the current crisis may have slowed these two drivers down, it has also increased the level of investor risk aversion and thus attraction of “safe havens” for mobile wealth.

### 3. Institutional Dimensions of International Tax Cooperation

International capital mobility has transformed national tax policy. Present national tax systems were designed in a post-WWII environment of trade protection, capital and labour immobility when very different rates of direct and indirect tax were feasible – but this is no longer the case (Tanzi 1996a). Free movement of capital and opportunities for the geographical dispersion of firms create fundamental challenges for tax authorities. Different national taxation norms and interstices between tax administrations create conflicts of interest. Lack of administrative co-ordination between tax jurisdictions supports capital flight and loss of vital tax revenue.

Moreover, a number of developing countries play a key ‘offshore’ role in the international investment process where tax avoidance is of particular importance. The object here is not so much to attract foreign investment as such, but rather the administration of assets and tax revenue a “process that has been described as ‘tax degradation’, whereby some countries change their tax systems to raid the world tax base and export their tax burden.” (Tanzi 1996b: 3). Effective income taxation thus becomes an international rather than a national development issue.

Information exchange is central to tax cooperation - although the scope and usefulness of exchanges of information are limited by political, legal, technical and administrative obstacles (Tanzi and Zee, 1999; Bacchetta & Espinosa, 2000; Huizinga & Nielsen, 2003). Tax avoidance on a large scale worldwide is also made easier by a lack of transparency in the way multi-national companies (MNCs) report and publish their accounts. Poorer and smaller developing countries are most vulnerable: they rarely have the necessary resources and capacity to challenge MNCs trading in their countries. The public accounts provided by MNCs represent the transactions of all the companies within the MNC group. However, the intra-group transactions, which are the basis for much tax avoidance, are not reported in the published accounts. Removing intra-group transactions from public view can make it impossible for tax authorities or anyone else to penetrate the accounts. This facilitates tax avoidance.

However, despite publishing their accounts as if they are unified entities, MNCs are *not* taxed in this way. Instead, each member company of the group is taxed individually. Given that over half of world trade is now intra-group trade (i.e. between companies under common control) and thus extremely susceptible to transfer mispricing, or routing through tax havens, the risk of tax loss is enormous. Country-by-country reporting, in contrast, means that an MNC would report in its accounts which countries it operates in; what name it trades under in each country; its financial performance in the countries where it operates; and this information must reconcile with the company's main published accounts.

Both factors are recognised explicitly by the UK Government in its current international development policy:

2.48 There is increasing concern that tax systems in developing countries are undermined by international banking secrecy, including in tax havens. The London Summit made real progress on this issue, and the UK will work to ensure that the commitments on standards and sanctions are met, as well as the decision to develop proposals by the end of 2009 to make it easier for developing countries to benefit from the new co-operative tax environment.

2.49 The UK believes it is important for all jurisdictions to implement their commitments to the international standard for the exchange of tax information and will work in particular with its own Crown Dependencies and overseas territories to ensure that they can meet or exceed the agreed international standards.

2.50 Along with other members of the G20, the UK is ready to take action against jurisdictions that do not meet these international standards. ....

2.51 In addition the Government is discussing with its international partners whether other initiatives, including country by- country reporting of tax payments, could offer an effective and suitable means of advancing the tax transparency agenda. (DFID 2009 p 32)

The U.N. Code of Conduct on Cooperation in Combating International Tax Evasion has recently made a step in the suggested above by agreeing that

“Governments commit to.... Ensure that the reliable information is available, in particular, bank account, ownership, identity and relevant accounting information, with powers in place to obtain and provide such information in response to a specific request” (UN, 2009a, Section III d)

However “exchange of information upon request” is not effective exchange of information because in effect it requires the requesting government already to know the information that it is requesting. This is evidenced by the very small number of requests for information that are made, and the smaller number of requests that actually are implemented. Moreover,

Automatic reporting [by financial institutions of information to the tax authorities] also can serve to increase voluntary compliance. If taxpayers know that their banks are required to report income information to the tax authorities, taxpayers will be more likely to file accurate returns regarding this income. In addition, automatic reporting enables tax administrations to implement programs that may benefit tax payers by reducing their compliance burden. (OECD 2000, para 109)

McIntyre (2009) has drafted a Model Effective Tax Information Exchange Agreement, which provides for exchange of information upon request (Article 5), Automatic Exchange of Information (Article 6), and Spontaneous Exchange of Information (Article 7); and thus represents a considerable advance on the 2002 OECD Model.

There does exist of course a network of international tax cooperation in the form of bilateral treaties which are now very widespread. Specifically, double taxation treaties are designed in effect to provide a direct transfer between fiscal authorities and thus not affect investment

decisions (Frenkel *et al*, 1991). In practice there are two models used in the design of taxes on non-residents' assets and residents' assets abroad, which are similar in their general provisions but have very different implications for developing countries. The OECD Draft Taxation Convention/ Model Tax Conventions (OECD, 1997) is based on residence taxation; while the United Nations Model Double Taxation Convention between Developed and Developing Countries (UN 1980, 2000) which is based on source (or 'territorial') taxation.

The effect of tax treaties depends on the credits and exemptions included in them in order to eliminate or reduce double taxation. When countries are at a similar level of development (and there is roughly balanced two-way investment) the implicit redistribution is not a serious problem, but for host (developing) countries the marginal revenue is of greater value than to the home (developed) country. As the flow of income is generally from developing to developed countries, the tax credit method is the most attractive to developing countries. From the point of view of developing country revenue authorities, such treaties are the only way to cover intra-firm transactions and thus overcome the problem of transfer pricing (OECD, 1997). These treaties, however, become ineffective if offshore centres are used as transfer pricing points as well as for tax avoidance.

It is thus necessary to ensure far more comprehensive information exchange within existing treaties than is currently the case – particularly in relation to assets in the US and the EU. Such measures, however, become ineffective if offshore centres are used as transfer pricing points as well as for tax avoidance. In consequence, the application of the US 'pass-through' principle to tax havens would also be essential. Country-by-country reporting could be introduced immediately by the International Accounting Standards Board (IASB), which sets accounting rules for the vast majority of MNCs.

Automatic exchange of information is more prevalent than is commonly recognized, providing ample evidence that it can be implemented widely. Some notable examples of automatic exchange of information include:

- a. The European Union Directive on the Taxation of Savings ("EU Savings Tax Directive") provides for automatic exchange of information on interest income paid within the EU to individuals resident in the EU. The EU is trying to expand the scope of the EU Savings Tax Directive to other types of income and to other types of recipients, and also to other jurisdictions. Other jurisdictions in Europe (Andorra, Liechtenstein, Monaco, San Marino and Switzerland), and also offshore EU dependent and associated jurisdictions have partially adhered to the EU Savings Tax Directive.
- b. A number of developed countries (Australia, Canada, Denmark, Finland, France, Japan, Korea, New Zealand, Norway, Sweden, United Kingdom) automatically exchange bank information with their treaty partners. In some cases, the automatic exchange of information is limited to certain treaty partners based on an agreement (Denmark, France, Korea, Sweden). The automatic exchange of bank information also may depend on reciprocity (Australia, Canada, Denmark, France, Norway, Sweden).

Since the 2000 OECD Bank Information Report was issued, at least several other countries are exchanging information automatically pursuant to applicable income tax treaties.

- c. The Convention between the Nordic Countries (Denmark, Faroe Islands, Finland, Iceland, Norway and Sweden) on Mutual Administrative Assistance in Tax Matters (effective 1991) requires automatic exchange of information with regard to dividends, interest, ownership of real property, royalties, wages, salaries, fees, pensions, and insurance (Articles 11 and 20). Australia and New Zealand exchange automatically tax information. (Robin Oliver, New Zealand, UN Tax Committee October 21, 2009)
- d. The U.S. Internal Revenue provides for the automatic exchange of information by the United States with Canada with regard to interest on bank deposits in the United States by individuals resident in Canada. The U.S. and Canada exchange automatically certain bulk information (such as interest payments between corporations, dividends and royalties) as do Mexico and Canada. But they do not exchange information on interest paid by banks from one country to residents of the other country, except on request on a case-by-case basis, in accordance with bilateral tax treaties.
- e. The United States qualified intermediary (QI) provisions (U.S. Internal Revenue Code section 1441 and Revenue Procedure 2000-12) require each foreign financial institution that is a QI to provide information automatically to the U.S. Government about U.S. persons investing in the United States through that QI. This is in effect automatic exchange of information, not between a foreign government and the U.S. Government, but between the latter and foreign financial institutions. However, this could clearly be extended to other OECD and G20 countries, at least.

Automatic exchange of information is not difficult to implement, step-by-step: most developing countries already handle automatic information very effectively at their border controls, using swipe technology and passport identification numbers to automatically retrieve Interpol records. The automatic exchange of tax information would be similarly based on the use of taxpayer identification numbers.

#### **4. International Tax Cooperation and International Development Cooperation**

The collection and allocation of the tax resources discussed so far raise considerable problems of equity between countries, and are closely related to the other form of fiscal transfer – official development assistance (ODA). These are highlighted by comparison with fiscal institutions in federations: assignment of revenue-raising authority, intergovernmental transfers, and the behaviour of subnational governments on the one hand; and revenue-raising in federations with no central government on the other:

“a ... main source of finance for development use might be global taxation of taxbases that nations are liable to compete away because of international mobility, or

that they underutilize because of monitoring problems. In principle, international agreement should be possible for a harmonized increase in taxes of these types, given that non-cooperative tax competition is responsible for their low equilibrium tax rates. However, there are significant problems with relying on such taxes for financing new development assistance. The incidence of these taxes will not bear a close relationship with fiscal equity considerations, so they may not be regarded as ‘fair’ taxes. In the absence of a need for development assistance, cooperative agreements on taxing mobile taxbases would likely lead to the taxes collected being returned to the nation of origin. ... There will be significant administrative and compliance problems associated with taxing these transactions unless an international tax administration is instituted with significant powers of audit and information gathering. .... Their incidence among nations would bear little resemblance to a fair allocation based on fiscal equity. .... Crowding-out of national voluntary contributions will be an issue. Boadway (2004: 236-7)

A reasonably reliable estimate of the tax income forgone by developing countries due to the lack of tax cooperation in the mid-2000s is of the order of \$200-250bn. This figure is rather more than double the level of official development assistance (ODA) from DAC members. At an aggregate (i.e. global) level if the tax authorities in developing countries – with the assistance of their counterparts in developed countries and comprehensive action on tax evasion through offshore financial centres – were in receipt of these sums, either of two outcomes might be achievable. On the one hand, the total amount of international fiscal transfers (aid plus tax) available for development finance could be tripled. On the other, development assistance could be entirely replaced by tax cooperation while doubling the net fiscal transfer. Either outcome would presumably make the attainment of the Millennium Development Goals more likely (or at least, less unlikely).

Logically, the main gainers from tax recovery would be the larger and richer developing countries, and specifically in per capita terms the middle-income countries or regions – because these are those that are most integrated into the world economy and generate the profits which underpin tax evasion. As Table 5 shows, the potential tax revenue gains (under either of the estimation methods) to Asia and LAC are far greater than ODA flows, as would be expected due to their larger economies - although the difference in per capita gains would be less. Logically, aid allocation works in the other direction because – geostrategic considerations (which account for the ODA to MENA and Europe) apart – ODA is focussed on poorer countries and regions, particularly Africa.

Table 4. Tax Potential and Development Assistance by Region (US\$ bn)

	Potential Tax Yield		ODA
	Model 1	Model 2	
Developing Countries	215	217	105
of which:			
Africa	3	11	40
Asia	101	95	19
LA & C	26	95	7

Source: Potential tax yield from Table 1; ODA from [www.oecd.org/dac/stats/data](http://www.oecd.org/dac/stats/data)

Clearly there are poor, small and/or fragile countries within the two regions that stand to gain most from tax recovery, but reallocation of between 10% (LAC) and 20% (Asia) of this recovery within the two regions could compensate for removal of ODA. If this were then reallocated to Africa, ODA to that region would rise by 65% and when combined with tax recovery would imply a resource increase of some 80%. This hypothetical reallocation exercise is shown in Table 6. Despite the tentative nature of these estimates, they do make clear that the development gains from recovery and reallocation are very substantial.

*Table 5. Hypothetical reallocation of Tax Gains and ODA by Region, (US\$ bn)*

	Tax Gain	Initial ODA	Reallocated ODA	Net Flow
Developing Countries	216	105		321
of which:				
Africa	7	40	26	73
Asia	98	19	0	98
Lat Amer & Caribb	60	7	0	60

Even within Africa, although the aid flow is much greater than the potential tax yield, individual countries such as Nigeria and South Africa would gain far more than from aid, and even less prosperous ones such as Ethiopia and Cote d'Ivoire would do relatively well as Table 6 demonstrates. The heavily aid dependent countries – particularly those with current or recent civil wars, would not of course be major beneficiaries of tax recovery. To the extent that a case could be made for reallocating tax resources within the region towards poorer countries, this could be done through regional institutions such as the African Development Bank. The hypothetical result of a reallocation of ODA as in Table 6, between these four countries, is also shown in Table 7. All four countries gain considerably, even without reallocation of the tax gain itself.

*Table 6. Tax Potential and Development Assistance between four SSA countries (US\$ bn)*

	Tax Gain	Initial ODA	Reallocated ODA	Net Flow
Total	6.3	3.2	3.2	9.5
of which				
Nigeria	2.8	0.6	0	2.8
S. Africa	2.5	0.6	0	2.5
Ethiopia	0.5	1.8	2.8	3.3
Cote d'Ivoire	0.5	0.2	0.4	0.9

Source: Potential tax gain from Table 4; ODA from OECD: [www.oecd.org/dac/stats/data](http://www.oecd.org/dac/stats/data)

In most of the lower-income developing countries international tax cooperation could not be a substitute for ODA, but could become a complementary source of development finance. This is logical because although the funds would be channelled through different institutions (typically ministries of finance and ministries of international development in 'donor' countries) they are both fiscal transfers from government to government, and they both have their origins in taxation. It would be logical, therefore, that the two flows should be administered in parallel, particularly because 'best practice' ODA increasingly takes the form

of budgetary support in cases of regular development programmes as opposed to humanitarian emergencies (DFID, 2004).

Indeed the current focus on ‘good governance’ as an objective of, and even condition for, aid can be seen in this light as well. In this context, increased tax revenue can be seen not only as a financial resource but also as a factor in strengthening state legitimacy:

2.46 Effective tax systems are central to effective states. Raised in ways that encourage economic growth and promote political accountability, taxes provide the resources to fund public services, leading to an eventual exit from aid dependence. (DFID 2009, p. 31)

To the extent that lower-income or small developing countries do not at present have the technical capacity, the UN, IMF and OECD should focus on helping developing countries acquire that capacity. Cooperation between developing countries would also be very effective: for instance Chile has a highly developed electronic tax compliance system, and is providing technical advice about that to certain countries in Latin America and Africa. Therefore, it would be possible to focus automatic exchange of information initially on those developing countries which already have the necessary technical expertise.

The use of these funds would be a matter for governments to decide rather than aid donors: indeed this would be one of the gains from the process. However, there would probably be a case for using increased resources to support public goods such as production infrastructure for at least three reasons. First, this would help to legitimise the process of tax recovery itself among the affected wealth holders. Second, by promoting growth it would help generate further revenue from corporate and income taxation. And third, by in effect hypothecating these receipts to infrastructure projects, it would be possible to leverage further private investment in sectors such as power, transport and telecommunications.

The literature on the economic effects of aid does not address the relationship with international taxation. Domestic taxation is regarded as part of the process of fiscal response to aid to the extent that it affects government decisions on expenditure and borrowing (McGillivray and Morrissey 2001). Empirical results show that the effects are complex and varied, but that aid tends to be associated with government spending increases in excess of the value of the aid, and can also have the effect of increasing borrowing and reducing tax effort. From the literature on open economy macroeconomics it is reasonable to expect that apart from raising the rate of growth (through increased demand and import availability) the real exchange rate would tend to rise and thus exports to fall in the short run. However, the long run effect would depend upon the use of the new resources, and in particular whether they are employed to increase output and productivity in the export sector. Thus the importance of the infrastructure allocation mentioned above.

Note also that a major macroeconomic effect would not only be through increased tax receipts through such identification of overseas assets (and possible legal action) but rather

from the disincentive to capital flight in the first place. Retention and recovery of such assets would raise domestic investment rates and thus the rate of economic growth.

To those countries in receipt of substantial aid – particularly budgetary support – it is essential that the new income not be simply deducted from aid flows as then there is no incentive effect. Table 7 assumes that poorer countries (such as Ethiopia) would receive increased ODA as well as increased tax revenue. Suppose aid agencies are providing budget support ( $B$ ) equal to a proportion ( $z$ ) of the difference between minimum welfare spend ( $W$ ) and tax income ( $T$ ).  $W$  is determined by: an agreed definition of basic needs provision per capita, adjusted for poverty profile; and the proportion ( $w$ ) of the total budget spent on this welfare. So

$$B = z(W - wT)$$

$$\frac{\partial B}{\partial T} = -zw \gg -1$$

For (say)  $z = 0.5$  and  $w = 0.6$ , then aid would only be reduced by 30p for each extra £ collected in tax.

Even if increased international tax income did lead to some reduction in other sources of taxation, as the fiscal response literature suggests might happen, this could also be beneficial. Low income countries – and Africa in particular – have tended to rely on indirect taxation to a great extent, which tends to be regressive as it is generally focussed on manufactured mass consumption items. Corporate income tax for Africa as a share of GDP (4 %) is low by international standards, despite comparable tax *rates* due to the small size of the tax base despite large resource rents (Keen & Mansour, 2009). The switch from trade taxes to VAT has made the regressive effect even greater, because the import duties on imports tended to bear more heavily on non-essential consumer goods. A substitution of VAT by international taxation would thus make the tax system more progressive and thus contribute to reducing income inequality.

Moreover, the implications of such a concept go beyond the volume of funds involved: it would imply that aid be reconceptualised as a form of fiscal decentralisation not unlike the notion of ‘fiscal federalism’ in terms of administrative practice – although not of course in terms of constitutional principle. There is an established literature on and growing practice of budgetary decentralisation in developing countries (Bird & Vaillancourt, 1998). However there little written or discussed about applying this principle to international transfers – beyond the brief discussion by Boadway (2004) cited above.

Fiscal federalism theory does suggest principles upon which tax and aid (i.e. transfers) can be related in order to overcome the familiar principle-agent problem (Bird, 1993).

Accountability requires that services should be paid for by residents in the form of taxation (or charges) on which they can vote. To the extent that central government provides extra transfers, these should be for clearly defined purposes and accountable by local to central government. To avoid disincentives to local revenue raising (or expenditure efficiency) these

transfers cannot simply cover deficits (even if citizen entitlements are defined) so some estimate of fiscal capacity has to be made before in calculating transfers. This ‘capacity equalisation’ aims to provide each local government with the funds (own revenue plus transfers) required to provide a (centrally) predetermined level of services. Because such capacity is based on *potential* rather than actual revenue, there is no disincentive to local tax collection (or indeed expenditure economies).

In sum the point here is that both tax recovery and aid should be combined in a single system of fiscal cooperation; which is what aid ministries could eventually become. However, both the incorporation of an appropriate measure of tax capacity in any general transfer formula and the implementation of an acceptable international monitoring system would thus be essential for such a framework.

While it is true that all developing countries would be in receipt of more resources, a key exception would be those developing countries which are themselves tax havens. The scale of this loss is impossible to estimate precisely because of the opacity with OFC authorities create about financial assets and transactions within their jurisdictions. However, given that these are all closely connected with advanced economies, it would be quite straightforward to reallocate a portion of the increase tax income to maintaining the incomes of their inhabitants and providing an alternative economic future for them. Where they are US or EU dependencies, this could be done by the respective tax authorities, who would of course themselves be major beneficiaries of tax recovery – which would undoubtedly be at least equal to the benefits to developing countries estimated above. Of course expatriate lawyers and tax consultants might lose their employment; but these latter are not as many as the volume of financial services might imply, because most if not all these services are in fact e-supplied from major onshore financial centres.

The main beneficiaries of these arrangements to prevent the exchange of information on income and wealth not however the inhabitants of these developing OFCs, but rather the elites of both developed and developing countries can avoid their legal tax obligations thereby. It would still be true that wealthy foreigners wishing to *settle* in OFCs would continue to benefit from low tax rates.

## 5. Drivers of Change

A decade ago, the Zedillo Commission proposed to address the tax cooperation problem from the point of view of developing countries by creation of an International Tax Organization (ITO) to:

- “At the least, compile statistics, identify trends and problems, present reports, provide technical assistance, and develop international norms for tax policy and administration.
- Maintain surveillance of tax developments in the same way that the IMF maintains surveillance of macroeconomic policies.
- Take a lead role in restraining tax competition designed to attract multinationals with excessive and unwise incentives.
- Slightly more ambitiously, develop procedures for arbitration when frictions develop between countries on tax questions.
- Sponsor a mechanism for multilateral sharing of tax information, like that already in place within the OECD, so as to curb the scope for evasion of taxes on investment income earned abroad.” (UN, 2001, pp iii-iv)

Although the creation of an ITO of this kind, even though it would not have any power over the tax schedules for any participating country, was not taken up by the ‘Monterrey Consensus’. However, tax cooperation has been taken up in recent G20 meetings, even if there is no proposal to establish a dedicated agency. For instance, the Final Statement of the Cannes Summit (2011) states:

*“Tackling tax havens and non-cooperative jurisdictions*

35. We are committed to protect our public finances and the global financial system from the risks posed by tax havens and non cooperative jurisdictions. The damage caused is particularly important for the least developed countries. Today we reviewed progress made in the three following areas:

- In the tax area, the Global Forum has now 105 members. More than 700 information exchange agreements have been signed and the Global Forum is leading an extensive peer review process of the legal framework (phase 1) and implementation of standards (phase 2). .... We underline in particular the importance of comprehensive tax information exchange and encourage competent authorities to continue their work in the Global Forum to assess and better define the means to improve it. We welcome the commitment made by all of us to sign the Multilateral Convention on Mutual Administrative Assistance in Tax Matters and strongly encourage other jurisdictions to join this Convention. In this context, we will consider exchanging information automatically on a voluntary basis as appropriate and as provided for in the convention;
- In the prudential area, the FSB has led a process and published a statement to evaluate adherence to internationally agreed information exchange and cooperation standards. ...
- In the anti-money laundering and combating the financing of terrorism area, the FATF has recently published an updated list of jurisdictions with strategic deficiencies. We urge all jurisdictions and in particular those

identified as not complying or making sufficient progress to strengthen their AML/CFT systems in cooperation with the FATF.

36. We urge all jurisdictions to adhere to the international standards in the tax, prudential and AML/CFT areas. We stand ready, if needed, to use our existing countermeasures to deal with jurisdictions which fail to meet these standards. The FATF, the Global Forum and other international organizations should work closely together to enhance transparency and facilitate cooperation between tax and law enforcement agencies in the implementation of these standards. We also call on FATF and OECD to do further work to prevent misuse of corporate vehicles.” (G20, 2011)

Meanwhile, some progress has been made towards the five aims set out by the Zedillo Commission (see above):

- On statistics, the IMF has started to improve the very weak data in the *GFS*. Article IV reports now contain more information on national tax receipts; while steady progress has been made in the estimation of assets in OFCs, and off countries’ external asset positions.
- On surveillance, the IMF has introduced the new Fiscal Monitor publication; the OECD has established the Tax Forum; and the FATF has extended its reach to tax evasion.
- A potential lead role on tax competition is now emerging among regional bodies such as the African Development Bank; while UNCTAD is providing more evidence of the lack of effect of corporation tax on FDI (compared especially to infrastructure, skills, and legal systems)
- On tax arbitration, there has not been much if any call from developing countries for this, beyond the existing provisions in the growing number of bilateral tax treaties; but would clearly be an ideal role for the UN through the tax committee
- Finally, on information exchange, progress has been outlined above but a central clearing house faces data security problems. None the less, the success of the UN/CED is a hopeful precedent.

It is unfortunate therefore, that the G20 have not seen fit to utilise the considerable expertise and legitimacy of the UN system – a central theme of the Zedillo Report – in their proposals for greater tax cooperation.

A body of scholarship has examined the OECD Project on Harmful Tax Practices, in attempt to explain why the initially tough conditions when the Project was established in 1996 – particularly on information exchange – were subsequently weakened. However, there is disagreement amongst scholars over the factors that have driven this change in regulatory approach, especially with regard to the role of non-state actors such as multinational firms, the transnational tax service industry, trade bodies, and pressure groups. Webb (2004) claims that offshore jurisdictions found a sympathetic audience among multinational corporations and the tax-service industry, who persuaded the OECD to acknowledge the legitimacy of international tax planning and legal tax avoidance. Consequently, the regulatory norms of the

OECD tax regime - its shared rules of appropriate values, beliefs, and behaviour - were transformed, which resulted in a change of regulatory approach.

In contrast Sharman (2006) finds that multinationals did not influence OECD policymakers; rather that corporate interests were excluded in the formative stages of the initiative, when they otherwise might have had most influence. Tax havens in effect sought to split the coalition of OECD member governments, and attempted to do so with the support of third-party pressure groups such as the Centre for Freedom and Prosperity and the Commonwealth Secretariat. Sharman concludes that a change in regulatory approach, eventually, occurred as a result of the OECD suffering a loss of institutional standing.

However, a third factor was undoubtedly the withdrawal of support for the Project on Harmful Tax Practices by the United States in 2001 after the change in presidency. In addition, ten of the tax havens that were targeted by the Project on Harmful Tax Practices are British overseas territories or dependencies, where the UK Foreign and Commonwealth Office is responsible for their defence and international relations. Despite energetic FCO action on issues of corruption and governance, the UK has not been prepared to use similar leverage over its dependencies in relation to tax information disclosure.

As noted above, tax transparency then featured prominently at G20 summits in Washington (November 2008), London (April 2009), Pittsburgh (September 2009), and Toronto (June 2010). In Washington, tax authorities were tasked to ‘[draw] upon the work of... the OECD to enhance regulatory cooperation between jurisdictions’ and to address vigorously the ‘lack of transparency and failure to exchange tax information’. The summit in London declared the era of banking secrecy to be over and agreed to ‘take action against non-cooperative jurisdictions, including tax havens, [and] to deploy sanctions to protect public finances and financial systems.’ In Pittsburgh, G20 leaders reaffirmed the need for quick progress, stating that G20 governments ‘...stand ready to use countermeasures against [uncooperative] tax havens from March 2010’.

Backed by this political determination, the OECD’s Current Tax Agenda, published in June 2010, reports that:

Prior to the London summit in April 2009, the standards on transparency and exchange of information published by the OECD in 2002 were endorsed by all OECD member governments, and tax haven jurisdictions previously opposed to exchanging information. Since then, the implementation of this international tax standard has progressed rapidly, with almost five hundred information exchange agreements negotiated between jurisdictions.

In October 2010, a restructured Global Forum met for the first time in Singapore with representation from all G20 and OECD member states and all forty-six tax haven jurisdictions that were identified prior to publication of the 2000 report. The FATF standards have also been revised to strengthen global safeguards and further protect the integrity of the financial system by providing governments with stronger tools to take action against financial

crime while. At the same time, these new standards will address new priority areas such as corruption and tax crimes (FATF 2012). Tax crimes in this context are a “designated category of offence” and related to both direct and indirect taxes.

The global financial crisis itself has also played an important part. Developed country treasuries are faced with pressing revenue needs in order to pay down sovereign debt and to avoid politically costly welfare cuts. Electorates have become increasingly critical of the use of OFCs by corporate executives and their companies.

Another driver of change has been the focus by international non-governmental organisations (INGOs) on “tax justice” as a fundamental issue of development and equity. The first of the NGO advocacy studies to estimate tax losses was Oxfam (2000) which estimated a loss of fiscal revenue to developing countries of \$38bn in 1998 on the basis of UNCTAD data on FDI stocks and rates of return. This was updated by Cobham (2005) to \$50bn a year for the early 2000s. Further work by Christian Aid focussed on trade mispricing rather than foreign investment returns as the source of profit shifting, using published estimates of mispricing margins and corporate tax rates and initially estimated a tax loss of \$160bn in 2005 to developing countries (Christian Aid, 2008). A subsequent study (Christian Aid, 2009) was more robust technically as it used US and EU trade data to measure profit shifting, to which the application of a generic corporate tax rate of 30 per cent generated an estimated developing country tax revenue loss of some \$122bn a year for 2005-7. These estimates have been widely quoted in government as well as advocacy circles – for instance by Norway (2009).

Last but far from least, the growing institutional capacity of tax authorities in developing countries themselves has increased their interest in capturing their full tax base as a feasible project. This has been helped by OECD and IMF technical training but two further factors have been important. On the one hand, during the 2000’s emerging market governments have become more confident about constructing their own economic policies – and less convinced of the virtues of fiscal austerity – a confidence only strengthened by the current global financial crisis. On the other hand, the deepening of democratic politics in developing countries has generated greater voter pressure – often informed by civil society organisations – against tax concessions to both wealthy citizens and foreign investors.

There is, therefore, probably enough international agreement now for the establishment of an agency to carry out the Zedillo aim of establishing “a mechanism for multilateral sharing of tax information, like that already in place within the OECD, so as to curb the scope for evasion of taxes on investment income earned abroad”. This would need to be led by the G20, and build on existing OECD and UN bodies, with technical support from the IMF. It could start with the construction of normative systems, followed by monitoring of these norms. Investigation of cases would only be necessary where requested by governments (most likely from the least developed countries) or where disputes between jurisdictions required arbitration. A suitable title would be the *International Tax Cooperation Agency*.

## 6. Conclusions

Effective income taxation by developing countries of foreign companies operating in their territory and of their own residents' overseas assets, is steadily becoming an issue of international development cooperation rather than one of domestic economic policy alone. This paper has attempted to establish the size of the potential gains to developing countries from such coordination, how they might be distributed, and the nature of the institutional changes required to make this happen.

The specific findings of the paper are four:

- *First*, the aggregate scale of the resources potentially available from the taxation of capital or income hitherto untaxed, based on two contrastable estimates from different databases, is clearly large in both absolute terms and in relation to ODA
- *Second*, the major requirement for such recovery to be feasible – automatic exchange of information between tax jurisdictions – is already in place between OECD countries; while the negative economic consequences for small island OFCs can be overcome.
- *Third*, although the regional and country distribution of the potential tax resources corresponds to levels of economic activity (as might be expected), regional distribution mechanisms through existing institutions would allow the poorest and smallest countries to benefit;
- *Fourth*, the governance implications of tax cooperation on this scale between rich and poor countries are considerable and could underpin a new model of development cooperation derived distinct from the discretionary system of ODA (itself a fiscal transfer).

The paper proposes no new tax and no change in tax rates – just the effective collection of what is already legally established; and can be considered due to developing countries as of right rather than a donation. None the less, it can be defined as “innovative finance” for at least five reasons:

- *First*, because the sources to be tapped (untaxed financial assets held outside the relevant tax jurisdiction) have hitherto been exempt and in effect unavailable to developing *and* developed countries;
- *Second*, because this source of fiscal income would not have the negative effect of other forms of resource transfer to developing countries, because it would form part of the democratic process of budgetary legislation;
- *Third*, because it would have a clear redistributive effect from wealth holders towards the beneficiaries of social services and public goods, as do other forms of progressive income taxation;
- *Fourth*, because the resources generated could be used to support global public goods provision at the regional level, as part of a global network of actions such as disease control or re-forestation.

- *Fifth*, because the stronger fiscal position resulting from greater tax revenue, allows developing countries to create more ‘policy space’ by reducing debt and increasing reserves, and thus manage exogenous shocks from world financial markets.

Above all, effective international tax cooperation would not require a new, large multilateral institution because the International Tax Coordination Agency (ITCA) would not need to collect tax, but rather regulate the flows between tax jurisdictions. Any redistribution towards poorer or smaller countries, would be done through existing regional institutions – although these would not have to channel funds either – just ensure agreement on the allocation of fiscal recovery between member countries. The ITO in turn could be built on the existing UN and OECD frameworks.

In sum, international tax cooperation should be seen as a vital dimension of international economic development policy, just as investment and trade rules have become. The ITCA would represent a much more sustainable and equitable system of support to economic development than other potential forms of “innovative development finance” based on the traditional donor-recipient relationship of “aid” or the construction of new market-based debt instruments.

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