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Tax Administration Priorities in Emerging and Frontier Markets

by

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Introduction

The subject of global corporations not paying their "fair" share of taxes has been the subject of public discourse for more than three years, and international tax rules such as transfer pricing a subject for discussion in daily newspapers. There are widespread concerns that multinational enterprises (MNEs) are active participants in undermining the tax base of developed as well as developing countries, and the new Action Plan on BEPS can be seen as one outcome of this thinking. Concerted global action on addressing risks to tax bases from cross-border activity is at an unprecedented level, and the tax world is presently full of uncertainty. National action following publication of the full action plans for BEPS are very much an unknown, and this is most true of emerging and frontier markets.

It is often observed that such behaviour by MNEs has had greater impact in emerging and frontier markets, with limited tax bases and reliance on a small number of large taxpayers for the bulk of corporate income tax. Some civil society advocacy groups have gone so far as to cite transfer mispricing by global companies as a reason for the failure of such countries to provide basic needs, e.g. adequate drinking water for citizens.

There is a common perception that the international corporate tax system as presently constituted reduces the tax base of lower-income countries. Many advocates also feel that the lack of information exchange on assets and income streams, and the asymmetry in tax administration capacities, affect the ability of countries classified as emerging and frontier markets to realize their fair share of taxes from MNEs. This applies particularly to companies active in "pioneer" industries such as FMCG, hotels, alcohol, telecoms, food, tobacco, banking, and energy, which are often early investors in such markets.

Role of Tax Administrations in Developing Countries

Domestic resource mobilization requires an effective system for tax administration and collection. Developing countries should strengthen their tax administrations to efficiently collect tax from a wide tax base. While tax system design and tax policy choices are the primary determinants in establishing the base, the lack of an effective administration is often the main reason why many developing countries fail to raise revenue commensurate with their level of economic development.

Common problems cited are:

- Lack of skills and resources in the tax administration;
- Large informal sector that remains outside the tax system;
- Widespread tax evasion by wealthy people;
- Perception of widespread corruption;
- Use of sophisticated tax planning techniques by multinational companies.

Tax administrations also have a significant role in state building in developing countries, especially in frontier markets where a transition from a centrally planned or

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authoritarian system is underway, or when a fragile state tries to rebuild after prolonged conflict or civil war. Many of the companies in "pioneer" industries are active in such countries; they can both benefit and also contribute to a virtuous cycle of economic management based on the rule of law. The mobilisation of the domestic tax base can reduce dependency on foreign aid or on income from a single natural resource. This enables governments to fund infrastructure and other public goods to attract further private investment, both domestic and foreign. Effective administration, accountability and transparent public financial management strengthen government legitimacy; a broader tax base also increases accountability of government to citizens. Finally, good tax administration may be the best tax policy in attracting foreign investment.

Tax administrations in many developing countries can also play a secondary role as a mechanism to train and/or groom high-quality, motivated staff for the public sector to fulfil broader economic functions. Such roles may include economic policy making, management of public-sector enterprises and so forth.

Revenue Risks from Transfer Pricing Issues in Developing Countries

In view of these twin factors -- i.e. awareness of potential risks to the national revenue base from MNEs and the pressing need for domestic revenue mobilization, tax agencies in developing countries can often take an overly aggressive stance towards MNEs. It is not unusual for an MNE to be audited two or three times in a single year with issues settled after one audit reopened in the next one. MNEs are often seen as easy targets when other elements of the taxpayer population are too hard to handle and do not produce the taxes and duties expected from them. A more aggressive audit stance based on the BEPS project can already be seen in some cases. Tax agencies are often aware that MNEs have strong accounting policies and record retention standards, whereas the same standard of record keeping is often not available for local enterprises, and virtually non-existent for small and medium-size enterprises. Finally, large local business groups may have strong political support, which makes it difficult for tax agencies to challenge the accuracy of their returns.

Many such tax administrations often have a less developed understanding of tax risk management and see deliberate transfer pricing manipulation as endemic within MNEs. While some MNEs do not get transfer pricing right and are ready to handle issues through a tax administration inquiry, many others work very hard to get things right. All too often all MNEs are tarred with the same brush. And while only MNEs know for sure whether their transfer-pricing policies and administration are well-based and honest, it is vital that tax agencies in developing and frontier markets build greater confidence in the desire of MNEs to comply with both the letter and spirit of the tax laws of the countries in which they invest.

MNEs do have a deep interest in effective and efficient tax systems and administration in these countries, and in a broader view, their ability to fund infrastructure, education and efficient government, including law enforcement. However, this message is often not clear to governments, and a practical way to get it across is to address misperceptions about the transfer-pricing area. MNEs can perform a very useful role in helping tax administrations understand their transfer-pricing policies and administration and the basis on which cost recharges are made by headquarters in higher tax countries.

Policy Priorities and Resource Allocation in Tax Administration in Developing Countries

There are of course a number of reasons behind the shortcomings of current tax systems in developing countries, e.g. policy priorities that reflect elite capture and resistance, corruption at both policy and implementation levels, etc. However, the work suggested in this paper would focus purely on the policy priorities at a tax administration level and on quantification of potential benefits. Tax agencies in developing countries could make better allocation of their limited resources if they had a clearer view of the challenges facing them, their strategic priorities and the relative risks and returns of policy choices.

This paper proposes a win-win solution that will examine how best to reduce the unproductive pressure that some tax administrations direct towards MNEs, and how to help tax administrations in less developed countries grow their capacity to tackle their informal economies.

Tax Administration Reforms in Developing Countries

Tax administration reforms in frontier and emerging markets have followed a general approach that is quite similar worldwide. Many are guided by institutions like the IMF and the World Bank, and include:

- The development of capacity for implementation of policy choices recommended by international advice, such as introduction of self-assessment for income tax and introduction of a value-added tax.
- A package of 'advanced' tax administration practices, thought to be conducive to more voluntary compliance by taxpayers. These have typically introduced a large taxpayer office, focus

on administration of rules by taxpayer rather than tax type, improved communications, and so forth.

- Enhanced training and exposure to international developments.
- A push towards automation of tax administration processes.
- Attempts to give tax collection agencies a degree of autonomy from the political executive, and to build more honest and transparent tax administration.

The IMF and the World Bank have also developed a series of manuals, tools and best practices to support tax administration reforms. Other donor agencies, notably the U.S. Treasury Office of Technical Assistance, the UK DfID and the Asian Development Bank, have also done important work in this area. These are welcome developments that are generally positive for the growth of more open rule-based investment regimes around the world. However, at a practical level, this paper argues that some of these initiatives have not had the desired effect in view of their implementation. It is thus appropriate to look at the effect of these developments, and consider alternatives.

Reform Priorities and Their Actual Impact

Reforms of tax agencies have typically included a review of the business processes and organizational structures of such agencies. A typical reform has been to a move to a function-based organization, and away from a subject-based organization where a different department looked after a specific tax. This has often been accompanied by the move to an independent, or nominally independent, unified tax agency that covers the principal domestic taxes including VAT, income tax, excise, and wealth taxes.

A typical reform undertaken in many countries is the introduction of the Large Taxpayer Office (LTO). While desirable in principle, in many cases this has had limited impact, as often the LTO brings together the best taxpayers and tax officials, and can mean that tax administrations do not give small and mid-size businesses the attention they require. In many countries, intensive compliance focus on MNEs known to pose tax risk has limited the resources available to address risks posed by smaller companies and increase the amount of taxes collected. Owing to widespread practices of revenue collection targets, ministries of finance often expect to see the bulk of their corporate income tax and VAT revenues to come from LTOs, and consequently give them first call on scarce resources. Finally, LTOs often fail in their core mission of providing a single service point for large taxpayers.

Tax administrations and donor organizations have also made significant investments in automation. With effective planning, IT systems can indeed increase the effectiveness and efficiency of tax administrations by easing the burden of receiving and processing data from taxpayers and third parties, and by providing a holistic view of taxpayers across tax administration functions, as well as other benefits. However, many of these investments have delivered poor returns, partly due to lack of capacity to absorb these changes, and partly because of unrealistic expectations of what automation can deliver. IT solutions are not an acceptable alternative to efficient and effective business processes; many tax administrations seem to have believed that they could simply organize their work around the IT systems acquired. The application of these large investments has often been limited to a few taxpayers who are able to deal with automated processes originally designed for developed countries.

These reforms have thus enabled revenue authorities to be quite well-placed to engage with the organised private sector, but not with the bulk of small actual or potential taxpayers in their own countries. Further, increased exposure to developments around the world, and the ability to access information by the limited range of capable people in small tax administrations have encouraged more of a focus on potential tax abuses by large multinationals, while ignoring some of the other areas.

Many tax administrations and ministries of finance in emerging and frontier markets have thus focused the bulk of their resources on measures aimed at large taxpayers in the formal sector. Other research has shown that while reformed revenue agencies appear to be quite impressive and influential organisations, they have not led to significant increases in revenue collection.[1] It would seem that returns from these investments have now started to diminish, and resources can be better employed in other areas.

Establishing New Priorities for Tax Administrations

Over the last three years, multilateral and bilateral aid agencies have substantially increased the funding available to tax administrations, but questions remain as to whether these funds are being used effectively. It may be argued that concerted action on the part of major donor agencies and efforts of governments themselves over the last 20 years have resulted in relatively effective public revenue systems, at least as compared to the past.

[1]Moore, M., *Revenue Reform and Statebuilding in Anglophone Africa*, ICTD Working Paper 10, May 2013.

While the investments made may not have delivered all the desired goals, and in some cases may have created perverse incentives, they have clearly enhanced the capacity in many administrations to understand and implement policy. These reforms have also contributed significantly to the environment in which tax policy is made, through better capacity to implement and better feedback.

It is argued here that tax administrations in emerging and frontier markets would benefit from enhanced focus on:

1. Improvement of capacity at the leadership levels for strategic design of tax administrations.
2. Improved capacity to identify new technologies that would work in their environment and to implement them effectively.
3. Improvement of the approach to risk assessment, -- e.g., the framework provided in the 2012 OECD FTA study on the challenges of transfer pricing written by a tax commissioner in a LDC could be used as a standard format for an MNE to respond to the fears raised about transfer mispricing.
4. Increased focus on bringing more of the shadow economy into the formal sector. Since the relatively high cost organisational investments focused on headquarters, IT-based activities and large taxpayers are already complete in many countries, governments can generate higher returns from these sunk costs by seeking to grow the tax base from a focus on the informal sector.
5. Enhanced capacity for better engagement with major corporate taxpayers, and improvements in clarity and simplification of compliance to ease doing business and pay taxes. It may be appropriate to see how the concept of cooperative compliance could work in a developing country environment.
6. Better insight on the international tax issues that tax administrations should focus on.
7. Better understanding of the interaction between global tax and trade/investment rules that will affect the business of tax administrations in such countries.

These initiatives will require much less effort and expertise than implementing, say, a new transfer pricing regime, or focusing on potential revenue losses from online sales and consumption.

Implementation Strategy

It is proposed that a conceptual framework be developed for the implementation of the seven research areas identified above, building on the work done elsewhere, and especially by the major multilateral agencies. This can be done by ITIC in partnership with the Academy of Public Finance (APF); ITIC would utilize its contacts with tax agencies in developing countries through the current regional engagement programmes, particularly in Africa and in MENA. ITIC would also invite major MNE investors in the participating countries to prioritise these issues, recognising that this is a programme that will take 3-4 years to complete. ITIC would thus continue to build on the public-private partnership model in tax policy that it has pioneered.

The research would draw upon the work of the IMF, World Bank and regional tax organisations to do an environment scan of where tax administrations in these countries currently stand. Work would then be initiated on each of the specific topics in section G, with first results on priority areas available in mid-2015. This would form the backdrop for the study, which could follow the approach taken in ITIC's Double Taxation Treaties study, in working with a sample set of countries, selected from range of emerging and frontier markets. The definition of a developing country for this purpose relates to the level of per capita GDP, the extent of industrialisation and the level of the Human Development Index for that country. The representative sample could be taken from four categories as follows:

- BRICS countries (Brazil, Russia, India, China, South Africa)
- High income developing countries, (e.g., Malaysia, Indonesia, Argentina, Chile)
- Middle income developing countries (e.g., Vietnam, Thailand, Kenya, Ghana, Bangladesh)
- Resource rich developing countries (e.g., Guinea, Oman, Angola, Zambia, Peru, Kazakhstan)

ITIC proposes to then present this initiative in a private dialogue with 20-25 heads of tax administrations in key developing countries, in a relatively accessible location such as Dubai, in mid- to late 2015. This would examine the issues outlined in section G above and present a work programme that would show possible benefits of the work for leaders in tax administration in emerging and frontier markets. The initial meeting would then seek extended support from and continued one-on-one dialogue with these officials during the course of the research programme. The outcome from these studies would be used to:

- Feed into global and regional meetings of the ITIC tax policy dialogue series
- As the basis for articles both in the technical

journals and general press

- As the basis for continuing a dialogue at the Commissioner/Deputy Commissioner level in cooperation with the APF, which has already begun work on this.

A methodology can be developed to examine the level of investments made in tax administration, which can be used to compare the results achieved by the relevant revenue administrations. Validation of current audit case-selection criteria and analysis of filing patterns can help show potential returns from additional educational or enforcement efforts in the informal economy.

The research work should also examine the costs of strengthening expertise in the tax administration to improve compliance and deliver improved services, as well as methods to leverage information available elsewhere through the use of technology. The focus of these costing efforts should be tied purely to the informal sector; other efforts such as better service delivery by the tax administration through taxpayer guidance should be included only to the extent that they mitigate efforts in the informal sector,

The results may then be compared with the possible returns from more intensive efforts in higher profile activities for tax administration such as transfer pricing and taxation of cross border services.

Conclusion

The proposed research programme is in line with ITIC's mission to promote international best practices in tax policy and administration, and in turn, pro-growth, investment friendly economic governance in developing countries. The research and engagement will help leaders of tax agencies in these countries in forming a strategic view on priorities, gain better insight into the relative value of alternative investments in their business, and the key international developments in tax and related trade/ investment policy.