Tax evasion, tax avoidance and development finance

Workshop on tax, poverty and finance for development
University of Essex, 6 July 2006

Alex Cobham
St Anne's, Oxford/OCGG
alex.cobham@st-annes.ox.ac.uk

Overview

- Development finance and the neglect of tax
- A simple model of tax leakages
- The costs – and opportunities – of foregone tax revenues

Development finance

- 'New sources' – but same old issues
  - Donors: Political will
  - Recipients: Resource curse
- Domestic revenue mobilisation
  - Old source – old problems?
  - Neglect and the tax consensus
- Importance of tax (and => growth)
  - Revenue (=> I, C; HD Stewart and Ranis)
  - Redistribution (WB-LAC; VF; lit)
  - Representation (Ross)

A simple model of tax leakages

$Y(\Omega)$: All income (Y) generated by economic activity (Ω) within an economy.

t: effective average tax rate in %.

If no leakages, total tax revenue is

$T_0 = tY(\Omega)$ ...(1)

Leakages 1-3 (4-5)

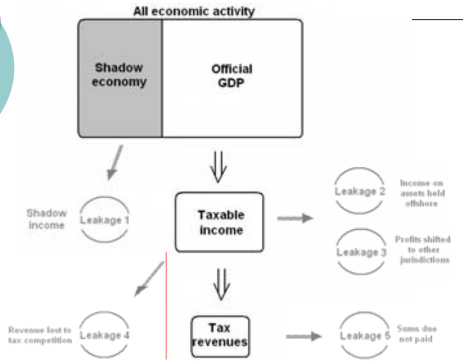
1. Shadow economy
   $T_1 = tY(\Omega(1\text{-}s))$ ...(2)

2. Offshore asset-holding ($h=h(Y)$)
   $T_2 = t[Y(\Omega(1\text{-}s))\text{-}h]$ ...(3)

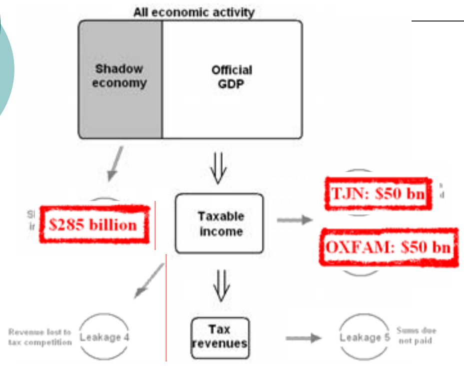
3. Corporate profit-shifting ($p=p(Y)$)
   $T_3 = t[Y(\Omega(1\text{-}s))\text{-}h\text{-}p]$ ...(4)

Since in any known economy $1 > s,h,p > 0$:
$T_3 < T_2 < T_1 < T_0$.

Where are tax revenues lost?



What's the damage? $385bn



Tax evasion, tax avoidance and development finance

- Tax matters for the 3 Rs
  - Revenue ($385bn foregone)
  - Redistribution (range of poverty and inequality implications)
  - Representation (vicious circle: experimental tax results, Ross, Otieno)

⇒ Costs are opportunities; action on each element is important

Tax 'consensus'

- Adam and Bevan point stands – important part of govt discretion to increase revenue lies in cutting avoidance and improving administration
- But: need for
  i. rethink on tax structures appropriate to income level;
  ii. communication of best practice between countries at similar income levels; and
  iii. recognition of dominance of 3Rs over misplaced 'neutrality' (e.g. trade result)

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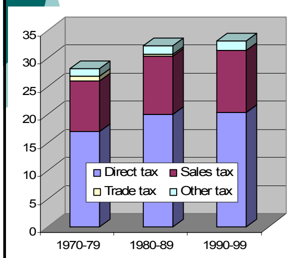
Tax/GDP ratios

EU-15



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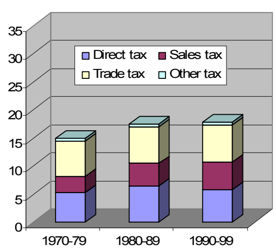

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Tax consensus (I)

"A large part of tax theory for developed countries rests on two fundamental assumptions. First, it is generally assumed that the economy will produce an efficient (Pareto optimal) allocation of resources in the absence of distortionary taxes. Second, it is typically assumed that there is a large variety of tax instruments available to the government: specifically, taxes on all transactions and direct payments to households (which can be combined to produce the equivalent of progressive income taxes).

"The idea that the pre-tax economy is efficient leads naturally to the goal of tax neutrality. The avoidance of taxes on international trade follows from the desirability of productive efficiency. Also, the assumed availability of direct payments to households means that one does not have to worry about the distributional consequences of uniform sales taxes." – p.139, Heady (2004).

Tax consensus (II)

"During recent decades, a powerful consensus has developed… [which] has included not only the structure of taxes, but also the level of tax rates. This conventional wisdom is probably pretty soundly based, and so to refuse to subscribe to it would be imprudent as well as incurring disapproval from IFIs.

"There also appears to be a consensus that this structure should lead to revenues on the order of 15-20% of GDP. Remarkably enough, however, very similar tax structures and tax rates seem to generate very different revenues in different countries. The reason presumably lies in different levels of taxpayer compliance and of the efficiency of tax administration, and this is where a government's discretion to increase revenue lies." - p.60, Adam and Bevan (2004). (back)(2)

Redistribution and growth

- "Surprisingly, empirical studies such as e.g. Easterly and Rebelo (1993), Perotti (1994) or Sala-i-Martin (1996) often find that redistributive transfers are significantly positively related to long-run growth across countries." Rehme, 2006, p.393.

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Leakages 4-5

4. Tax competition where $t_c < t$

$T_4 = t_c[Y(\Omega(1\text{-}s))\text{-}h\text{-}p]$ …(5)

5. Unpaid tax

$T_5 = t_c\ [Y(\Omega(1\text{-}s))\text{-}h\text{-}p]\ \text{-}\ U$ …(6)

(back)

Shadow economy calculation

- Shadow economy data:
  - from Schneider (2005), latent estimation using a dynamic multiple-indicators multiple-causes (DYMIMIC) model, comparable results across 145 countries.
- Key assumption:
  - one-to-one relationship between economic activity and income generated: that is, reducing Ω by a factor of e.g. (1-s) has the same effect on *Y*.
- Scale of effects:
  - the implied percentage changes would lead to government revenues of $83 per capita in low income countries, as against $54 now, and aid flows of $10.

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Offshore asset-holding and corporate profit-shifting

- TJN (2005) provide a conservative estimate for the *global* revenue cost of offshore asset-holding by wealthy individuals of $255 billion. High-income countries accounted for 80% of world GDP in 2003 (WDI data). If offshore asset-holding by high net wealth individuals is assumed to be as likely in developing countries as elsewhere, then we can allocate 20% of the lost revenue to the former: or $51bn.
- Oxfam (2000) found the cost of corporate tax evasion to developing countries to be of the order of $50 billion annually. (back)