



## TAX SYSTEMS: A CHANNEL FOR CORRUPTION – OR A WAY TO FIGHT IT?

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Fighting tax evasion, corruption and opaque money flows should be seen as advancing the same end point: more equitable and better governed countries. When a tax system works right, it can create an effective framework against corruption.

Curbing corruption and building a fair, effective tax system are prerequisites for creating well-functioning public institutions and funding quality public services. When strong anti-corruption and tax regimes are in place, they are mutually reinforcing. They contribute to an increase in domestic resources, an equitable fiscal regime and an effective spending of tax revenue.

Yet this virtuous circle can also turn into a vicious one.

Corruption can plague a country's entire tax administration. It can be collusive, where deals are struck to elude paying one's fair share of taxes. It can also be abusive, where extortion and bribery are the rules of the game levied against honest taxpayers.<sup>1</sup> Tax havens – or secrecy jurisdictions – add to the overlap of problems by providing a safe place for corrupt monies to go.

Corruption can jeopardise the entire system by undermining the responsible institutions, the enforcement of tax compliance, tax collection itself, and the effective use of tax revenue, including how and which public services are provided. Any or all of these problems often translate into taxpayers across the board being less willing to pay their corresponding share of taxes to fund a system that is corrupt. The results include the rise of shadow economies, a distorted tax structure, higher rates of evasion, and lower levels of trust in public institutions.

Those working to strengthen tax systems and to fight corruption should link their efforts. Nationally, building the integrity and transparency of the tax system can help to restore trust in it. Globally, putting an end to secrecy jurisdictions and shining the light on related policies can help to close a backdoor for the corrupt.

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## THE ISSUE

### TAX & GOVERNANCE SYSTEMS

A tax system is a critical institution and an essential building block of a country's revenue administration and broader governance systems. Taxpayers into the system are individuals as well as entities (e.g. companies and organisations). The 'tax system' forms a key element of the full fiscal trail: how taxes and revenue are raised and spent, how policies are designed and how the system is administered. Apart from funding public services, taxation is increasingly seen as a tool to strengthen governance and create a system built on citizen-state accountability. In young democracies and some developing countries, more accountable tax systems often give citizens a stronger basis to demand how public resources are spent.<sup>2</sup>

Compliance in paying taxes can be promoted by the idea of a 'fiscal exchange', in which people pay taxes based on the perception of the benefits they will receive from the state. Evidence from Africa suggests that taxpayers' attitudes to compliance are influenced by their level of satisfaction with particular public services.<sup>3</sup> In addition, perceived levels of fairness, honesty, and overall governance and corruption will affect tax payers' compliance. Higher levels of tax compliance are critical to close countries' financing gaps. This includes the monies needed to meet global development and climate commitments, which will exceed US\$ 1 trillion.<sup>4</sup>

Tax systems require trust, effective governance and low levels of corruption. Without these elements, there will be higher rates of evasion and ineffective use of the revenues collected. There is a strong relationship between an increase in corruption and a rise in tax evasion.<sup>5</sup> Higher corruption is associated with a lower collection of income, value added tax (VAT), sales and trade taxes.<sup>6</sup> If tax collectors are known to be corrupt, evidence shows the rational choice may be for tax payers to pay them off, instead of their taxes.<sup>7</sup>

## CHANNELS FOR CORRUPTION

The main entry points<sup>8</sup> for corruption in taxation are through:

- Reporting taxes: This can happen with or without the involvement of tax collectors and through the use of incentives and resources to exert influence (legal and illegal) to allow for inaccurate reporting (e.g. of company turnover and/or expenditures and/or individual earnings).
- Collusion: Tax officials take advantage of their authority to issue tax exemptions or levy lower tax rates for individuals or companies, creating a context of policy capture.
- Patronage: Ties of community or kinship may favour or penalise certain constituencies, such as by lifting certain exemptions, imposing additional levies, or unevenly enforcing tax compliance.
- International tax fraud and evasion schemes: Opaque global financial systems exacerbate the problem through legal and illegal channels and often use tax havens as part of the process. Weak legislation, legal loopholes and the breaking of laws often permit companies not to pay taxes where the profits are made, and instead shift these monies to other jurisdictions with lower tax rates. As the World Bank President recently stated, such company actions are a form of corruption.<sup>9</sup>

All of these issues can be classified, either directly or indirectly, as forms of tax evasion<sup>10</sup> and each are explored in more detail below by looking at how these manifest through tax policy, tax administration and the global financial system.

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## TAX AGENTS FOR WHOM

Corruption in a country's tax authority can run from the bottom to the top, as one case from Guatemala shows.

In 2015, both the current and past heads of the country's tax authority were taken into custody due to their involvement in an alleged scheme to defraud the government of taxes paid on imports through bribery and theft.

Investigators believe that the private secretary to Guatemala's vice president is the ring leader and that workers at the national tax authority accepted bribes from a criminal network made up of businesses and individuals in return for not paying the full legal tariffs on their goods.

In the wake of the scandal, the president and vice president have both resigned and their immunity against investigation has been revoked.<sup>28</sup>

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## THE CHALLENGES

### TAX POLICY

Certain groups and actors have sway over tax policy decisions. Although it is a widely recognised problem, questions about whether such policy influence is fair and if manipulating this is corruption remain under debate. Influence can take the form of staff from tax advisory firms designing a government's tax policy that then move between the government and these companies, such as has happened in the UK.<sup>11</sup> Or influence may manifest when setting the beneficial tax rates or exemptions for certain sectors, companies or groups, such as the ongoing exemption of Kenyan MPs' salaries from income tax.<sup>12</sup> In its worst forms, it is driven by collusion and patronage.

Still, the greatest risk of manipulating tax policy decisions for private gain concerns those actions that are taken outside of the established legislative process. These decisions undermine public confidence in the tax system's integrity since they reduce tax resources available without a debate. They ultimately limit any public discussion on tax and how it can promote good policies and services.

One example of this problem is settlements made to resolve back taxes that are owed. These can be reached in secret between tax authorities and large taxpayers.<sup>13</sup> Another example is the use of 'sweetheart deals': preferential tax packages offered by tax authorities to companies to entice them to set up shop in one country over another. These have also allegedly been used by some companies to illegally shift their tax bills. The European Commission is currently set to rule on various agreements in EU countries, including Ireland, Luxembourg and the Netherlands.<sup>14</sup> An additional area of concern is the discretionary granting of tax incentives (see side bar). While tax incentives may facilitate a country's economic development and growth, it is the process that is used to grant them that may call into question whether corruption was involved, especially when they are done in secret and without legislative oversight.<sup>15</sup> Research<sup>16</sup> suggests that there is a link between the prevalence of corruption and the adoption of discretionary tax incentives.<sup>17</sup>

### TAX ADMINISTRATION

A government's tax administration can help to detect corruption<sup>18</sup> but it also can serve as a channel for abuses. Corruption in tax administration is a common problem in developing as well as some developed countries, such as Greece (see side bar).<sup>19</sup> Historically, personal relationships between individual tax collectors and individual taxpayers are the main vehicle for corrupt behaviour, particularly when assessing tax liabilities and collecting them.

When these two tasks are done for a tax payer by the same official, abuses can arise. In Transparency International's 2013 Global Corruption Barometer survey, some 15 per cent of people who had come into contact with their tax authority in the previous year reported paying a bribe. In countries such as Liberia, Pakistan Senegal and Tunisia, the rate topped more than 50 per cent.<sup>20</sup>

Traditional responses to problems in tax administration have been to focus on policies to separate tax assessment from tax collection duties, improve political will, strengthen senior management and improve staff remuneration. These actions are interconnected and aim to promote integrity. In more developed countries, tax assessors now tend to directly verify a filer's taxable assets and activities as well as rely on digital information that is cross-checked. Still, not all countries or the administration of different types of taxes (particularly customs, property and local taxes) operate in this way, making such reforms incomplete.<sup>21</sup>

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## FILMS, TAX & CORRUPTION

Over half of US states offer tax incentives for the film industry that are estimated to be worth over US\$1.5 billion.<sup>29</sup>

With such a large pot of money available, abuses have been common. Government officials from several states have been convicted for corruption in the administration of these incentives. This includes the director of the state of Louisiana Film Commission, who accepted bribes in return for fraudulently inflating movie budgets submitted by a company. The director of the state of Iowa Film Office also was convicted for falsifying documents as part of a scandal involving US\$26 million in improperly issued tax credits, which accounted for 80 per cent of the tax credits issued.<sup>30</sup>

### GREECE'S TAX GAP

According to a study done by the Bank of Greece, the large shortfall between the tax revenue expected and actually collected in cash-strapped Greece – some six per cent for the period 2001 to 2009 – was in part due to under-reporting of income by the self-employed. This amounted to an estimated cost of €6.2 billion in lost taxes through evasion.<sup>31</sup> Among the study's recommendations are higher penalties for evasion, ending bank secrecy, and the auditing of tax auditors themselves:

*"In view of the accusation of corruption in tax collection, the relatively few individuals who perform audits (approximately 6,000 tax auditors in Greece) should be held to higher accountability. For example, they should voluntarily subject their family to audits, with a view to improving the reputation of tax auditors and staying on the moral high ground".<sup>32</sup>*

In spite of these recommendations, the problem still persists of taxes going unpaid by other groups. An estimated €72 billion is still owed to the Greek government in back taxes.<sup>33</sup>

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## FINANCIAL SYSTEMS & REGULATIONS

International rules that govern cross-border financial transfers have been criticised by civil society organisations on the grounds that it is still too easy to hide money behind a veil of secrecy, allowing for the proceeds of corruption and tax evasion to be laundered. Money laundering can happen through a jurisdiction (i.e. tax havens) that may have: a low tax rate, generous (or simply different) rules defining what is taxed and how, a willingness to offer discretionary settlements, or a tax treaty with the country in which the funds originate (that limits the latter's ability to tax them).<sup>22</sup> The preferred destination may also be one in which the funds can be kept secret from investigating authorities. In recent years, there has been a rise in the use of tax havens and money laundering. According to one estimate, illicit flows leaving developing and emerging countries have increased 9.4 per cent annually since 2003.<sup>23</sup>

Two ways that tax-related illicit flows are produced are trade mis-invoicing and transfer mis-pricing.

Trade mis-invoicing is where the value of a legitimate trade transaction is falsely declared by either the importer or the exporter, with the difference – the illicit part – remitted to an offshore intermediary and channelled through the financial system. The opaqueness of corporate ownership as well as corruption can facilitate the use of mis-invoicing. For example, investigations of 20,000 trade transactions in Russia between 2006 and 2013 found that international companies used 150 opaque shell intermediaries to sell the country medical devices worth US\$2.8 billion at hugely elevated prices.<sup>24</sup> These intermediaries allegedly facilitated corrupt dealings with the Russian government and then hid their company profits from Russian tax authorities in offshore bank accounts.

Transfer mis-pricing is when a firm generates income in a country through legitimate business but then seeks to transfer some or all of this income offshore without paying the correct tax in the first country. This problem is often framed within the debate about legitimate profit shifting (called BEPs – Base Erosion and Profit Shifting - see side bar). Transfer mis-pricing can occur for both goods and services. In the case of trading goods, the result is to manipulate the price of the goods so that it reduces the declared profits of the highly-taxed importer and increases those of the less-taxed exporter (which are owned by the same company). Transfer mis-pricing overlaps with corruption where corruption has been used to facilitate the process.

Efforts are under way to close some of the loopholes of the financial system and its regulations. Tax evasion is now considered a criminal offence open to prosecution by the intergovernmental Financial Action Task Force (FATF) although the lack of national enforcement remains a challenge. The OECD has issued its BEPs recommendations, which will lead to multinational companies reporting their tax planning, tax paid and other key financial information on a country-by-country basis to tax authorities. However, the country-by-country reporting model introduced by the OECD falls short of public disclosure. Policy-makers, journalists and society at large will not have access to this information. The European Union has made country-by-country financial reporting mandatory and public for financial and credit institutions. Moreover, it has introduced a public reporting requirement on payments to governments for the extractives and logging sectors. Currently, there is a debate to expand country-by-country reporting legislation to companies from all sectors registered in the EU.<sup>25</sup> Additionally, the G20 as well as individual countries are advancing policies to make beneficial ownership of companies transparent by introducing searchable registers.<sup>26</sup>

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## SHIFTING THE BURDEN

Tax havens can be the preferred destination for companies attempting to shift the tax burden to places where taxes are lower or there are none at all. The case of MTN, the largest mobile operator in Africa, allegedly shows how the process works.

MTN, a South African company, is reported to have moved billions of Rand in profit to the tax haven of Mauritius, where it has a holding company with no staff.

Investigative journalists allege that MTN subsidiaries in Nigeria, Ghana, Cote d'Ivoire and Uganda were making questionable payments to the Mauritian holding company in order to reduce their tax payments in their respective countries and South Africa.

Following alleged problems before, the company already has been forced to reverse payments made in Nigeria and the tax authorities in Uganda are asking for a similar repayment strategy. Investigations are being launched into whether the process was legal, as MTN claims.<sup>34</sup>

## ALL IN A NAME

There is a growing argument that transfer mis-pricing and aggressive tax avoidance constitute acts of corruption, especially where the rules of the game have been manipulated.

This can happen through questionable practices such as inappropriate lobbying, cronyism, bribery or poorly-regulated revolving doors.

The absence of mandatory reporting of company revenue on a country-by-country basis for many sectors means these violations often go undiscovered.

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## WAY FORWARD

Any changes made to make global and national tax systems more transparent and effective must be linked with related efforts to strengthen financial and anti-corruption regulations. Such a shift recognises that corruption and tax evasion are carried out through the same channels and often using the same actors. They share common key elements that, if reformed, would impact both areas. These include policies to address beneficial ownership transparency, customer due diligence and better anti-money laundering practices by banks. The tax and anti-corruption movements must wage one unified fight.

The following actions are urgent steps that governments could take:

### TAX POLICY

- Increase transparency about the amounts and conditions of settlements reached with taxpayers over back taxes.
  - This information should be proactively disclosed, including the rationale used to determine any penalty.
- Share with other interested government institutions information about preferential schemes provided to companies regarding future tax burdens.
  - This should be put in the public domain.
  - Companies should make public such 'sweetheart deal' agreements.
- Implement effectively the BEPs recommendation to address the 'spill over' effects on other countries from corporate taxation policies.
  - This process should quickly move beyond the OECD and G20 group to prevent undue advantages and illicit flows among other countries.

### TAX ADMINISTRATION

- Work with tax revenue authorities to organise procedures and staffing in a way that maximises the integrity of collection.
- Support measures to allow for enhanced scrutiny of tax collectors and potential conflicts of interest through a system of checks-and-balances and a separation of duties.

### FINANCIAL SYSTEMS & REGULATIONS

- Increase information sharing and cooperation between countries to tackle illicit financial flows.
  - This should be accelerated under the BEPs recommendations.
  - Moreover it should include the automatic exchange of information on taxpayers' cross-border activities and greater transparency of corporate information, such as on beneficial ownership.
- Ensure swift adoption of country-by-country reporting legislation in the EU, based on the current proposal included in the Shareholders' Rights Directive by the European Parliament.
- Aim to develop anti-corruption, taxation rules and administrative capacity hand-in-hand.
  - Laws and regulations should reflect how tax revenues are currently being administered, while capacity development of tax bodies should be undertaken to ensure their ability to adequately enforce policies and understand the linkages with related concerns such as money laundering.

## NOTES

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