Addressing tax evasion and tax avoidance in developing countries

This Version:
22 December 2010
Imprint:
The International Tax Compact (ITC) is an international initiative to fight against tax evasion and inappropriate tax practices in developing countries. The German Federal Ministry for Economic Cooperation and Development (BMZ) has launched the initiative and commissioned GTZ with the implementation.

Published by:
Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH
Dag-Hammarskjöld-Weg 1-5
65760 Eschborn
Telephone: +49 61 96 79-0
Fax: +49 61 96 79-11 15
Email: info@gtz.de
Internet: www.gtz.de/public-finance

Commissioned by:
Federal Ministry for Economic Cooperation and Development (BMZ)

Contact:
Claudia Pragua, Head of Division 203 – Governance, Democracy, Rule of Law
Federal Ministry for Economic Cooperation and Development (BMZ)

Person responsible:
Dr. Elke Siehl, Director of Division
State and Democracy, GTZ

Authors:
GTZ Sector Programme Public Finance, Administrative Reform

Layout and Print:

Eschborn, Date
Table of Contents

1. Introduction ........................................................................................................................................ 6
2. What is the issue? .................................................................................................................................. 8
   2.1. Terms and definitions .................................................................................................................. 8
   2.2. Measuring tax avoidance and tax evasion .................................................................................. 9
3. Reasons for tax evasion and tax avoidance ....................................................................................... 11
   3.1. Low level of (voluntary) tax compliance ..................................................................................... 11
       3.1.1. Low tax morale .................................................................................................................... 11
       3.1.2. High compliance costs ....................................................................................................... 12
   3.2. Weak enforcement of tax laws .................................................................................................... 14
       3.2.1. Insufficiencies in tax collection ............................................................................................ 14
       3.2.2. Weak capacity in detecting and prosecuting inappropriate tax practices ....................... 15
4. Modes of tax evasion and avoidance in developing countries ......................................................... 16
5. Strategies against tax evasion and tax avoidance .............................................................................. 21
   5.1. Measures improving tax compliance ............................................................................................ 21
   5.2. Measures improving the ability to enforce tax laws ..................................................................... 22
       5.2.1. Addressing weak enforcement at the national level ............................................................. 23
       5.2.2. International endeavours to strengthen national tax law enforcement ......................... 25
6. Summary and Conclusions .................................................................................................................. 27
List of Figures

Figure 1: Facilitating factors for tax avoidance and tax evasion...........................................11
Figure 2: Time to prepare and pay tax in hours ..................................................................13
Figure 3: Types of tax evasion and avoidance......................................................................16
# List of Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>ATAF</td>
<td>African Tax Administration Forum</td>
</tr>
<tr>
<td>CATA</td>
<td>Commonwealth Association of Tax Administrators</td>
</tr>
<tr>
<td>CBC</td>
<td>Country-By-Country Reporting</td>
</tr>
<tr>
<td>CIAT</td>
<td>Inter - American Center of Tax Administrations</td>
</tr>
<tr>
<td>FDI</td>
<td>Foreign Direct Investment</td>
</tr>
<tr>
<td>GFI</td>
<td>Global Financial Integrity</td>
</tr>
<tr>
<td>GST</td>
<td>Goods and Service Taxes</td>
</tr>
<tr>
<td>GTZ</td>
<td>German Technical Cooperation</td>
</tr>
<tr>
<td>IASB</td>
<td>International Accounting Standards Board</td>
</tr>
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<td>IOTA</td>
<td>Intra-European Organization of Tax Administration</td>
</tr>
<tr>
<td>LTO</td>
<td>Large Taxpayer Office</td>
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<td>LTU</td>
<td>Large Taxpayer Unit</td>
</tr>
<tr>
<td>MNE</td>
<td>Multinational Enterprise</td>
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<tr>
<td>SARS</td>
<td>South African Revenue Service</td>
</tr>
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<td>SME</td>
<td>Small and Medium Size Enterprises</td>
</tr>
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<td>SUNAT</td>
<td>The Peruvian Revenue Authority</td>
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<td>TIEA</td>
<td>Tax Information Exchange Agreements</td>
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<td>TJN</td>
<td>Tax Justice Network</td>
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<td>VAT</td>
<td>Value Added Tax</td>
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1. Introduction

Most developed countries are characterized by a broad base for direct and indirect taxes with tax liability covering the vast majority of citizens and firms. Developing countries, in contrast, are confronted with social, political and administrative difficulties in establishing a sound public finance system. As a consequence, developing and emerging countries are particularly vulnerable to tax evasion and avoidance activities of individual taxpayers and corporations. This can be considered one of the primary reasons for large differences in the ability to mobilize own resources between developed and developing countries. While tax revenues in OECD-countries amount to almost 36 per cent of gross national income in 2007\(^1\), the share in selected developing regions amounts around 23% in Africa (in 2007)\(^2\) and 17.5% Latin America (in 2004)\(^3\). Nonetheless, tax revenue has increased over time in many low-income countries. However, this development is mostly due to increased revenues from natural resource taxes, e.g. income from production sharing, royalties and corporate income tax on oil and mining companies and cannot be interpreted as a sign of an improved tax system or administration.

Tax systems in many developing countries are characterized by tax structures being not in line with international standards, by lack of tax policy management, low compliance levels and inappropriate capacities in tax administration. The difference in revenue mobilization also stems from economic conditions (size of the informal sector). In fact, most developing countries show a trend towards the prevalence of indirect taxation. Many of them rely to a great extent on indirect taxes such as value-added taxes (VAT) with indirect taxes amounting for up to two-thirds of total tax revenues. In contrast, personal income taxes as a proportion of total tax revenue still play a minor role in contrast to OECD countries. And although developing countries still realize some of their domestic revenues through international trade taxes and tariffs, they have declined over the last twenty years. Aside from these structural differences in the tax systems between developing and developed countries, it is important to recognize that tax losses that arise in the course of tax evasion and avoidance activities do largely contribute to the poor performance of state revenue mobilization in developing countries.

Tax evasion and avoidance are both phenomena that are probably as old as taxation itself. Wherever and whenever authorities decide to levy taxes, individuals and firms try to avoid paying them. Though this problem has always been present, it becomes more pressing in the course of globalization as this process extends the range of opportunities to circumvent taxation while simultaneously reducing the risk of being detected.

In the last couple of years, strengthening self financing capacities of development countries has become a topic of increased concern and interest. Domestic revenue mobilization as a central issue of the international development agenda has been emphasized in both the Monterrey Consensus and the Paris Declaration on Aid Effectiveness. This is due to a number of reasons. Firstly, the establishment of own revenue raising abilities is crucial for any state as it constitutes a prerequisite to ensure a sustainable development process and implement pro-poor policies. Since self-financing capabilities in developing countries are

\(^1\) OECD Statistics, http://stats.oecd.org
\(^2\) OECD (2010a)
\(^3\) OECD (2008)
often not sufficient, generating tax revenue is highly relevant for many developing countries. Secondly, fair and efficient tax systems can contribute to good governance, accountability of the state and democracy by establishing a bargaining process between the state and its citizens: Governments that rely on broad based taxation are forced to take the demands of their taxpayers into account. At the same time, the way in which a government levies taxes essentially affects the citizen’s identification with the state and its governmental agencies, potentially increasing trust and compliance of its citizens and ultimately promoting political participation. Thus, besides generating public revenues, strengthening tax systems in developing countries is equally important from a governance or state-building perspective. Thirdly, revenue raising systems typically include the entire population, thereby exhibiting a direct effect on the poor and their household income. Designing a tax system in a pro-poor way can e.g. be achieved by including a redistributive component. All in all, collecting a sufficient amount of revenues is essential for a country to fund pro-poor programs, built effective government institutions and strengthen democratic structures, stimulate sustainable economic growth and reach national and international development goals. To reach these goals it is, however, essential that the tax system is implemented the way it was designed. Thus, counterproductive activities like tax evasion and avoidance practices, that undermine the intentions of the system, need to be reduced.

The present study aims at developing a deeper understanding of the problem of tax evasion and avoidance in developing countries. Against the background of growing interest by international development cooperation, governments of developing and developed countries and international institutions in this topic, this study shall contribute to the systematization of knowledge. It becomes apparent that although there is a theoretical basis explaining tax evasion and tax avoidance behavior, we know little about the patterns and the extent of tax evasion and avoidance in the regions of the world and the different techniques used to evade and avoid paying taxes in individual developing countries. Section 2 focuses on the terminology of tax avoidance and evasion followed by a presentation of governmental, cultural, social and legal factors that influence the (voluntary) compliance with the tax system (Section 3). Different modes of tax evasion and avoidance are outlined in Section 4. Section 5 describes approaches and measures to combat and reduce the scope of tax evasion and avoidance activities. The last section concludes.
2. What is the issue?

The issue of tax evasion and avoidance is a complex multidimensional problem. There are many different reasons why individuals and corporations try to avoid or reduce the amount of tax they have to pay either by (semi-)legal or illegal practices. Before these different dimensions are analyzed in more detail, this section provides an overview about relevant terms and definitions as well as measures to assess the relevance of the problem.

2.1. Terms and definitions

The subject of tax evasion and avoidance embraces many dimensions and problems. As there exists no clear-cut distinction between tax evasion and tax avoidance, one firstly needs to define which practices can be considered as violation or abuse of tax codes. To create a level playing field when discussing these issues, the following terms and definitions are helpful.

**Tax evasion** in general refers to illegal practices to escape from taxation. To this end, taxable income, profits liable to tax or other taxable activities are concealed, the amount and/or the source of income are misrepresented, or tax reducing factors such as deductions, exemptions or credits are deliberately overstated (see Alm and Vazquez, 2001 and Chiumya, 2006). Tax evasion can occur as an isolated incident within activities that are – in other aspects – legal. Or tax evasion occurs in the informal economy where the whole activity takes place in an informal manner – this means the business is not only evading tax payments but is also not registered as formal enterprise at all.

**Tax avoidance**, in contrast, takes place within the legal context of the tax system that is individuals or firms take advantage of the tax code and exploit “loopholes”, i.e. engage in activities that are legal but run counter to the purpose of the tax law. Usually, tax avoidance encompasses special activities with the sole purpose to reduce tax liabilities. An example for tax avoidance is strategic tax planning where financial affairs are arranged such in order to minimize tax liabilities by e.g. using tax deductions and taking advantage of tax credits.

The taxpayer is not obliged to follow the spirit or the underlying purpose of the tax code but only the letter of the law. Yet in practice, this boundary often is less than clear. Sometimes, the loopholes which are explored via tax planning are clear and unambiguous. Often, they are not. Hence, tax avoidance often takes place at the margins of the tax code, in areas where the code is ambiguous and in need of interpretation. In areas where the tax administration decides with a certain degree of discretionary authority, the distinction between avoidance and evasion is blurred. This becomes even more relevant if countries change the tax regulations concerning tax loopholes retroactively.

In many instances, the distinction between tax avoidance and tax evasion is clear only from the ex post perspective, ultimately a post-court perspective. For this reason, tax evasion and tax avoidance are usually treated jointly, despite their differences.

**The tax gap – or tax revenue gap** is defined as the difference between the tax revenue which would be raised under hypothetical, perfect enforcement of taxes and the actual tax revenue. A policy intended to fight tax evasion and avoidance is a policy to narrow the tax

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4 Tax mitigation and tax planning are synonyms for tax avoidance.
5 “If you get away with it, it was tax avoidance. If not, it was tax evasion.”
gap. Trying to close the tax gap, though, is a pointless task – even if perfect enforcement was possible (which is not the case) – since the necessary administrative cost to detect each and every tax evader would be far higher than the additional tax revenues generated.

Measuring the tax gap is a challenging task. Several countries are working on calculations of their national tax gap and publish tax gap estimates. However, these estimates serve only as proxies and are not comparable because estimations techniques and used data differ widely. The tax gap sometimes is used as an indicator for the level of tax evasion and avoidance. Yet, since there are several factors affecting the size of the tax gap e.g. the capacity of tax administrations to determine and collect taxes, one should be careful when using the tax gap as an estimate for tax evasion and avoidance.

International and national perspective: The international dimension of tax evasion and avoidance can be divided into two stylized strands: On the one side, one can find – legal or natural – persons taking advantage of differences in tax laws or rates and the resulting tax liabilities between countries resulting in attempts to shift tax liabilities to low-tax countries. This starts with efforts to reduce tax payments in a private environment, e.g. tax-induced cross-border shopping and tank-tourism, and ends with the flight of financial capital to low tax destinations or tax havens. On the other side, the international dimension of tax evasion and avoidance covers all kinds of tax evasion and avoidance activities which occur as a result of international trade, the international division of labour, and international competition for foreign investment. In this field, one can find multinational enterprises’ (MNE) tax-driven shifting of profits, tax evasion and avoidance against the background of investment incentives and special enterprise zones, as well as various kinds of VAT and tariff fraud accompanying international trade in goods and services. Besides the international perspective there also exists a national dimension. This relates to all incidents in which individuals or firms evade or mitigate taxes within their country of residence while no transactions with companies or individuals abroad are involved. The national perspective comprises incomes and revenues generated in the domestic informal economy, income not reported by a legal or natural person and other means of ‘getting around’ solely domestic tax liabilities.

2.2. Measuring tax avoidance and tax evasion

Although the topic of tax evasion and tax avoidance represents a problem for developed and developing countries, literature and data concerning this topic are still scarce. This is partly due to the fact that the extent of tax evasion and avoidance is hard to estimate as the phenomena are difficult to observe and precise data is, thus, lacking. Hence, there are no reliable empirical findings which provide a clear picture of size of the problem or the relative importance of different kinds of tax evasion and avoidance. Rather, one needs to base any analysis on estimations. As a consequence, quantifying tax evasion and avoidance as well as identifying the underlying factors is a difficult task which is, especially in developing countries, aggravated by the lack of necessary high-quality data.

An overview of the controversies of different studies and their respective results concerning the range of tax evasion and avoidance is provided by Fuest/Riedel (2009a)⁶. Due to

⁶ See also Global Financial Integrity (2008), Friedman et al. (2000), Torgler/Schneider (2009), Kanniainen/Paakkonen (2004).
insufficient data and different estimation techniques, existing estimates on the tax gap resulting from tax evasion and avoidance are difficult to compare and often cover a broad range: Cobham (2005) calculates a sum of US$285 billion per year which developing countries lose because of tax evasion in the domestic informal economy\(^7\). Estimates on tax revenue lost due to corporate income shifting vary between US$35 billion and US$160 billion per year\(^8\). Tax evasion by wealthy individuals is estimated to cause additional revenue losses in developing countries ranging from US$15 billion\(^9\) to US$124 billion annually. Global Financial Integrity (GFI) calculates that developing countries lose between $859 billion to $1.06 trillion a year through illicit financial flows. Illicit financial flows are defined as money that is illegally earned, transferred, or utilized. By definition of GFI this includes the transfer of money earned through illegal activities such as corruption, transactions involving contraband goods, criminal activities, and efforts to shelter wealth from a country’s tax authorities.

Empirical evidence about the extent of tax evasion and avoidance for different world regions is also very limited. A new study by GFI estimates that African countries have lost US$854 billion in cumulative capital flight over the period 1970-2008 (GFI, 2010).

These studies certainly reveal the importance of the issue and might even provide a rough indication of the size of the problem. However, it should be noted that underlying definitions and assumptions differ widely and the estimates are, therefore, neither comparable nor reliable.

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\(^7\) The calculation is based on estimates of the size of the domestic informal economy by Schneider (2005, 2007).

\(^8\) Oxfam (2000) estimates a sum of US$50 billion per year due to corporate profit shifting. Baker (2005) calculated the extent of capital leaving through mispricing of international trade and fake transactions adding up to US$350 billion per year (in developing countries). Different estimation methods and results have been discussed in more detail by Fuest/Riedel (2009a).

\(^9\) This estimate refers to the 1990s.
3. Reasons for tax evasion and tax avoidance

There are various reasons for tax evasion and tax avoidance. In order to develop methods and instruments for fighting tax evasion and avoidance, it is important to foremost establish a broad understanding of the different reasons underlying these problems. These reasons can be filed in two categories. The first category comprises factors that negatively affect taxpayers’ compliance with tax legislation. These factors can be subsumed either contributing to a low willingness to pay taxes (low tax morale) or to high costs to comply with tax laws. The second category contains reasons for the low ability of tax administration and fiscal courts to enforce tax liabilities. These factors can be summarized as resulting from insufficiencies in the administration and collection of taxes as well as weak capacity in auditing and monitoring tax payments which limit the possibility to detect and prosecute violators. These facilitating factors are summarized in Figure 1.

Figure 1: Facilitating factors for tax avoidance and tax evasion

- **Low tax morale**
- **High compliance costs**
- **Tax avoidance and tax evasion**
- **Insufficiencies in tax collection**
- **Weak capacity in detecting and prosecuting tax violators**

3.1. Low level of (voluntary) tax compliance

3.1.1. Low tax morale

Taxpayers’ willingness to pay taxes differs widely across the world. It cannot be viewed as simply depending on the tax burden. Rather, empirical research indicates that taxpayers throughout the world pay more taxes than can be explained by even the highest feasible levels of auditing, penalties and risk-aversion\(^{10}\) (Alm et al. 1992, 2007). These high levels of tax compliance result from the tax morale of society that fosters self-enforcement of tax compliance. Tax morale is, however, not easy to establish. Especially countries without a deep-rooted ‘culture’ and habit of paying taxes find it difficult to establish tax morale.\(^{11}\) This “willingness to pay” of the taxpayer is influenced by the following factors:

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\(^{10}\) Risk-averse individuals tend to pay more taxes attempting to avoid the risk of detection and punishment.

\(^{11}\) Concerning tax morale, tax compliance and their empirical evidence, see Cummings et al. (2005) and Torgler et al. (2007).
i. Low quality of the service in return for taxes
In general, citizens expect some kind of service or benefit in return for the taxes paid. If the government fails to provide basic public goods and services or provides them insufficiently, citizens may not be willing to pay taxes and tax evasion and avoidance will be the consequence (Pashev, 2005; Everest-Phillips, 2008; Lieberman, 2002; Bräutigam et al., 2008).

ii. Tax system and perception of fairness
Some studies suggest that high tax rates foster evasion. The intuition is that high tax rates increase the tax burden and, hence, lower the disposable income of the taxpayer (Allingham and Sandmo, 1972; Chipeta, 2002). However, the level of the tax rate may not be the only factor influencing people’s decision about paying taxes. In fact, the structure of the overall tax system has an impact as well. If, for example, the tax rate on corporate profits is relatively low, but individuals are facing a high tax rate on their personal income, they may perceive their personal tax burden as unfair and choose to declare only a part of their income. Similarly, large companies can often more easily take advantage of tax loopholes, thereby contributing to the perceived unfairness of the system. Tax rates and the overall structure of the tax system, therefore, have a significant effect on the disposition to evade and avoid taxes.

iii. Low transparency and accountability of public institutions
Lack of transparency and accountability in the use of public funds contributes to public distrust both with respect to the tax system as well as the government. This, in turn, increases the willingness to evade taxes (Kirchler et al., 2007).

iv. High level of corruption
If due to high levels of corruption, citizens cannot be certain whether their paid taxes are used to finance public goods and services their willingness to pay suffers and it becomes more likely that they evade their tax liabilities. A taxpayer might consider evading taxes if the cost of bribing a tax auditor is lower than the potential benefit from tax evasion.

v. Lack of rule of law and weak fiscal jurisdiction
Strong fiscal courts are essential to protect taxpayer’s rights and safeguard them from arbitrariness. If the legal system does not operate in accordance with the rule of law, citizens have to fear arbitrariness, discrimination, unequal attendance in court, etc. The lack of rule of law reduces transparency of public action and fosters distrust among citizens. As a result, citizens may not be willing to finance the state through taxes, and decide to evade these liabilities.

3.1.2. High compliance costs
High compliance costs, that are the costs the taxpayer has to bear to gather the necessary information, fill out tax forms etc, can be an additional reason for tax evasion and avoidance. The World Bank’s 2008 World Development Indicator for “time to prepare and pay taxes” shows huge differences between countries: While preparing and paying taxes requires 210 hours on average in high income OECD countries, the required time extends to 1080 hours
in Bolivia and Vietnam and even 2600 hours in Brazil. Similarly, Everest-Philips (2008) describes a recent mapping of local taxes in Yemen which found over 1500 different taxes, licenses and fees covering various bases at different rates. This situation led businesses to worry more about the administrative burden than about the actual tax burden. In such a situation it can be assumed that compliance costs are very high and the probability of the taxpayer complying with such a great variety of taxes low.

Particularly small and medium sized enterprises (SME) suffer from high compliance costs. A survey among South African firms on the regulatory costs of doing business revealed that taxes, in particular VAT, are perceived as the most problematic set of regulations followed by labor regulation (SBP, 2005). Above all it is the paperwork that has to be mastered to comply with tax legislation which is deterring firms from paying their taxes appropriately. When asked on their strategy to cope with regulatory costs of running their business about 18 percent responded to simply try to avoid or evade taxation.

Figure 2: Time to prepare and pay tax in hours

Source: The World Bank, World Development Indicator “Time to prepare and pay tax in hours”, 2008

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12 See definition by World Bank, Doing Business: Time to prepare and pay taxes is the time, in hours per year, it takes to prepare, file, and pay (or withhold) three major types of taxes: the corporate income tax, the value added or sales tax, and labor taxes, including payroll taxes and social security contributions.
3.2. Weak enforcement of tax laws

While the preceding section discussed the sources for low voluntary compliance and high regulatory costs of tax compliance, the current section turns to challenges in the enforcement of tax laws. There exist several circumstances that restrain tax administrations from performing their functions properly thereby increasing the possibility of tax evasion. As depicted in Figure 1, shortfalls in tax collection procedures as well as weak capacities of tax administrations to detect and prosecute tax violators are both factors that contribute to a low enforcement of tax legislation.

3.2.1. Insufficiencies in tax collection

Regarding tax collection, many developing countries face difficulties with respect to important premises for a well functioning tax administration, especially with respect to identifying and administering those citizens and firms that are liable to tax payments. Although there has been progress, tax administrations’ capacity to introduce and sustain e.g. well-functioning tax registers still pose severe difficulties in many developing countries. Problems of insufficient capacity may also occur due to the organizational set up of the tax administration and its relationship to the ministry of finance. In general, there are two approaches for the organizational set up of tax administration. The first option is where the ministry of finance itself assumes the tax administration function and departments within the ministry of finance collect taxes. The second option is a semi-autonomous revenue authority where tax administration is moved out the ministry of finance into a separate entity. Often, tax administration and collection by ministries of finance were considered inefficient and suffering from corruption and high compliance costs (see Fjeldstad/Moore, 2009). Therefore the creation of semi autonomous revenue authorities has been pursued in many developing countries mostly as part of comprehensive tax administration reforms as will be discussed in greater detail in Section 5. Additionally, unclear responsibilities regarding the collection and administration of specific types of taxes by different institutions can lead to inefficiencies and tax losses and require a reorganization of the tax administration. Typically, an organizational approach according to the functions of tax administrations is considered more efficient than one following different tax and revenue types.

Moreover, one has to bear in mind that tax administration and tax policy are intertwined spheres. Tax policy directly affects the costs and the organization of the tax administration. Additionally, the capacities of tax administration influence the way tax policy is implemented. Thus, both areas tax policy as well as tax administration have to be taken into consideration when designing successful tax reforms. Otherwise, the proper functioning of the overall system is affected. For this reason, the tax system should be aligned to the administrative and legal prerequisites of the respective country.13

Qualified, well trained and motivated tax officials are crucial for the collection of taxes and the performance of tax administration bodies as a whole. In order to motivate tax officials to work in accordance with the interests of the government and to reduce their vulnerability to corruption, attention has to be given to wages and other incentives.

Finally, insufficiencies in tax collection result from the fact that economies of most developing countries are characterized by a large informal sector. Firms and individuals active in the informal sector usually do not pay direct taxes on personal or business income, and they do

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13 For example in Malawi, raising indirect taxes (VAT) seems much more difficult than levying direct taxes because of tax practitioners being vulnerable to bribery (see Chiumya, 2006).
not charge consumption taxes or excises on their sales. The state loses these potential tax revenues and, as a consequence, lacks necessary funds to provide goods and service. Often, the reasons to be active in the informal economy are not directly related to attempts to avoid taxation but rather to limited options or excessive administrative requirements to enter the formal economy or excessive costs of labour regulations. However, there are also cases where individuals and companies choose to be active in the informal sector with the intention to escape their tax liabilities. Nevertheless, tax evasion does not need to be the primary reason why firms remain or become informal.

3.2.2. Weak capacity in detecting and prosecuting inappropriate tax practices

A well-functioning body of tax investigation is essential for the detection and prosecution of cases of tax fraud. The lack of sufficient capacities in tax administrations reduce the probability of detection that again influences the decision of a taxpayer as to whether evade or not. Additionally, the legal framework is an important prerequisite for any enforcement activity. For example, the size and nature of penalties that are incurred after evasion has been detected is directly connected to the level of tax compliance (Fishlow and Friedman, 1994).

Finally, tax laws in many countries, especially in developing countries, changes rapidly, thus producing instability and low transparency of the tax code. As a result, complicated tax legislation and ongoing changes of the tax code confuse tax administrators and taxpayers alike. This produces ample opportunity for tax avoidance (Mo, 2003). Furthermore, it results in tax evasion which is not intentional, but occurs due to lack of knowledge ignorance. In extreme cases, tax evasion and avoidance even become inevitable when the tax system becomes too complex and/or contradictory to follow.

The reasons listed above do not occur in isolation and some are mutually enforcing. Often, tax evasion and avoidance are by-products of deficient political, economic and social governance in a country. Especially in these circumstances – which are not untypical for many developing countries – any ‘exit strategy’ away from evasion and avoidance needs to be based on a profound analysis of the current situation and the types of tax evasion and avoidance used predominantly.
4. Modes of tax evasion and avoidance in developing countries

This chapter outlines different modes of tax flight strategies that are employed by private individuals or corporations with the purpose to minimize or circumvent their tax liability. The chapter intends to give a broad overview on the most prevalent instruments that are constraining revenue mobilization efforts in developing countries. These different modes of reducing a firm’s or private household’s tax burden are summarized in Figure 3. Note that the overview does not provide a comprehensive list of all possible modes of tax evasion and avoidance but rather focuses on the most relevant ones in terms of tax losses in developing countries. While the figure explicitly differentiates between tax avoidance efforts which occur within legal boundaries and tax evasion, that is illegal attempts to evade taxes, one has to bear in mind that this distinction is far less clear in practice.

Figure 3: Tax evasion and avoidance

<table>
<thead>
<tr>
<th>Intentional falsification of tax relevant information</th>
<th>Exploiting the legal scope for discretion of the tax system running counter to the purpose of the tax law</th>
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<tbody>
<tr>
<td><strong>Tax Evasion</strong></td>
<td><strong>Tax avoidance</strong></td>
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<tr>
<td>- Non-declaration of financial assets in offshore financial accounts</td>
<td>- Profit Shifting</td>
</tr>
<tr>
<td>- Trade Mispricing</td>
<td>- Pricing of intercompany tangible goods transactions/barter trade</td>
</tr>
<tr>
<td>- VAT fraud</td>
<td>- Increase in intercompany debt</td>
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<tr>
<td>- Missing trader fraud / carousel fraud</td>
<td>- location of central services and intangible assets</td>
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<tr>
<td>- Misclassification of goods</td>
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<tr>
<td>- Smuggling of goods</td>
<td><strong>Bargaining for tax incentives</strong></td>
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<td>- Bribing tax officials</td>
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<tr>
<td>- Abuse of tax incentives by falsely claiming eligibility</td>
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Figure 3 starts out with different modes of evading tax obligations that violate national tax laws. These include misreporting and non-declaration of personal income or corporate profits to circumvent direct income taxation or tax obligations resulting from sales of goods and services. In this context, holding offshore financial accounts to conceal taxable income from

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14 It is worth noting that this does not only include accounts in tax havens as not every low-tax country can be classified as a tax haven. Usually, tax havens show two common features: Little or none of the real commercial activity of the registered companies occurs in the haven country; and most tax havens use a tax and regulatory regime that distinguishes between local investment and investment made by foreigners, with the latter given
tax authorities in the country of residence allows tax evaders to benefit from low or zero taxes abroad, exploiting bank secrecy and poor financial regulation abroad. The resulting tax revenue loss for developing countries is substantial: According to estimates reported by GFI, developing countries have lost $858.6 billion – $1.06 trillion in illicit financial outflows in 2006 (See also Baker, 2005).

Along these lines, trade mispricing through faked invoices between colluding exporters and importers serves as a commonly used way to illegally transfer money from developing countries to financial accounts abroad usually with the purpose to evade taxes (GFI, 2010). In the past, developing countries like Côte d’Ivoire or Nigeria fell prey to substantial illegal capital outflows that where based on deliberate over-invoicing of imports or under-invoicing of exports (TJN Newsletter 2006, Vol.2(3)).

VAT fraud:

False statements of business transactions subject to VAT represents a type of tax evasion that has attracted increased attention in the course of broader adoption and rising rates of VAT or goods and services taxes (GST) in developing countries. For example, Sri Lanka which introduced the VAT system in 2002 had to incur major revenue losses (approximately 10 % of its net VAT receipts, see Keen and Smith, 2007) from a single case of VAT fraud. Fraudulent exploitation of the VAT system thereby takes a number of different forms and is carried out within as well as across national borders. All different forms of VAT fraud rely on the principle that all registered businesses are able to credit VAT expenses from purchasing input goods against VAT due on their sales.

In the simplest case, missing trader fraud includes under-reporting of sales by falsifying records and accounts allowing the fraudster to collect taxes without remitting them to the tax authority. Similarly, overstating purchases and forging invoices to increase the amount of VAT refunds are methods applied especially by new businesses where corresponding levels of sales are not expected immediately (Keen and Smith, 2007).

At the international level, carousel fraud takes advantage of the zero-rating\(^\text{15}\) of exports between multi-country trade operations which have been identified to be most vulnerable to VAT fraud as they occur across national borders and hence, affect different tax authorities.\(^\text{16}\) In principle, carousel fraud consists of two parts – the collection of VAT payments without remitting them to the corresponding tax authority (missing trader fraud) followed by illegitimately claiming a tax refund for the good that is exported.

Misclassification of commodities and smugle of goods: Another source of tax evasion stems from the misclassification of commodities subject to different VAT rates with the purpose to reduce tax liabilities or increase claims for tax refunds. Related to revenue losses stemming from tax evasion activities is the smuggling of goods across borders as a way of evading not only VAT liabilities but also other forms of indirect taxes such as customs and excise duties.

Bribery of tax officials: Developing countries that suffer from inefficiencies in the administration and enforcement of taxes are exposed to bribing activities by companies as

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\(^{15}\) VAT exemption on export goods with VAT from purchasing inputs still being refunded.

\(^{16}\) For a detailed description on carousel fraud refer to Keen and Smith (2007).
shown in the case of Bangladesh where sugar importers evaded 90% of excise taxes in collaboration with corrupt tax officials (TJN, 2003).

All in all, it is important to note that the above described modes of tax evasion are not mutually exclusive but may also result as a consequence of one another. For instance, illicit financial flows that are directed to offshore accounts may result from proceeds that are realized through criminal activities such as the smuggling of goods or fraudulent manipulation of VAT records or bribery.

The remainder of this chapter describes tax avoidance strategies predominantly applied in practice, which are listed in Figure 3. We distinguish between two modes of tax avoidance. The first mode, which can be subsumed under profit shifting, refers to the legal exploitation of loopholes in the legislative tax code granting corporations some discretion on the formation of the tax base and/or the level of taxable income. The second mode refers to the exploitation of selectively granted tax incentives reducing the tax base immediately.

**Profit shifting:** Typically, subsidiaries of a MNE are treated as separate entities by tax authorities, i.e. they are liable to taxes in the country where they operate and reside. The separate entity approach is considered as a viable option to avoid double taxation as profits of the MNE are taxed only once in the residence country of the subsidiary. However, the approach can also be applied by the MNE to minimize the overall corporate tax burden. To this end, the MNE can engage in tax planning activities to shift profits within the affiliated group from high tax to low tax countries. Profit shifting can be achieved by manipulating transfer prices that is pricing of goods and services traded within the group, exploiting intra-group loans and deliberately choosing the allocation of profitable (intangible) assets.\(^\text{17}\)

Transfer prices are intra-group prices for (cross-border) inter-company transactions of goods, services, (in)angible and financial assets that are traded between affiliated companies. They constitute a necessary and legitimate tool for a corporate group to deal with intra-group transactions, assigning profits correctly to the relevant affiliate. This allows not only to identify profitable parts within the group, but also to avoid double taxation. Apart from that, MNEs can distort transfer prices to reduce the group’s overall tax burden manipulating the allocation of profits in particular high- and low-tax jurisdictions. The possibility to manipulate transfer prices arises as there usually exists no commonly observable market prices that normally result from market transactions among independent economic agents to which the intra-group prices could be compared to. As inter-company transactions are often unique in their nature this offers a MNE considerable power of discretion in setting intra-firm transfer prices violating the arm’s length principle.\(^\text{18}\) Consequently, to reduce its overall tax burden the MNE can try to set higher transfer prices for products and services that are transferred to divisions located in high-tax countries whereas low transfer prices are used for transactions with low tax countries. That way, costs for inputs are overstated and taxable profits generated in high-tax countries can be artificially minimized.

From the international perspective, barter trade and transfer pricing are closely related mechanisms of profit shifting. If goods and services are directly bartered – instead of being sold and bought – the firms involved in the exchange are mainly interested in receiving fair value in return for their barter goods. Prices are only fixed for purposes of taxation. As a

\(^\text{17}\) For a detailed survey on profit shifting activities and empirical evidence see e.g. Hines and Rice (1994), Clausing (2003), Buettner and Wamser (2007), Dischinger and Riedel (2010).

\(^\text{18}\) The arm’s length principle postulates that transfer prices are to be set as if the transaction would occur between unrelated parties.
consequence, artificially reducing these prices may help all parties involved to reduce their liabilities for taxes related to sales (VAT, excise duties, energy taxes etc.).

**Thin capitalization** of subsidiaries results from an increase in the proportion of debt of a company e.g. by means of intra-company loans or other instruments of inter-company financing. It represents an additional instrument of tax avoidance as tax deductibility of interest paid offers an incentive to grant inter-company loans to affiliates located in high tax countries, thereby substantially lowering their tax obligations (see Box 1).

The deliberate choice of location for certain (intangible) assets offers MNE an opportunity to optimize their overall tax liability within the legal framework. Intangible assets such as patents, trademarks and copyrights that generate substantial profits out of license payments are assigned to subsidiaries located in low tax countries whereas cost intensive units such as R&D or central services are located in high tax countries to reduce taxable profits. As a matter of fact, Microsoft’s worldwide effective tax rate dropped from 33% to 26% which partly resulted from earnings of foreign subsidiaries that were taxed at lower rates (Simpson, 2005). Much of these tax savings have been realized in an Irish subsidiary, Round Island One Ltd., which holds much of Microsoft’s intellectual property such as copyrighted licensing software codes that were developed in the US. Similar examples include Google Inc. or Oracle which have all set up Irish subsidiaries with the purpose to save taxes. Limitations and difficulties in applying the arm’s length principle imply that transfer pricing is be particularly prone to abuse for illegal tax evasion purposes e.g. through fake transactions, artificially under- and over-billing of cross-border sales.

**Tax incentives / tax expenditures** – which also go by the names tax exemptions or tax subsidies - are intentional exceptions from the general rules guiding the tax code. They present a frequently used instrument of governments to reach a specific economic, social or other political goal, e.g. they are often used to promote (foreign) investment. Governments promote certain activities by lowering tax rates, by postponing tax liabilities; by exempting activities from taxation or by giving them some other kind of favourable tax treatment (see Fuest/Riedel, 2009a).

Not all tax exemptions are implemented for some legitimate societal goal. Under certain circumstances – nepotism, corruption, and low transparency – they may just appear to be “tax evasion with an official stamp on it.” Certain individuals, firms, or groups receive favourable tax treatment – for instance, due to lobbying – which is formally legal, but nevertheless illegitimate. Furthermore, such favourable treatment evokes negative governance effects.
In the context of developing countries, tax incentives to attract FDI can be the outcome of preceding lobbying activities by multinational companies which possess high bargaining power towards government officials of developing countries. Their bargaining power has additionally been aggravated in the course of increased global competition for mobile capital.\(^{19}\) As a matter of fact, tax incentives for foreign investments not only enable foreign firms to avoid taxation but in turn give rise to illegal tax evasion activities of domestic companies e.g. by re-labelling domestic investments as FDI (\textit{round-tripping}) as reported for China (Tseng and Zebregs, 2002) or selling businesses to subsidiaries disguised as new investors as a means to become eligible for tax holidays that are exclusively granted to new investors (\textit{double dipping}).\(^{20}\)

\(^{19}\) There are few successful examples (especially Ireland), but many countries find themselves in a very weak bargaining position in face of potential foreign direct investors “shopping around” for subsidies.

\(^{20}\) For a detailed survey on tax incentives see Easson (2004).
5. Strategies against tax evasion and tax avoidance

As the preceding sections indicate, there is a large variety of reasons and factors contributing to a situation where tax evasion and avoidance occur on a large scale. Tax evasion and avoidance may derive from low tax morale, high compliance costs or may result in the course of firms’ endeavours to maximize profits by reducing their tax liabilities. Hence, in the same way as there is not only one type of tax evasion and avoidance, there is “no one size fits all” (GTZ, 2006a, p. 12) solution to counter tax evasion and avoidance. The practicability and the size of the window of opportunity depend on the specific situation and the predominant type of tax evasion and avoidance in a country. An effective strategy needs to address the underlying causes and most importantly - in the context of developing countries - needs to be tailored to the specific country environment. Any imbalance between a country’s absorptive capacity and the complexity reforms can either induce a failure of reform or a wasted opportunity. If, for example, the absorptive capacity is low, reform strategies should either not be too ambitious or be accompanied by extensive capacity development initiatives. If, on the other hand, the absorptive capacity is very high, simple reform strategies will likely be successful. Still, such a strategy would be unbalanced in the sense that more complex and more ambitious reforms could already be initiated.

Based on the preceding chapters on the reasons and modes of tax evasion and avoidance, the present chapter describes potential ingredients of such an effective, country-specific strategy to fight specific causes and factors contributing to tax evasion and avoidance.

5.1. Measures improving tax compliance

Low tax compliance contributes to a large extent to insufficient revenue mobilization resulting from to evasion and avoidance of tax payments. It involves voluntary compliance of the single tax payer but also further aspects like taxpayer’s knowledge on tax procedures necessary for the fulfillment of her duties.

The improvement of citizens’ tax morale requires measures ensuring and visualizing that the state is acting in a transparent, accountable and efficient manner with the ultimate aim of providing services for its citizens. These measures go far beyond reforms of the tax system or administration by developing a sound state-society relationship and enhancing the legitimacy of the state requires taking into account the entire public system. Such broader strategies cover e.g. the quality of public services, the transparency and control of the public budget or the fight against corruption. The following description will, however, focus on reforms in the area of taxation.

Taxpayer education and taxpayer service

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21 One has to bear in mind that the success of such a reform strategy depends on fundamental changes in the way of thinking and the perception of paying taxes in the entire society. Therefore, this change takes time and requires sustainable, long-term changes and commitment to finally materialize.

22 Yet, one has to acknowledge, that even if social trust can be established and the state is perceived as legitimate, there will remain some degree of tax evasion and avoidance resulting from free-rider behaviour: part of the population will never be willing to contribute to public services if they can free-ride on contributions of others. While this behaviour can to some extent be addressed by adequate sanction mechanisms, perfect compliance of all tax payers will probably never be established.
The importance of taxes for the functioning of the state is not always apparent to the taxpayer. Similarly, individual tax liabilities as well as requirements to comply with the tax system such as filling out different tax forms might be unknown or difficult to understand. By means of taxpayer education and taxpayer service, citizens can be informed and educated about the tax system and be assisted in their attempts to comply with the tax system. Efforts in this direction have been conducted e.g. by the Rwandan Revenue Authority (see Box 2).

Box 2: Taxpayer education and taxpayer service in Rwanda and Peru

A key factor to strengthen voluntary tax compliance is sound education of (future) taxpayers in focal areas of taxation. Taxpayers need to understand the importance of contributing to the tax system. Further, they need to develop a deeper understanding of the tax system and the taxpaying procedures.

With the objective to change the public’s opinion of the revenue authority to a benevolent attitude and promote a “tax-paying citizen” culture, the Rwanda Revenue Authority has integrated its external environment into the capacity development process. This includes the organization of an annual “taxpayer’s week” with parades and the awarding of certificates and prizes. Additionally, opinion leaders and political figures are sensitized how to encourage compliance among constituents. Moreover, the Rwanda Revenue Authority is cooperating with partner organizations to reinforce their efforts to disseminate information about paying tax (Land, 2004). This emphasizes the importance of integrating a wide range of stakeholders into the education process. In addition to the typical efforts of politicians and tax officers, important taxpayers, donors and NGOs can help to improve the tax morale or function as a role model for a responsible and sensitive citizen.

The Peruvian Revenue Authority (SUNAT) educates citizens in the scope of taxation. SUNAT offers, among other services, E-learning, education programs at schools and universities, education courses, video lessons, a virtual library and a range of publications. The aim is to educate both current and future taxpayers. The use of comics and videos can help to reach illiterates, children and in the end the majority of the citizens. The aim is to develop tax morale, tax culture and a deeper understanding of the tax system in the long run.

Addressing tax compliance costs and administrative costs

Apart from promoting voluntary tax compliance, governments in developing countries as well as development partners should concentrate on measures that reduce taxpayers’ costs of fulfilling their tax liabilities.

In this regard, revenue authorities must be aware of the importance of acting service oriented and should therefore monitor customer satisfaction. Many revenue authorities shift towards a customer service orientation which reflects the growing awareness of the need to offer a quality service to the taxpaying public and to be responsive to public concerns. For instance, measures to simplify the taxpaying process and promoting service oriented tax administration include a reduction of the number of tax forms and officers assisting clients in filling out documents or the introduction of online services.

5.2. Measures improving the ability to enforce tax laws

Similarly to low tax morale, the ability to enforce taxes is influenced by a broad variety of factors. Not all of these can be tackled directly by reforms of the tax system or the tax administration. The following section identifies important measures related to taxation while broader strategies affecting the environment, e.g. formalization of the informal sector, will not be covered.
Particularly developing countries suffer from the lack of enforcement of national tax laws that can to large extent be traced back to insufficient administrative capacities. Additionally, weak enforcement by national authorities also originates from cross border activities of firms to save or even escape from taxation as outlined in Section 4. Whereas the first cause presents a challenge to be addressed domestically, the latter calls for actions taken at the international level.

5.2.1. Addressing weak enforcement at the national level

Tax administration reforms are a crucial part of any effective strategy to strengthen enforcement of at the national level. Measures in this area include different approaches of organisational reform such like the creation of semi-autonomous revenue authorities, setting-up of Large Taxpayer Units as well as capacity development such as trainings and courses on selected topics, e.g. specialized courses in the area of detecting illegitimate profit shifting activities or tax fraud, but also restructuring of the wage schedule to offer sufficient incentives in order to attract and recruit capable staff and to minimize the risk of corruptive behaviour.

Reforms referring to the organization of the administration are a sensible step to enhance law enforcement. Often, the organizational setup of the tax administration is a reason for the extent and prevalence of inefficiencies. Therefore, public administration reforms should aim at simplifying the organizational body of tax administrations and its working structure. For instance, countries could try to reduce the number of authorities dealing with tax issues and centralize the collection of tax revenues to one single authority. Between and within different authorities, competences need to be divided and different departments within the institutions need to be mandated explicitly. Especially when it comes to exchanging information within the institution, simplification of the administrative organization might be a useful contribution. A common step in public administration reforms is the establishment of semi-autonomous revenue authorities as discussed in Box 3.

Strategies to strengthen tax administration should also focus on reducing administrative costs inside the tax administration. For this purpose introducing unique taxpayer identification numbers are considered a useful instrument as they facilitate cross-checking of information between different types of taxes such as VAT and income tax. In addition, monitoring and auditing of tax payments and tax arrears are easier if a unique taxpayer identification number exist. Along the same lines, the creation of a large taxpayer unit (LTU) allows for specialization of tax auditors and thus increases efficiency. Additionally, LTUs help tax

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**Box 3: Semi-autonomous revenue administrations**

A common measure in tax administration reforms in recent years has been the establishment of semi-autonomous revenue authorities. By setting up semi-autonomous revenue administrations, many developing countries expected to enhance revenue mobilization, improve service orientation and staff quality, and fight tax related corruption and evasion. The semi-autonomous status enables revenue authorities to pay higher salaries than the public sector which enables them to recruit highly educated staff. It is also believed that higher salaries reduce corruption by lowering incentives to accept bribes. This leads to better work ethics as well as a proactive and professional administrative culture which ultimately contributes to improved law enforcement. Finally, semi-autonomous tax revenue authorities become de-politicized, promoting their acceptance in public by lowering the risk of being abused for interests of political elites (Mann, 2004).
administration concentrate all available capacities to those firms that contribute considerable amounts to domestic revenues (see Box 4).

The cases of Kenya and Ghana illustrate that the establishment of LTUs is particularly suitable to target limited administrative capacities in developing countries. However, despite of these advantages, one has to bear in mind that the creation of LTUs might slow down the process of integrating all citizens into the tax system in the long run. Including small and middle sized enterprises as well as natural persons into the tax system is essential to get society involved in public finance and to strengthen a state’s legitimacy and accountability. If citizens pay taxes they are more concerned about how the government spends their money. Taxing also small taxpayers leads to a critical monitoring of both the government and other, larger taxpayers by the public, thereby strengthening mutual accountability.

Complex and often changing tax laws cause confusion and uncertainty among tax officials and taxpayers. Addressing deficiencies in the tax system is therefore probably as important as process orientated reform actions that enhance the user-friendliness and transparency of the taxation procedure. Particularly small and medium size enterprises (SME) with only limited administrative capacities and private households do not only suffer from the bureaucratic burden of complicated tax procedures but also from the complexity of the tax system itself. Simplifying the (corporate) income tax structure by reducing the number of tax brackets and high statutory tax rates lowers the tax burden and may support voluntary compliance. A comprehensive reform of the tax law might be more advisable than reforming the system step by step, thereby risking a complex financial law as is common in many (developing) countries today.

Furthermore, the possibility to detect and prosecute tax violators depends crucially on data availability and data quality. Hence, actions taken against tax evasion and avoidance relate to an improvement of the data quality available to tax officers. The (inter-)institutional exchange of high quality information requires different steps. On the one hand, it is important to ensure the collection of adequate data. Therefore, one needs to ensure a sufficient endowment with technical equipment and the establishment of good performing statistic divisions with competent staff members to collect data and keep records. On the other hand, good technical equipment and technically educated staff are also a prerequisite for a well functioning information exchange. Along these lines, automation of tax collection

Box 4: Large Tax Payer Unit

Particularly in developing countries, a small number of enterprises bear the lion’s share of the tax burden. Focusing on a small group of crucial taxpayers simplifies the enforcement of corporate tax laws and, hence, allows tax compliance at minimum costs, as the Kenyan experience reveals:

In 1998, the Kenyan revenue authority formed a large taxpayer office (LTO) as a one-stop-service, substantially reducing costs of complying with the tax law. The LTO’s mandate covers the administration of income taxes, VAT, domestic excises and agency taxes. In 2006, the LTO covered 700 institutions which contributed about 75% of the domestic tax revenue.

Ghana established a LTU in 2004 and was able to increase revenues by about 86% between 2003 and 2005 although the corporate tax rate was reduced (GTZ, 2006b).

23 Stiglitz (1986) and Golob (1996) argue that a flat corporate income tax would benefit small businesses the most, not least because of lower compliance costs.
procedures e.g. through online tax assessment, payment and monitoring opportunities may serve as an efficient way to reduce the scope for tax evasion and avoidance. In fact, the Tanzanian Revenue Authority successfully implemented a computerized tax administration system (iTAX) which simplifies tax compliance and contributes to enhanced efficiency of tax collection as well as auditing processes (GTZ, 2010).

Tax fraud and avoidance are also a result of a weak judiciary. Addressing revenue shortfalls needs to go hand in hand with legislative reforms strengthening the rule of law. This includes insufficient punishment and prosecution of violators which can only be tackled when detected tax criminals face stricter penalties that are effectively executed by courts. As shown by Fishlow and Friedman (1994), higher penalties act as a deterrent and help to improve tax compliance. To achieve this goal governments have to strengthen the rule of law and develop capacities of investigation authorities. Moreover, investigators as well as courts and judges should receive greater support by politicians in order to emphasize the importance of this issue.

5.2.2. International endeavours to strengthen national tax law enforcement

The liberalization of goods and financial markets and the increased international mobility of capital flows pose a new challenge for countries on the field of taxation. In contrast to purely domestic tax issues, international modes of tax evasion and avoidance (e.g. transfer pricing and the existence of tax havens) can hardly be solved unilaterally by a single country. Given the low levels of revenues in many developing countries, the revenue shortfall due to tax evasion and avoidance at the international level causes severe problems to fund essential (pro-poor) programs. Hence, there is a necessity to solve the problem on an international, regional and bilateral level. The transnational nature of these challenges commands actions to be taken at the international level through enhanced exchange and cooperation among countries to promote transparency of MNEs' activities.

For instance, unveiling mispricing activities as well as irregularities in firms’ transfer pricing practices requires a well functioning cross-border information exchange between domestic tax administrations, auditors and foreign public authorities. Tax Information Exchange Agreements (TIEA) aim at enhancing cooperation with low-tax jurisdictions including tax havens to foster exchange of information which helps to disclose illegal forms of profit shifting (see Box 5).
Box 5: Tax Information Exchange Agreements


TIEAs constitute non-binding bilateral agreements in which contracting countries commit to exchange information on tax matters upon request, conditional on the relevance of the requested information to enforce national tax laws. Mutual exchange occurs on a strictly confidential basis and the protection of taxpayers’ rights. Currently, 360 TIEAs have been signed, others are still being negotiated. Although TIEAs are a promising first step towards enhanced transparency in tax matters for developed countries, their applicability for developing countries needs further improvement: Agreements on information exchange are established bilaterally resulting in numerous separate agreements with single contracting states. This poses significant challenges particularly to less developed countries as limited capacities restrict these countries to negotiate bilateral agreements with many different countries. The OECD has, therefore, proposed to extend the available set of instruments to multilateral agreements. Moreover, in its council conclusion on tax and development, the EU encourages strengthening of developing countries’ capacities to negotiate TIEAs.

Source: OECD, EU Council Conclusion

Consolidation of financial accounts of MNEs contributes to a lack of transparency and information asymmetry, thereby imposing an additional challenge on detecting harmful tax practices. This can be addressed through increased transparency in bookkeeping e.g. by introducing financial accounting standards that require disclosure of disaggregated and unconsolidated accounts at the country level as suggested in the Country-by-Country (CBC) reporting approach (see Box 6).

Box 6: Country-By-Country Reporting

Insufficient transparency in financial reporting of MNEs is a key factor which facilitates international tax evasion and avoidance. While tax payments are due in the country where the subsidiary operates, the current financial reporting system requires the parent company to report on its consolidated accounts. Inappropriate cross border profit shifting activities between subsidiaries are, therefore, difficult to detect.

The Global Task Force on Financial Integrity and Development proposed a new system of accounting rules for MNEs based on the country-by-country reporting principles to enhance transparency in financial reporting and reduce the scope for tax evasion and avoidance practices for MNEs. CBC involves the disaggregation of financial reports to single countries including detailed information on sales, purchases, costs of financing, wages and salaries, numbers of employees, pre-tax income, local taxes paid, etc. This procedure would facilitate the identification of illegitimate profit shifting activities.

The proposal requires the revision of the current accounting standards of the International Accounting Standards Board (IASB) and introduction of CBC as an International Financial Reporting standard for MNEs. The OECD is currently elaborating on country-by-country guidelines.
Finally, to strengthen regional and international cooperation in tax matters, countries can participate in international networks, forums, organizations etc. The establishment of and participation in such networks are key to pool information and to facilitate the exchange of best practice approaches and lessons learned. Likewise, regional fora are important as they contribute to exchange of best practices between developed and developing countries as in case of the Intra-European Organization of Tax Administration (IOTA) and the Commonwealth Association of Tax Administrators (CATA). Moreover, they can promote platforms for south-south learning processes as the institutionalized exchange of information in the Inter-American Center of Tax Administrations (CIAT) and the African Tax Administration Forum (ATAF) reveal (see Box 7).

**Box 7: Regional Networks - the African Tax Administration Forum ATAF**

The African Tax Administration Forum (ATAF) was established with the view to strengthen efficient and effective tax systems and to promote state building and good governance in Africa. The inaugural conference in November 2009 was the first milestone of a process that started at the “International Conference on Taxation, State Building and Capacity Development in Africa” in Pretoria in August 2008 where it was resolved to create an Africa-wide network of tax administrations. Up to now, 29 tax administrations of 29 African countries have already joined the network, indicating the significance and importance of exchange of experience between countries.


To sum up, a strategy countering tax evasion and avoidance should involve both measures at the national as well as the international level. Especially with respect to tax evasion of MNE, the international dimension has received increased attention in the course of the global financial and economic crisis. Activities involve international cooperation e.g. in the areas of cross border exchange of information that add to existing double taxation agreements which involve clear rules for taxing cross border income and capital flows.

Yet, this action at the international level can only be implemented successfully if specific prerequisites at the national level are guaranteed. For example, to ensure an effective exchange of information among countries, adequate capacities of the tax administration are needed to provide and process this information. Therefore, measures undertaken at the international level have to be accompanied by adequate domestic strategies at the national level. Clearly, any reform measure needs to match the absorptive capacity of the potential partner institution. The strategy will only be successful if capacities are sufficient to ensure an effective and sustainable implementation. This includes as a crucial factor a certain degree of commitment and willingness to reform.

6. Summary and Conclusions

This paper gives an overview of the available knowledge on tax evasion and tax avoidance in developing countries. Although the topic of tax evasion and tax avoidance represents a problem for developed and developing countries, literature and data concerning this topic are still scarce. This is partly explained by the fact that the extent of tax evasion and avoidance is hard to estimate as the phenomena are difficult to observe and precise data is lacking. So far
there are no reliable empirical findings which provide a clear picture of size of the problem or the relative importance of different kinds of tax evasion and avoidance.

The findings suggest that there are various reasons and facilitating factors for tax evasion and tax avoidance. These might be categorized into factors that negatively affect taxpayers’ compliance with tax legislation on the one hand and into reasons explaining the weak capacity of tax administration and fiscal courts to enforce tax liabilities on the other side. In order to develop methods and instruments for fighting tax evasion and avoidance, it is important to foremost establish a broad understanding of the different reasons underlying these problems. Moreover, developing countries seem to be especially vulnerable to profit shifting of multinational enterprises and to the misuse of tax incentives designed to attract foreign direct investment. Which of these problems dominate in a particular country, however, depends on a combination of country-specific factors. It is, therefore, difficult to identify a single ‘one size fits all’ strategy for tackling tax evasion and avoidance in the developing world. However, it seems necessary to combine measures at the national and the international level when designing tax reform strategies. At the same time it is important to bear in mind that actions at the international level can only be implemented successfully if specific prerequisites on the national level are guaranteed. And vice versa measures undertaken at the international level have to be accompanied by adequate strategies at the national level.

In this study we identify three fields that call for further elaboration by researchers, practitioners and policymakers:

First of all, there is a need for more detailed research on tax evasion and avoidance in developing countries. Deeper knowledge that is produced on the basis of common, comparable academic standards and with the aim of collecting reliable cross-country data is of key importance. In this context, first of all it is essential to consider carefully the research questions raised. From a policy perspective, the overall amount of tax avoidance or tax evasion may not be of highest priority. Rather, it is more relevant to understand the causes of the tax losses and the policy instruments that are most effective in encountering tax evasion and avoidance. This implies that empirical research should put an emphasis on the evaluation of policy reforms.

The second element that needs further assessment is increased international co-operation. Collaboration is important because, on the one hand, the international exchange of knowledge can strengthen all parties involved. This includes the promotion of exchanges on tax procedures and reforms to identify ‘best practices’ for fighting tax evasion and avoidance as guidance for national policies. On the other hand, co-operation is essential as a great deal of tax evasion and avoidance arises from cross-border activities of MNE such as transfer mispricing which has to be tackled at an international level.

Finally, reforming tax policies and strengthening tax administrations in developing countries is crucial to establish a ‘level playing field’ in tax matters between developing countries’ administrations, globally active MNEs and large and well informed taxpayers. In this regard, specialized trainings in the field of cross-border profit shifting and tax fraud represent a promising strategy for future work.

We would like to conclude by suggesting two concrete proposals for research projects and strategies which would extend the available knowledge on tax revenue mobilisation in developing countries. Firstly, it would be promising to investigate the determinants of tax payments of individual taxpayers using micro data. Since the availability of household data is
very limited, this endeavour seems more promising for firms. For instance, different national databases\textsuperscript{24} offer detailed information on activities of multinational corporations in developing countries. A first approach along these lines can be found in Fuest and Riedel (2009b). This approach would possibly facilitate better designed tax reforms with regard to the specific circumstances in each country and in the long run allow for a thorough analysis of the impact of policy reforms.

Secondly, significant insights could be provided by pilot projects (sometimes called pathfinder projects) which have been applied in a variety of other policy areas, e.g. education policy. These pilots are suitable to evaluate the impact of specific reforms in developing countries. In cases where development agencies co-operate with tax authorities in developing countries, it would be helpful to implement piecemeal policy reforms either in an individual region within a country or with a limited group of taxpayers. The impact of the policy changes can then be studied by comparing the pilot region or the pilot taxpayer group to other regions or groups. These pilot projects would have to be set up in close co-operation between local tax authorities, developing agencies and researchers, to make sure that the project is set up in such a way that an empirical evaluation is possible.

As we have seen more research that draws a clear picture of size of the problem and the relative importance of different kinds of tax evasion and avoidance and the underlying reasons is needed. In the meantime we suggest fostering the dissemination of successful practices and exchange of reform experience in legislation, administration and capacity development between developing countries and also developed countries. Here, international development cooperation can play an important role in supporting developing countries in this endeavour and in facilitating dialogue.

\textsuperscript{24} E.g. the MiDi database of the German Bundesbank, the AFDI database provided by the U.K. Office for National Statistics (ONS) or the ORBIS database provided by Bureau van Dijk.
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