Taxation of firms and development

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Outline

Introduction

The importance of foreign firms

Estimates of international tax evasion

Conclusion

Motivation

- Tax capacity in developing countries improving, but the tax take still too low
- Developing countries are relatively more dependent on corporate income tax (CIT) revenues
- These countries need jobs and investments, and foreign direct investment (FDI) and multinational enterprises (MNE)s can help in reaching this goal
- How does one strike a good balance in attracting investment and generating sufficient revenues?
- Especially: How severe are the losses from international tax avoidance by MNEs?

An aside: tax incidence

- Tax incidence: the entity that remits the tax is not necessarily the same as the one who bears the economic burden of it
- In the case of CIT, the incidence can fall on
  - owners (in terms of lower after-tax profit)
  - workers (lower demand for labour, lower wage rates)
  - consumers (higher prices, as in the case of the VAT)
- In economics literature, ample evidence that workers pay a large burden of the CIT
- Theoretically this effect is especially pronounced for the case of MNEs
  - Their after-tax profit determined at the international capital market. If taxes increase, pre-tax profits must increase

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Background

- FDI a much more significant source of finance to developing countries than aid
- A recent survey paper (meta study) by Demena and van Bergeijk (2017):
  - review 70 empirical studies for 30 developing countries
  - find that FDI has a positive and statistically significant impact on the productivity of domestic firms
- This is important
  - FDI not only affects the target firm, but generate positive externalities (spillovers)
  - FDI is more than domestic investment (knowledge transfer)

Tax take

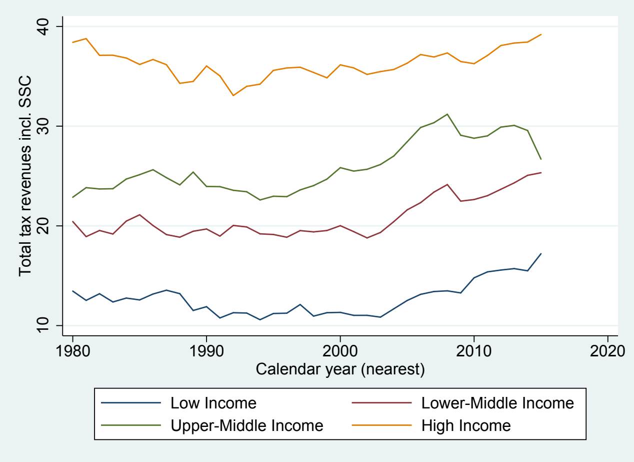


Figure: Tax to GDP ratios by income groups. Source: Own calculations based on the ICTD UNU-WIDER GRD data.

The relative role of CIT

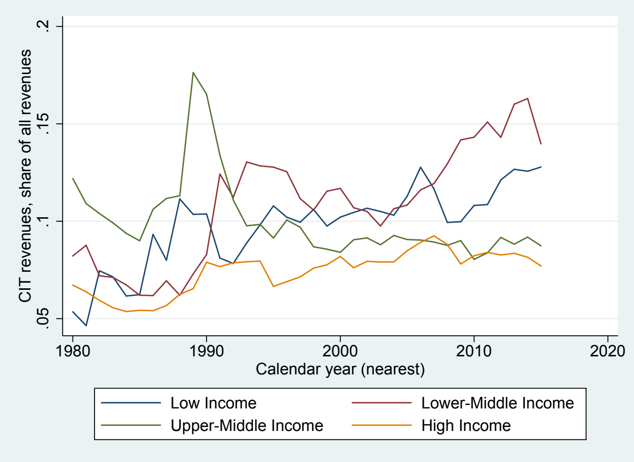
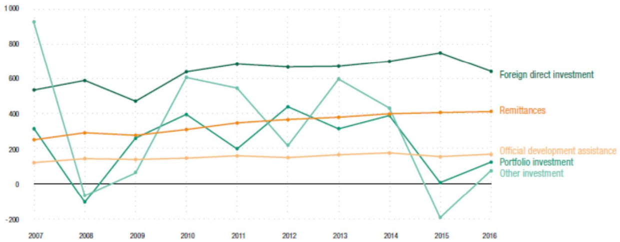


Figure: CIT revenues as a share of overall tax revenue. Source: Own calculations based on the ICTD UNU-WIDER GRD data.

The relative role of FDI

Figure I.12. External sources of finance for developing economies, 2007–2016 (Billions of dollars)



Source: ©UNCTAD, based on data from IMF (for portfolio and other investment), from the UNCTAD FDI/MNE database (for FDI inflows), from the Organization for Economic Cooperation and Development (for ODA) and from the World Bank (for remittances).
Note: Other investment includes loans among non-affiliated enterprises.

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Some well-known estimates

- Estimates by Global Financial Integrity (2015) have attracted much attention
- Their method
  - hot-money-narrow + trade misinvoicing = total illicit flows
  - 200 billion USD + 800 billion USD = 1 trillion USD
- The former is based on errors and omissions in the balance of payments
- It is the trade misinvoicing part that is responsible for the great majority of flows
  - whether this part is right is decisive

Trade misinvoicing channel

- If rich country imports exceed exports from developing country + trade costs (10%) = seen as evidence of export underinvoicing = illicit outflow
- Similarly overinvoiced imports lead to unreported outflows
- Some problems
  - estimates can be sensitive to what is assumed of trade costs
  - all false claims are assumed to be made by developing countries
  - estimates very fragile (fluctuate a lot from year to year)
  - products differently categorized in origin and destination countries (that is why product-level analysis often misleading)

Trade misinvoicing channel II

- Perhaps most puzzling is that if one estimates also illicit inflows using the same method (but a mirror image), they exceed illicit outflows. So on average, developing countries benefit from these flows
- Bottom line: it is hard to use their numbers to come up with convincing estimates (see also Nitsch 2016)
- Even if numbers were correct, one needs to remember that the greatest outflows are from large middle-income countries, meaning that public finance issues in poorest countries would not be solved if these flows were curtailed

Estimates of hidden wealth by individuals

- Zucman (2013, 2015) estimates the extent of financial wealth held by private individuals offshore
- The method relies on discrepancies in assets and liabilities positions of countries
  - worldwide total liabilities exceed total assets as not all assets are reported
  - there is also a systematic pattern that tax havens feature the largest discrepancies
- He estimates that 8% of financial wealth is hidden in tax havens
- Using assumptions on rates of return and effective capital income tax rates, the stock can be changed into a flow of revenue losses, summing up to around 200 billion USD annually

Indirect estimates of income shifting by MNEs

- While not necessarily illicit, income shifting by deliberate manipulation of transfer pricing by multinational companies is also quite obviously problematic
- A recent UNU-WIDER study (Johannesen, Tørsløv, and Wier, 2016) utilizing firm-level data indicates that the problem is a more severe one for countries outside of EU
- Estimates by the OECD (2015) and the IMF (Crivelli, de Mooij, and Keen, 2016) suggest that revenue losses would be in the range of 100-240 billion globally or 200 billion from the non-OECD countries
- Further disaggregated analysis by Cobham and Janský (2017) reveals that the revenue loss for Africa slightly larger relative to GDP than for other non-OECD countries

Direct estimates using product-level data

- Within UNU-WIDER project, one has access to product category level data within firms for South Africa
- Can compare imports of same goods by the same firm with internal and external partners
  - If the trade is within the same firm, the group has an incentive to charge a higher price for imports coming from low-tax countries
- Confirms that this is the case: internal imports from low-tax countries is overpriced by 10%
  - significant, but not larger than evidence from similar studies from developed countries suggests

What do the (aggregate) numbers mean for Africa?

- Zucman (2015) calculates that Africa loses tax revenues amounting to 14 billion USD due to capital held offshore by individuals
- Applying the estimates of Crivelli, de Mooij, and Keen (2016) implies that the revenue loss from income-shifting by MNEs is approximately 20 billion USD
- At the same time, ODA to Africa (50 billion USD) exceeds the revenue loss due to illegal capital flight in Africa
  - the revenue loss is around 10% of their tax revenues
- To sum up: illicit capital flight is a serious problem but unlikely to solve African revenue issues. Domestic sources must continue to be responsible for the bulk of tax collection

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Final thoughts

- Poor countries need FDI
- They are dependent on the CIT revenue, and lose part of it due to illegal transfer pricing
  - Combating tax avoidance is important but alone not sufficient to solve the revenue problems of developing countries
- Tax havens facilitate evasion and crime (due to secrecy). Unclear if they serve any useful role
- Many argue that special economic zones do not work very well in Africa. Unclear if tax concessions offered to international companies have been useful
- Technical assistance that is targeted to improve the tax capacity of revenue authorities holds a great promise. No evidence about its impacts

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