Enabling more efficient auditing in developing countries: Profit shifting by multinational corporations in transaction-level data

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PRESENTATION LAYOUT

- Introduction
- Illicit Financial Flows
- Data
- Empirical Strategy
- Pilot study
- Implications for Policy
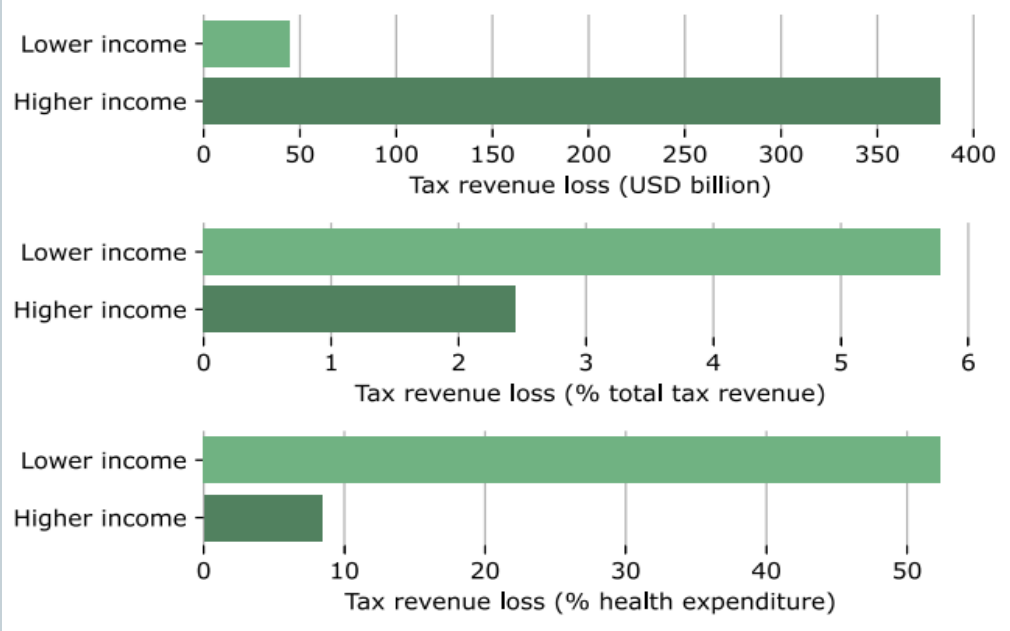- Proposed Policy Interventions

INTRODUCTION

- Multinational corporations exploit existing tax arbitrage opportunities.
- The overall scale of profit shifting and the resulting tax revenue losses - economically significant.
- It has an important negative effect on economic growth.
- Undermines countries' capacity to mobilize its revenue resources.
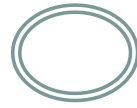- Which countries are likely to be affected more?

INTRODUCTION CONT'D

$427 billion in tax is lost every year

$245 billion lost to global corporate tax abuse by multinational corporations

$182 billion lost to global private tax evasion by weatlhy individuals

Tax revenue loss (USD billion) — Lower income, Higher income

Tax revenue loss (% total tax revenue) — Lower income, Higher income

Tax revenue loss (% health expenditure) — Lower income, Higher income

IFFs by source/destination

- Considering all of a country's external economic relationships, **where** is the highest risk for illicit financial flows?

- Geographic risk: Which partner countries are relevant?
  - E.g. Cayman Islands are the largest global contributor to financial secrecy, but how important are they for North Macedonia?

- What data sources exist to answer these questions?

TAX JUSTICE NETWORK

Basic intuition
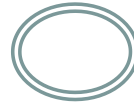
- Illicit Financial Flows are enabled by legislative opportunities:
  - Secrecy → Provides anonymity. Typically involves an **offshore** corporate structure.
  - Lax legislation → Provides motivation and opportunities for corporations and individuals to escape tax or other regulation.

Financial secrecy
• Corporate ownership secrecy
• Non-cooperation
• No exchange of information
• Lax anti-money laundering measures
• Loopholes, exemptions, gaps, tax holidays
• Secrecy on economic activity and tax paid
• Tax treaty aggressiveness
• …

TAX JUSTICE NETWORK

Vulnerability score

(= how harmful is the secrecy provided by a country's partners)

Average of Secrecy Scores of partners, weighted by the value of the flow

TAX JUSTICE NETWORK

TJN's IFF vulnerability tracker

http://iff.taxjustice.net/

TAX JUSTICE NETWORK
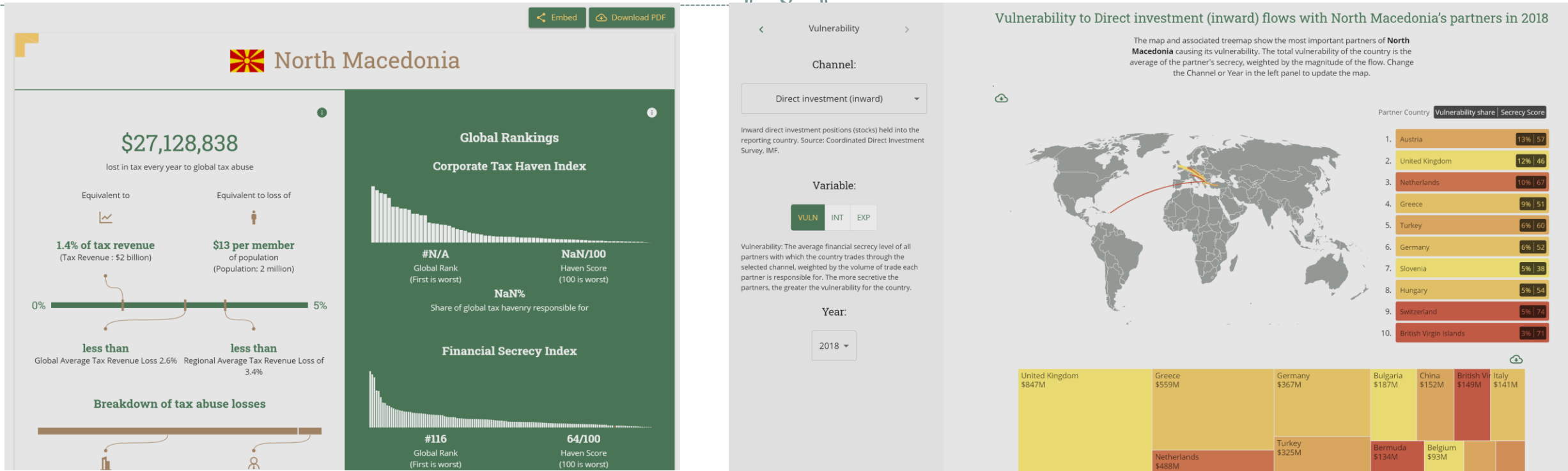
Inward direct investment to North Macedonia

TAX JUSTICE NETWORK
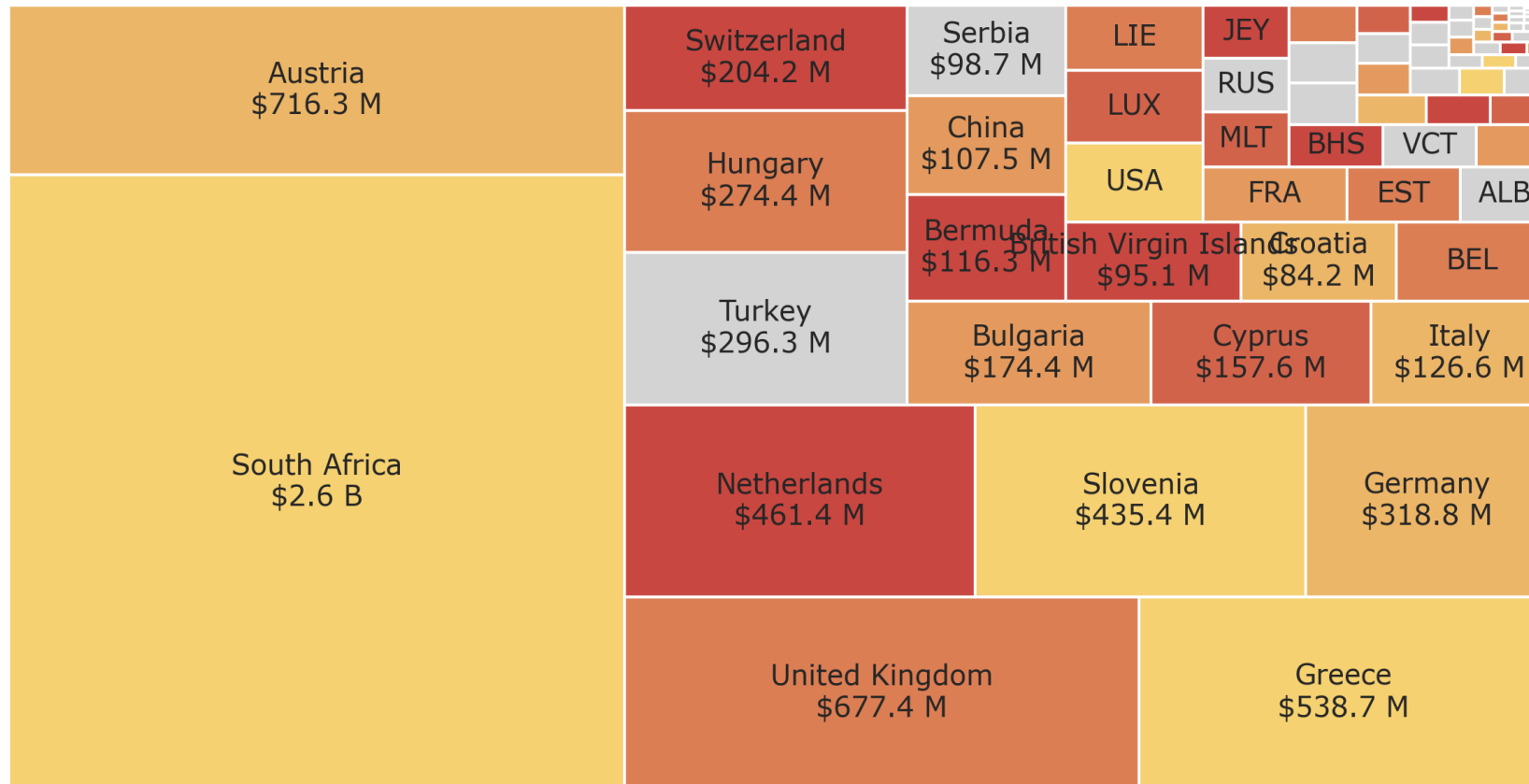
DATA – MACRO VS MICRO

	MACRO	MICRO
Level	Country level	Firm level
Channels	Economic aggregated (Trade/FDI/Bank/Portfolio)	Transfer pricing transactions
Intensity	Compared with GDP	Compared with Revenue or Gross Profit
Goal	Understand vulnerabilities, target policy	Red-flag transactions or companies for audit

DATA CONT'D

PART D: SUMMARY OF CONTROLLED TRANSACTIONS WITH CONNECTED PERSONS

SN	Controlled Transaction	Amount	Currency	Connected Persons	Jurisdiction of Connected Persons	Classification
1	ADVERTISING SERVICES	30,296,295	▮	▮▮▮ ▮	▮ Note: Home country	INCOME
2	INTEREST ON LOAN	12,428,593	▮	▮▮ ▮	BRITISH VIRGIN ISLANDS	INTEREST EXPENSE
3	INTEREST ON LOAN	2,322,825	▮	▮	GILBRATAR	INTEREST EXPENSE

❖Use a new source of administrative data: Transfer Pricing Disclosure Forms (TPDFs).

❖To estimate the relative importance of five transaction categories: (i) tangible goods, (ii) services and fees, (iii) royalties, (iv) interest, and (v) reimbursements.

EMPIRICAL STRATEGY

Our empirical strategy to using transaction-level data to estimate the relative importance of individual profit shifting channels consist of two steps. First step;

$$T_{i,x} = \sum_{x,c} \tau_{x,c} \cdot X_{i,x,c}$$

We calculate the hypothetical total tax paid on the transaction's value, $T_{i,x}$, defined as

the sum across x and c of the products of the applicable tax rate, $\tau_{x,c}$, and the value of

the transaction category, $X_{i,x,c}$

EMPIRICAL STRATEGY CONT'D

Second step, we move from transaction-level data to the company-level

$$\log(\pi_i) = \beta_0 + \beta_x \cdot \log(\mathbf{T}_{i,x}) + \gamma_x \cdot \log(\mathbf{V}_{i,x}) + \delta_\chi \cdot \chi_i + \epsilon,$$

- Use hypothetical taxes in a variation approach pioneered by Hines and Rice (1994)
- *$T_{i,x}$ is a vector of hypothetical taxes applicable to transaction x;*
- *$V_{i,x}$ is the value of transaction x;*
- *χ_i is a vector of controls containing the company i's financial information available in the TPDFs*
- *and ϵ is the error term*

PILOT STUDY IN NIGERIA

Figure 1: Average Haven Score of partner countries for Nigerian MNCs' intra-group transactions, by type of transaction
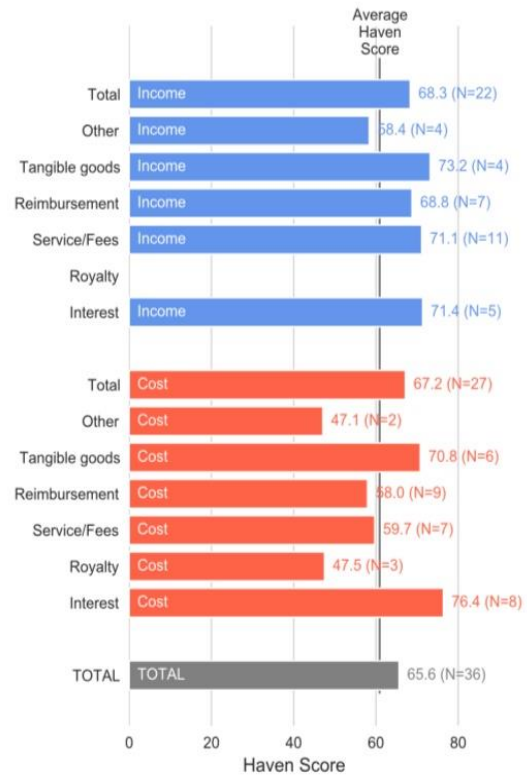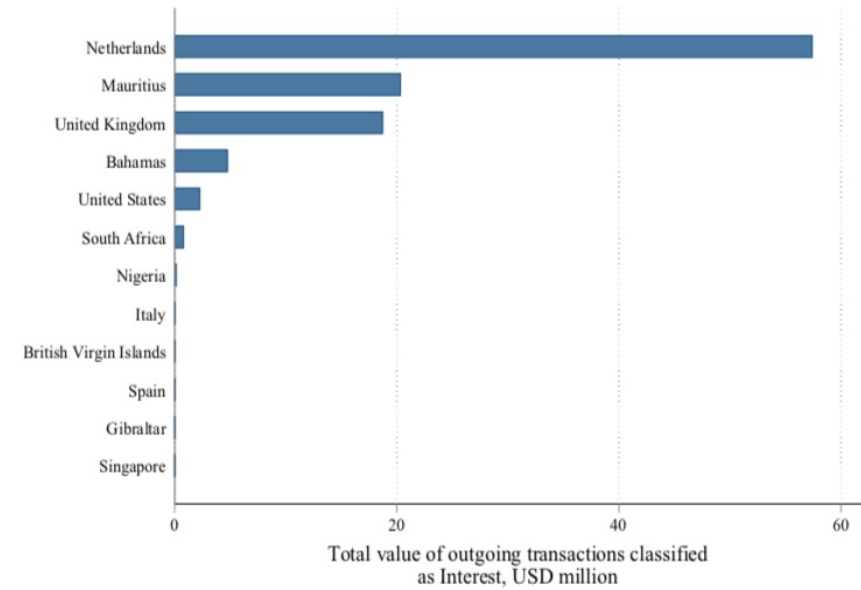
Figure 2: Destinations of outgoing transactions classified as Interest

IMPLICATIONS FOR POLICY

❖ In Nigeria, we analyzed a sample of 87 companies.

❖ Risk profiles were created for each company based on the value of the transactions and the location of the subsidiary.

❖ Six companies were selected to be audited: three using the old methodology, three using vulnerability analysis.

❖ The audits are underway and are expected to be completed soon.

PROPOSED POLICY INTERVENTION

❖ Proposed policy intervention in two phases;

- Phase one - identify companies with the high risk of profit shifting.

- Phase two- send letters to a randomly chosen subgroup of companies.

❖ Assess the treated companies' change in behavior by analyzing TPDFs in the year following the intervention.

CONCLUSION

- We use administrative data and we are happy to help you do that too.

- To identify transactions that are most often used by multinationals to shift profits out of developing countries, or by the wealthy to hide their assets and evade tax and other regulation.

- Interest payments to affiliates in low-tax countries emerge as the likely most important channel of profit shifting for our sample of Nigerian companies.