UBS Center for Economics in Society

at the University of Zurich

Universität Zürich[UZH]

Economics of Global Challenges

Combating tax evasion

Dina Pomeranz
University of Zurich

in association with CEPR

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Reducing tax evasion is a key concern for governments around the world

Tax Evasion: 90% of Kenyan companies pay no corporate tax

Kenya Revenue Authority's enforcement unit is pursuing suspected tax evaders

Staff Writer, ZAWYA

France takes aim at multinationals' tax evasion

By Courtney Wilson

Manila Standard

Tax evasion charges filed vs. four 'ghost' companies

The Bureau of Internal Revenue (BIR) on Thursday filed tax evasion complaints before the Department of Justice against four "ghost"...

16 Mar 2023

Global Deal to End Tax Havens Moves Ahead as Nations Back 15% Rate

More than 130 countries agreed to set a minimum tax rate of 15 percent as governments look to end a race to the bottom on corporate taxation.

up first

ECONOMY

LISTEN & FOLLOW

The IRS just got $80 billion to beef up. A big goal? Going after rich tax dodgers

August 14, 2022 · 5:00 AM ET

Heard on Weekend Edition Sunday

Dina Pomer

Why tax evasion matters

- No modern state can exist in the long run without effective taxation
  - To execute its various functions, from assuring security and rule of law to infrastructure and providing services in education or health

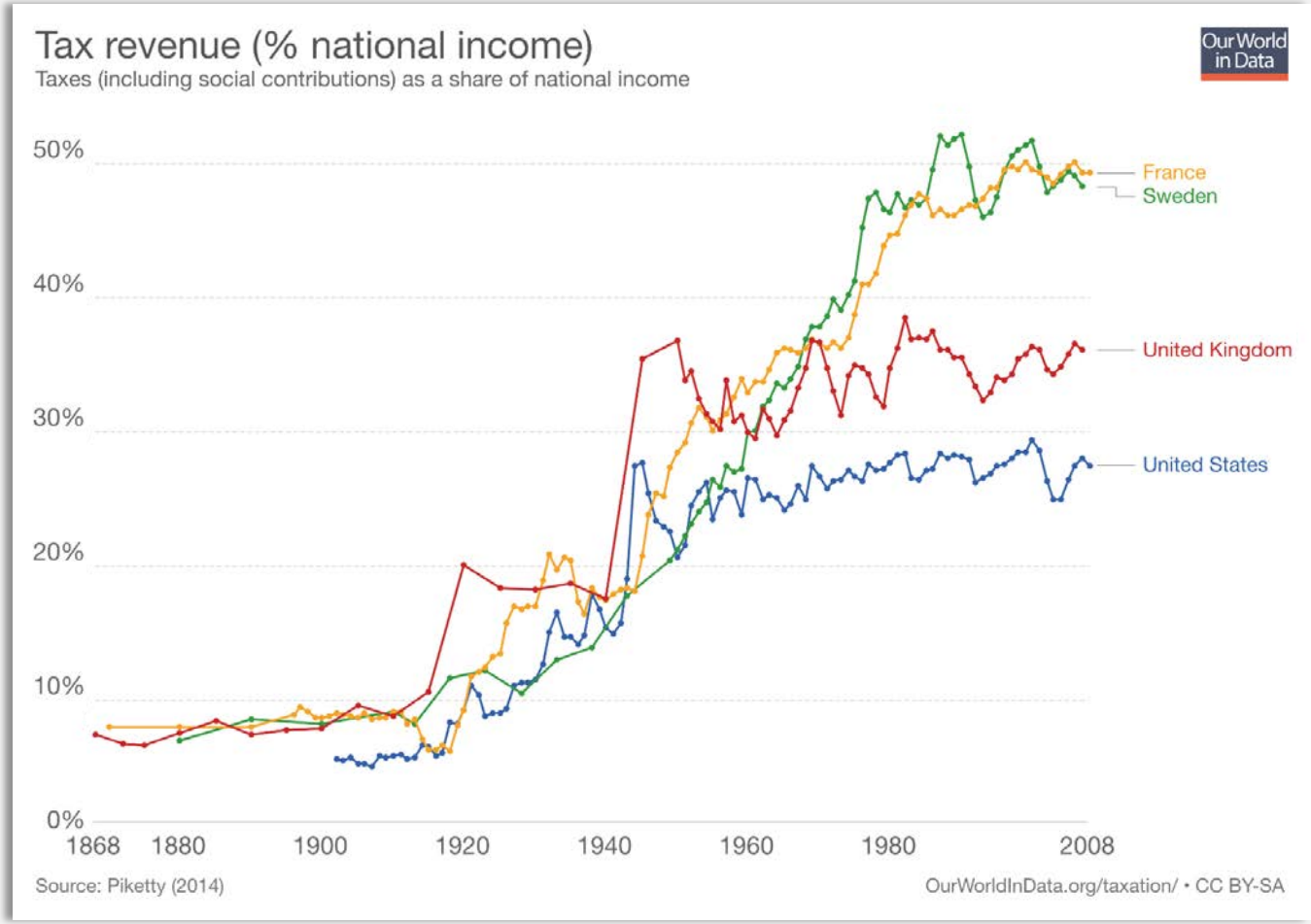
- Tax evasion generates billions of dollars of losses in government revenue

- It also creates large distortions between economic activities that are taxed and those that escape taxation through evasion
  - For a given size of government revenue, the burden on those who (have to) comply with tax obligations becomes larger

→ **Strengthening the ability to effectively and fairly collect taxes is a central element of state capacity**

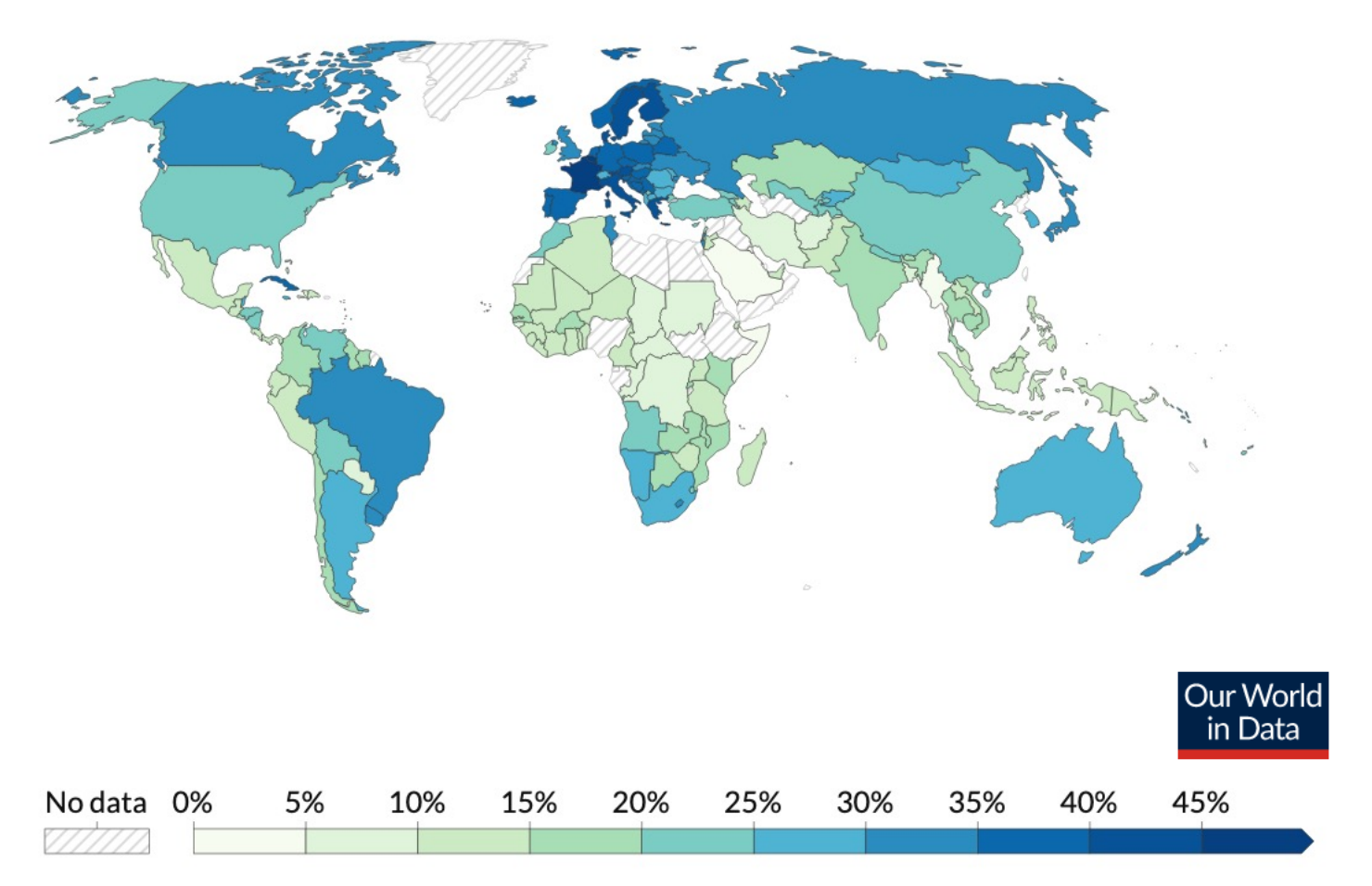
Historical development

- Today's rich countries acquired their taxation capacity over the last century
  - Taxes as share of GDP in Sweden, France, UK & U.S.
  - Share in 1920 are similar to shares in low-income countries today



Lower-income countries still have lower tax capacity

Taxes as a share of GDP



Dina Pomeranz

How do you think tax revenues in developing countries compare to international aid?

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Why is tax collection more difficult in lower income countries?

- Key challenge for governments: to impose any tax, governments need information about the taxable transactions

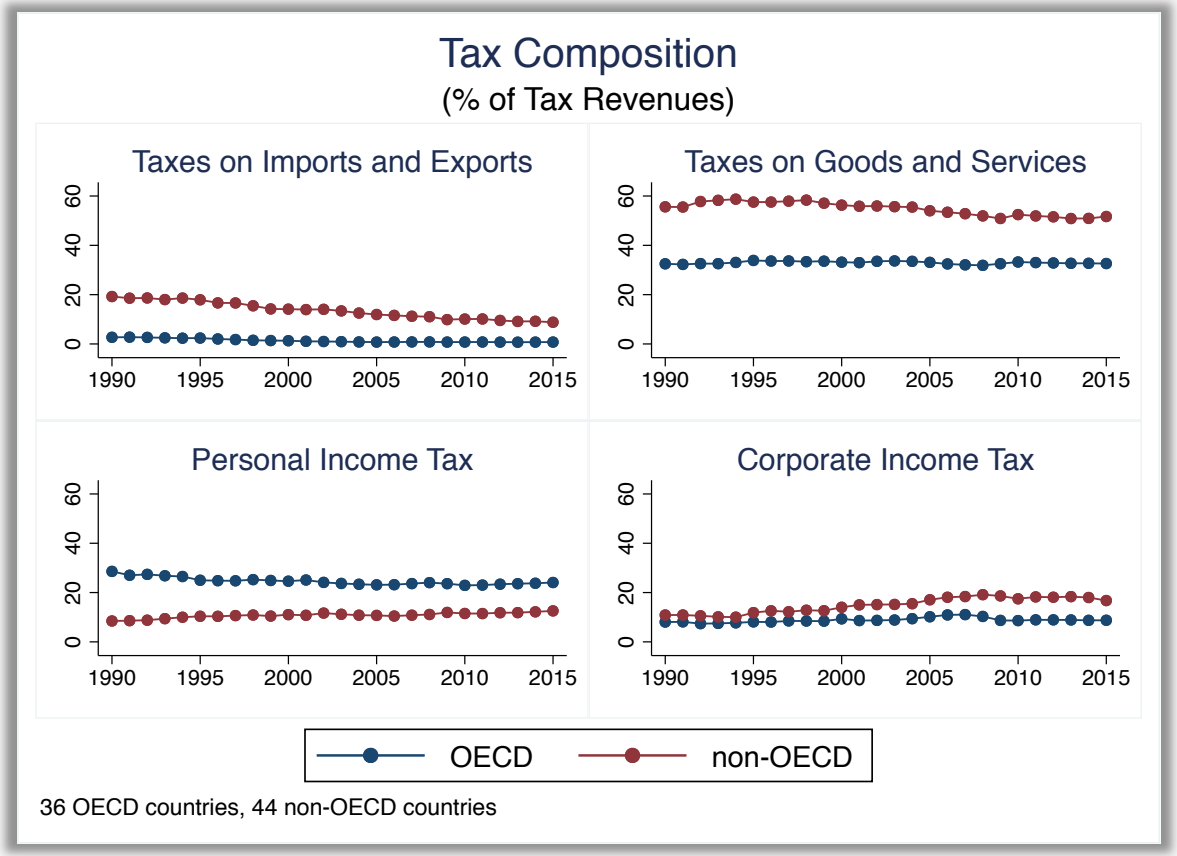
- Particularly challenging in less developed economies
  - Less formalization of firms and of transactions
  - → Less information about taxable transactions

Tax structures are affected by access to information

- Tax structures in developing countries reflect access to information
  - (Gordon & Li 2009)

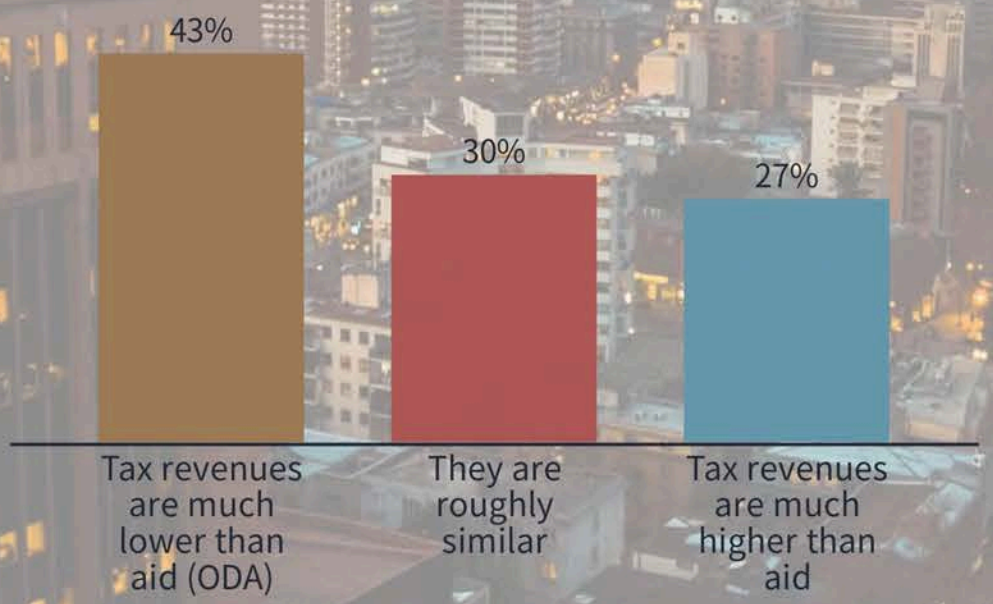
- Collecting taxes from firms rather than individuals
  - (Slemrod, 2008)

  - Less personal income tax, more taxes goods and services (VAT), tariffs and corporate income taxes



Source: OECD Global Revenue Statistics Database

How do you think tax revenues in developing countries compare to international aid?



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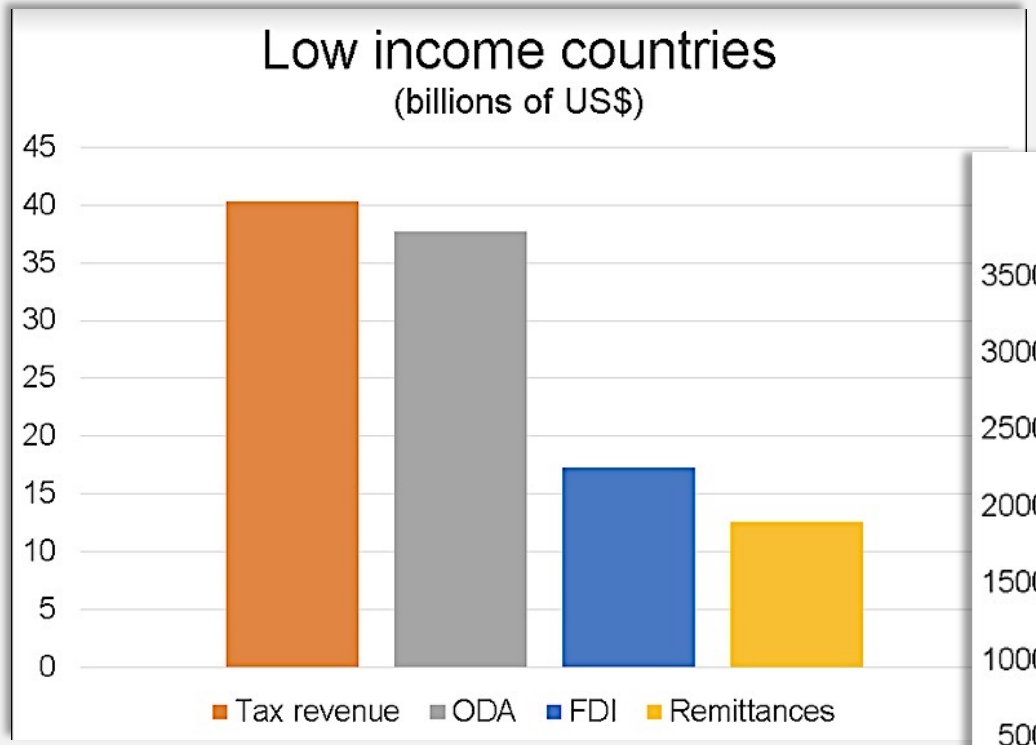
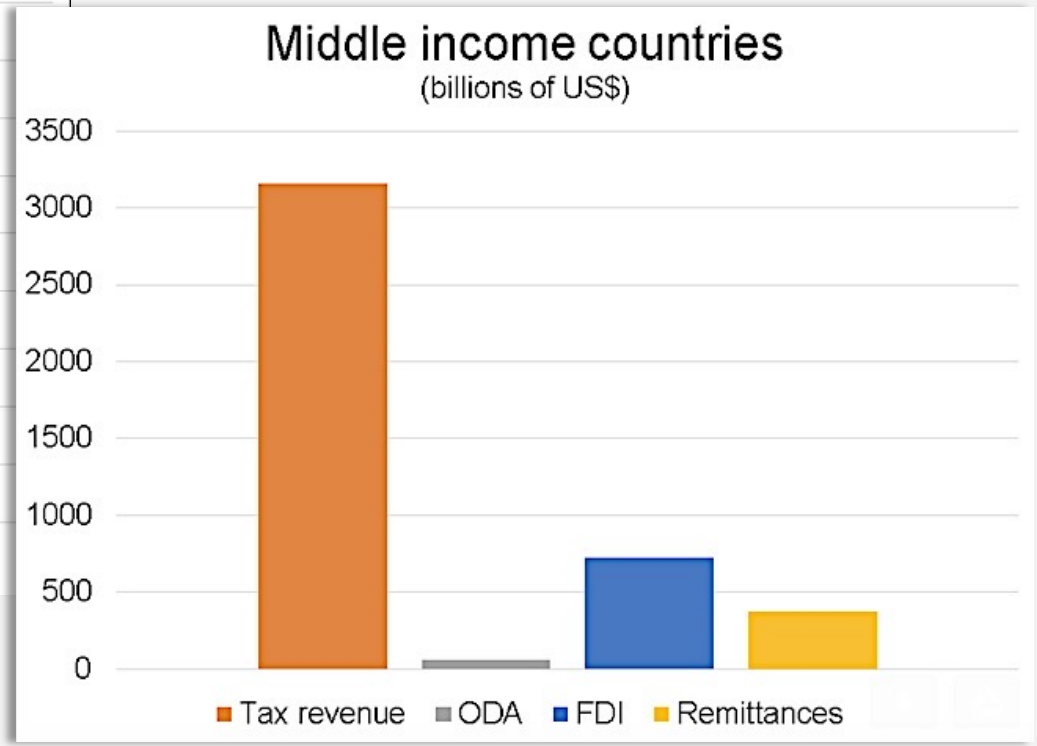
How taxes compare to other financial flows





→ As states grow economically, aid tends to fall and tax revenues grow

Source: World Bank's World Development Indicators

Today's presentation

- Two papers on tax evasion in firm networks, and governments' attempts to combat it by collecting more information
  - One very successful, the other less so …

1) Tax fraud through fake documents
   - Firms making illegal tax deduction by buying fake receipts from ghost firms

2) International profit shifting
   - Multinationals reducing their tax bill by artificially shifting profits to affiliates in lower tax countries

Ghosting the Tax Authority: Fake Firms and Tax Fraud in Ecuador

Joint paper with Paul Carrillo, Dave Donaldson and Monica Singhal
(forthcoming in American Economic Review: Insights)

Background

- Companies pay VAT and corporate income tax revenues minus expenditures
  - Evasion: underreporting incomes or overreport expenditures

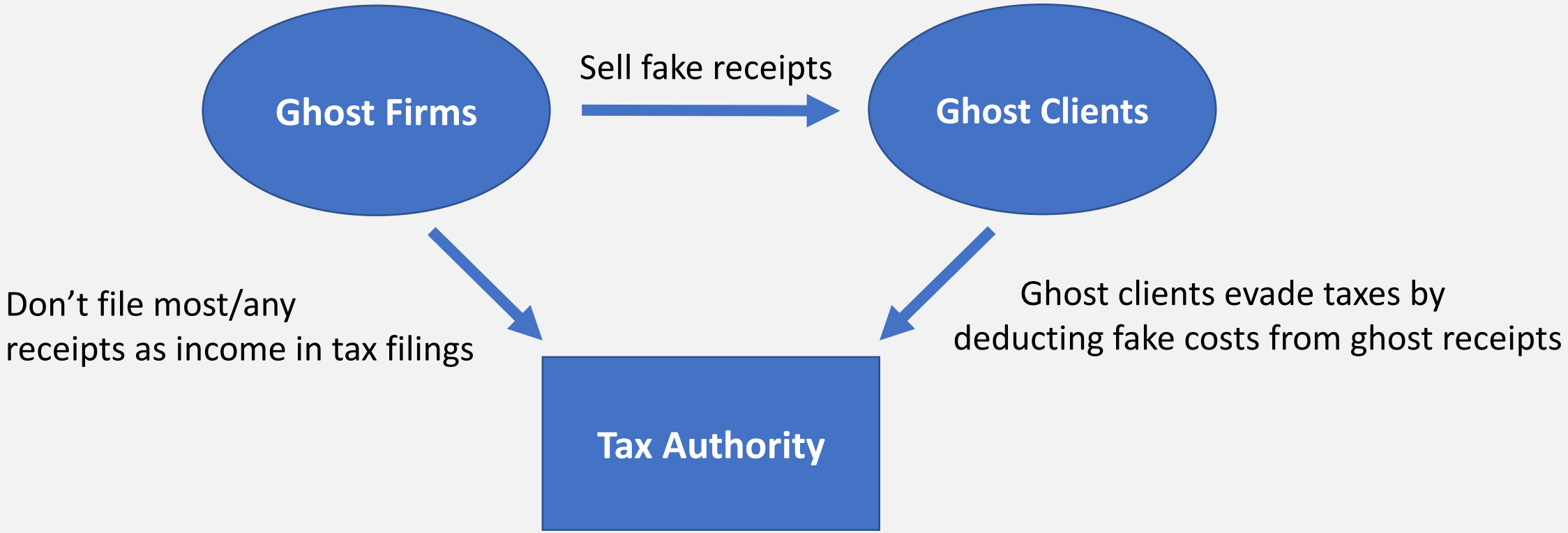
- As economies become more formalized, it becomes more difficult for firms to hide their incomes
  - Due to paper trail on receipts that show the sales happened
    - (Pomeranz, 2015)

  → Firms try to reduce their tax bill by increasing their reported expenditures
    - (Carrillo, Pomeranz & Singhal, 2017)

- This paper: Ghost firms
  - Fake firms that help other firms evade taxes by selling them fake receipts
  - Client firms use those receipts to deduct bogus expenditures from their tax bill

Ghost firms sell fake receipts, to help other firms evade

- Help other firms make illegal deductions to artificially lower their reported profits



Ghost firms in Ecuador

- We study this global phenomenon in Ecuador, where we worked with the tax authority using micro-level administrative tax data

1) Provide a window into the nature and patterns of this phenomenon

2) Evaluate an innovative enforcement policy by the Ecuadorian tax authority to combat evasion via ghost firms
   - Enforcement directly against ghost firms is challenging
   - New approach: targeting ghost *clients*

What type of firm uses ghost firms the most?

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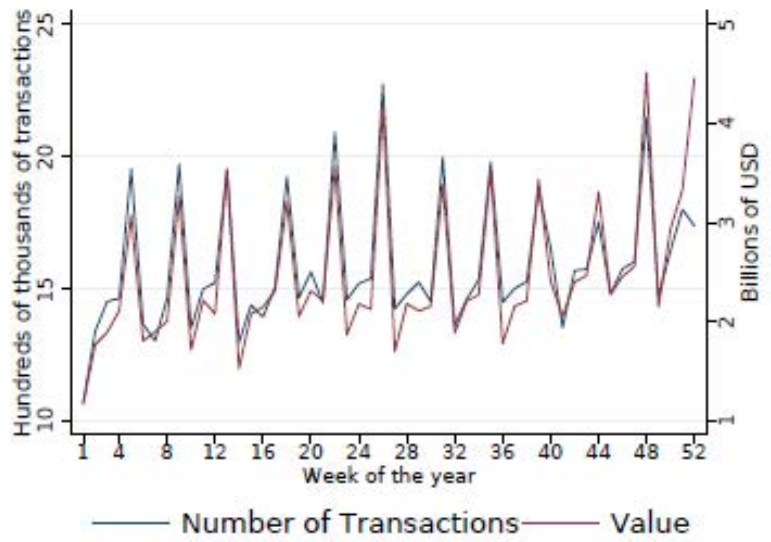
Results: New facts about ghost firms

1) Deductions based on fake receipts from ghosts are prevalent and large
    - Almost 5000 firms made purchases from ghost firms in 2015, representing 5.3% of all incorporated firms in Ecuador

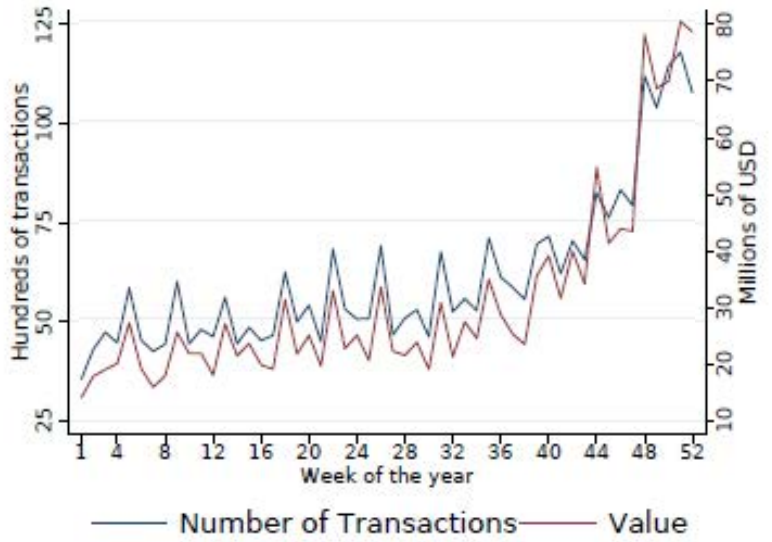
Results: New facts about ghost firms

2) The number and value of ghost transactions increase towards the end of the year

(a) Number and Value of Reported Purchases from Non-Ghost Firms Over the Year

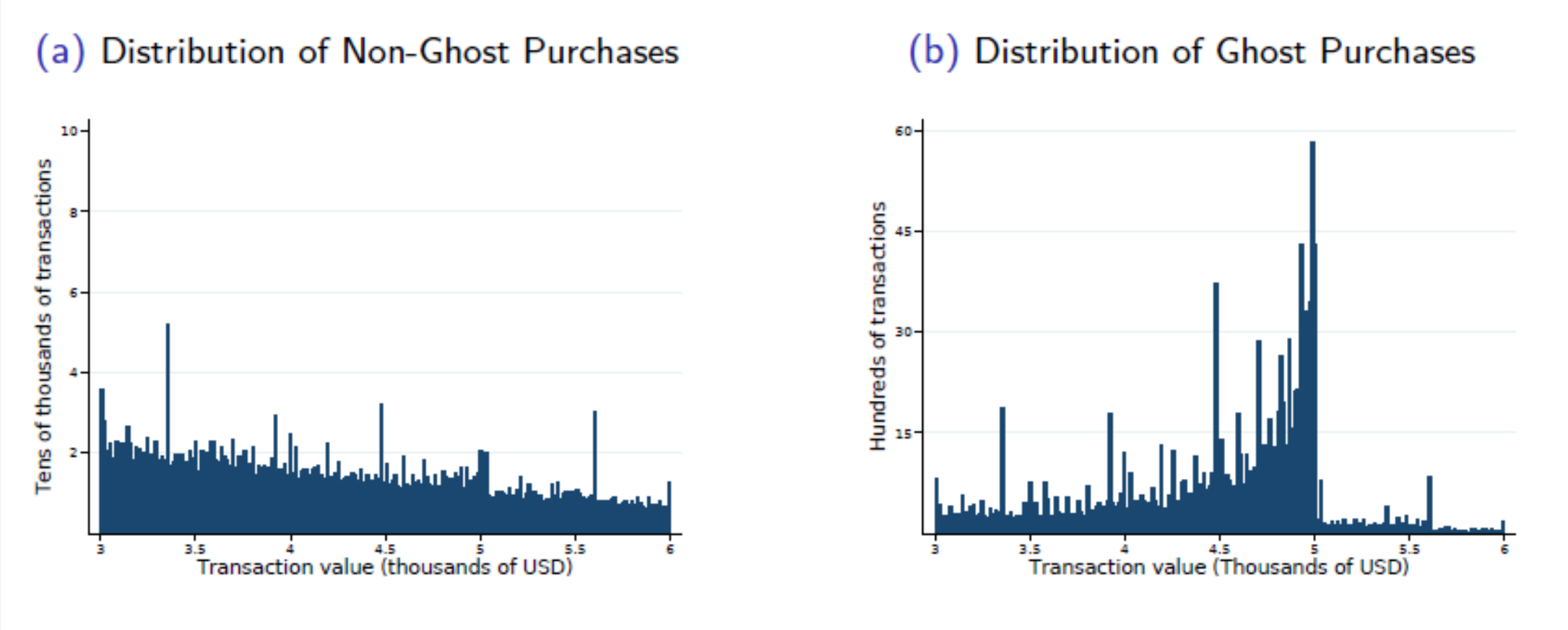


(b) Number and Value of Reported Purchases from Ghost Firms Over the Year



Results: New facts about ghost firms

3) Transactions by ghost firms are bunching just below $5,000, above which it becomes mandatory to use the financial system for payments



What type of firm uses ghost firms the most?

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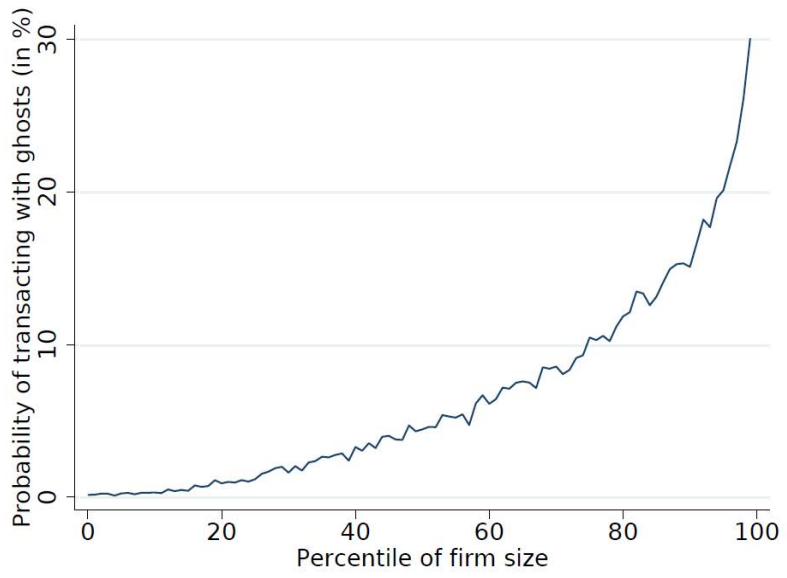
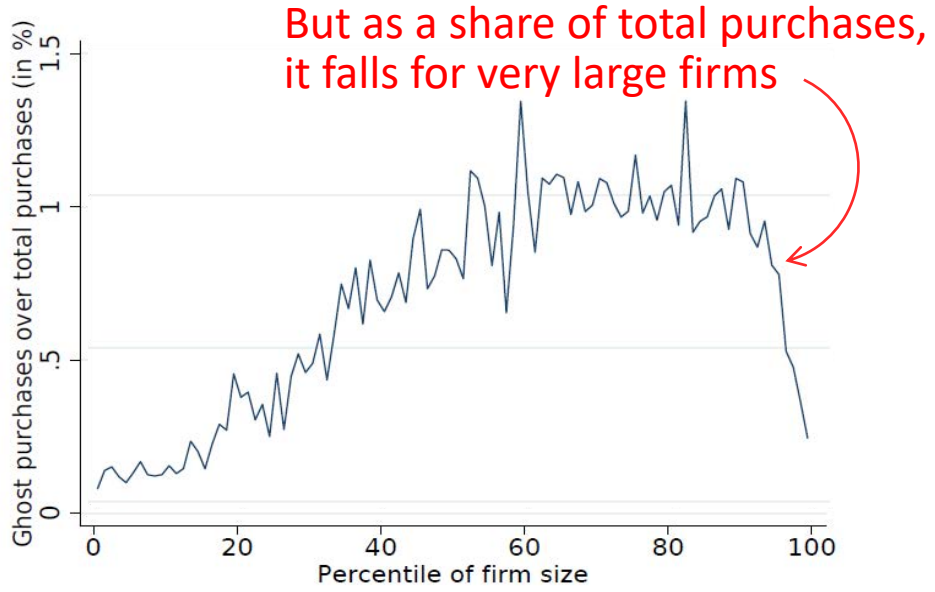
Results: New facts about ghost firms

4) Use of fake receipts from ghost firms is more prevalent among larger firms

(a) Probability of Being a Ghost Client, by Firm Size



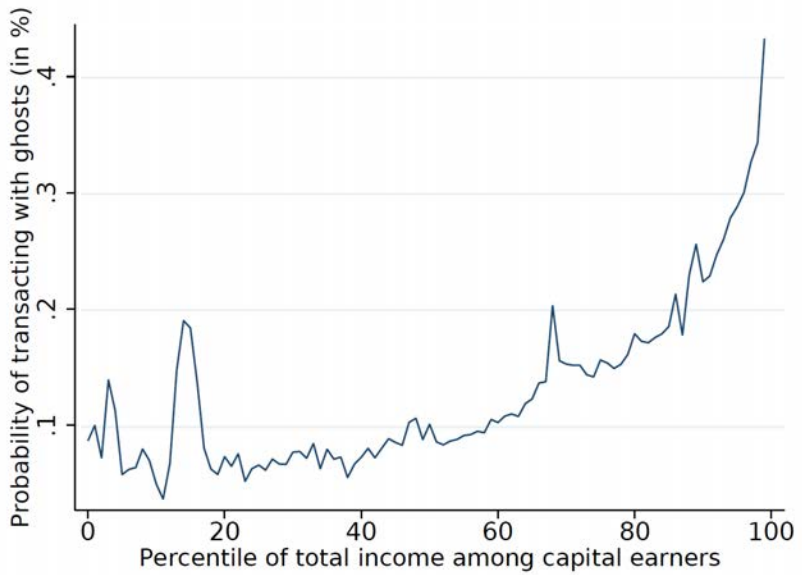
(b) Value of Ghost Purchases Over Firm Total Purchases, by Firm Size



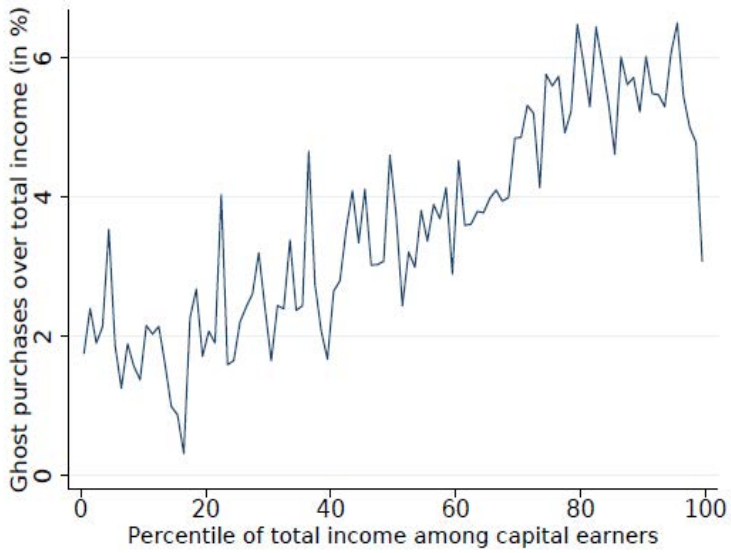
Results: New facts about ghost firms

5) Ghost deductions are more prevalent in firms owned by high-income individuals

(a) Probability of Owning a Ghost Client, by Owner Total Income



(b) Value of Ghost Purchases Over Total Owner Income, by Owner Total Income



Policy to combat evasion: targeting clients firms rather than ghosts

- The Ecuadorian tax authority undertook an innovative approach to combat the use of ghost firms
  - Detected firms from whom others had filed large purchases, but who filed (almost) no sales
  - Tried to contact them via visit, phone and email
  - Listed those that could not be found as suspected ghost firms on the internet
  - Invited firms on the list to respond, if they were actually real firms
  - Remainder considered ghost firms

- Sent notifications to firms with large expenditures with receipts from ghost firms

Policy to combat evasion: targeting clients firms rather than ghosts

The SRI has identified transactions with firms that are regarded as inexistent for tax purposes or with ghost firms engaged in pretended economic activity [. . .].

You are required to justify the veracity of these economic activities and the expenses reported in your tax declaration in relation to the following transactions, or file an amendment within 10 working days:

Fiscal year	Tax ID of supplier	Amount
2010	102145	14,000
2011	154699	27,620

The policy had huge effects

- Adjusting client firms decreased reported costs by around $230,000 per firm
  - Increase in tax liability corresponds to 81% of the pre-treatment filing

- Summary of the policy intervention:
  - Targeting and prosecuting ghost firms or their owners is very challenging
    - The firms do not really exist in brick and mortar, and new ones can be created quickly → game of whack-a-mole
  - Policy that retroactively targets ghost *clients* can be highly successful

The Race Between Tax Enforcement and Tax Planning

Joint paper with Sebastián Bustos, Juan Carlos Suárez Serrato, José Vila-Belda and Gabriel Zucman

International profit shifting by multinational firms

- Tax avoidance by multinational firms: a growing concern for governments around the world
  - Multinationals shift profits to subsidiaries in lower-tax jurisdictions
  - E.g., revenue of Google in Bermuda: 75 billion USD in 2019

- OECD has promoted policy reforms to combat profit shifting
  - Thus far difficult to study their impact

Evaluating anti-profit shifting regulation

- This paper provides a comprehensive evaluation of a large reform in Chile that implemented the OECD profit shifting regulations in 2011
    - More information reporting about transactions with affiliates
    - Firms have to explicitly justify prices and payments ("*transfer pricing*")
    - More monitoring by the tax authority

- Measuring impacts on
    - Each channel of profit shifting
    - Tax payments
    - Tax advisory industry

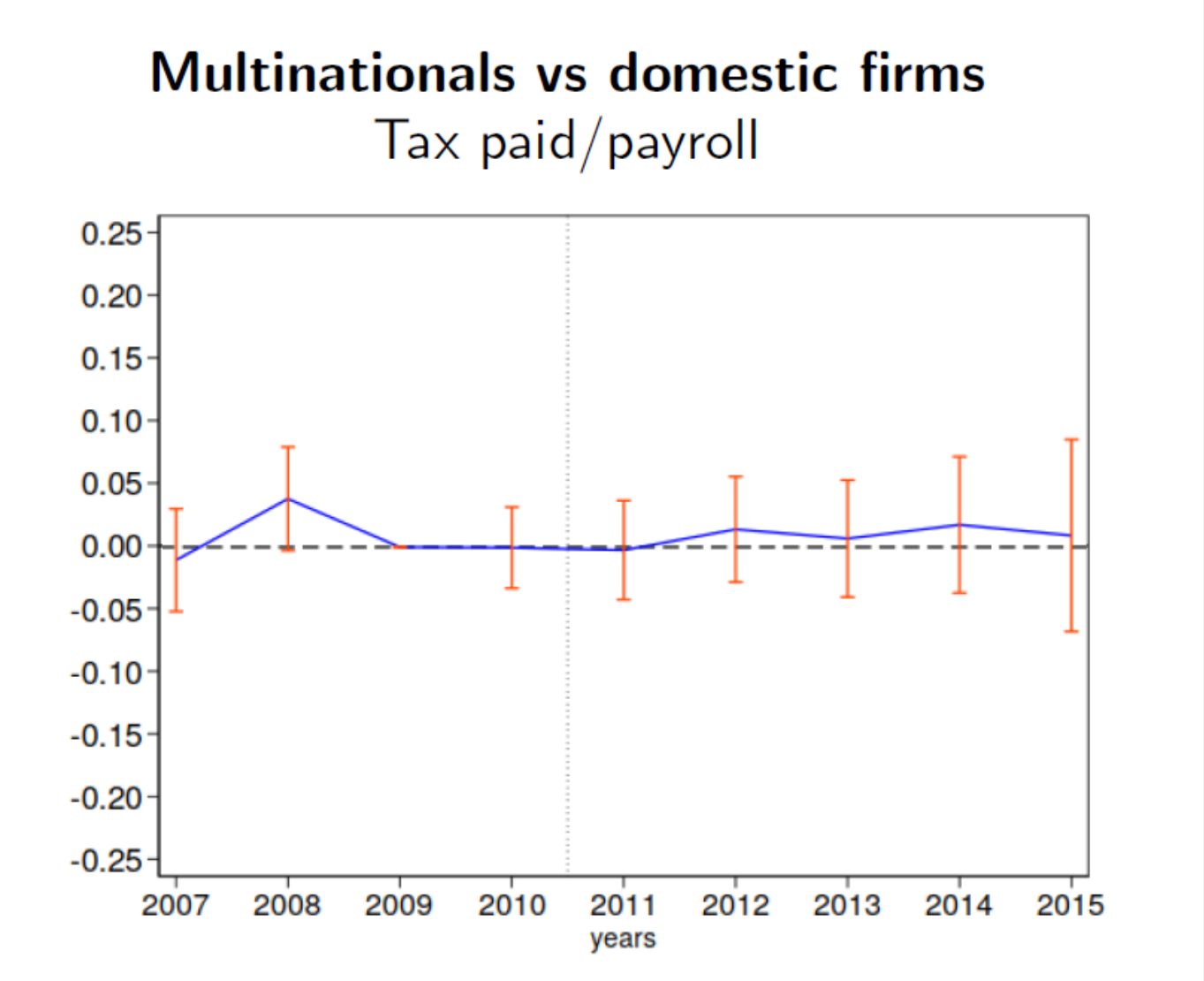
- Combining
    - Administrative data from tax filings and customs
    - In-depth qualitative interviews

No impact on profit shifting

- Payments of Chilean multinationals to their foreign affiliates follow the tax advantage
  - When tax rates in a country fall, payments to affiliates in that country grow
  - No such association for payments to non affiliates

- This responsiveness to foreign-country tax rates is not reduced after the reform, on any of the channels of profit shifting
  - Payments for royalties
  - Services
  - Interests
  - Goods prices

Therefore: no increase in tax payments



→ Big disappointment compared to expectations

Did nothing happen?

- No, something did change: boom in the tax advisory industry

How did the number of transfer-pricing tax consultants change following the reform?

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Extensive in-depth qualitative interviews

- With tax experts both in tax consulting firms, and in-house in the multinationals
  - Asked about experiences during the time of the reform

- Consistent information about the process emerged from the conversations

  1) The reform created new demand for tax consultants: complexity of the new reporting requirements drove many multinationals to seek compliance support from specialized consulting services

> *"The big majority of multinationals contracted the consultants for the new transfer-pricing tax annex. Some did it in-house in the beginning, but it was done poorly, and they received complaint notices from the tax authority. Following this, these firms also started relying on consultants."*

Impacts on the tax consulting industry

2) Consultants had strong incentive to up-sell clients on additional tax planning services

Doing so was easier once costs of organizing the books for compliance had been paid

> *"In the first years, companies were only focused on compliance. We told them every year about tax planning services. For example 'You are losing a lot of money in this transaction.' And sooner or later, they started to make changes to their transfer prices. Consulting firms see tax planning as a growth opportunity, so they focus on selling tax planning."*

3) The advisory industry was able to respond quickly to this demand by reallocating international experts to Chile. This was possible because the regulation is global

> *"The transfer pricing partners (of the Big Four) were all foreigners. Still many of the partners are today. The advantage for transfer pricing specialists is that the rules are international, so people can move around."*

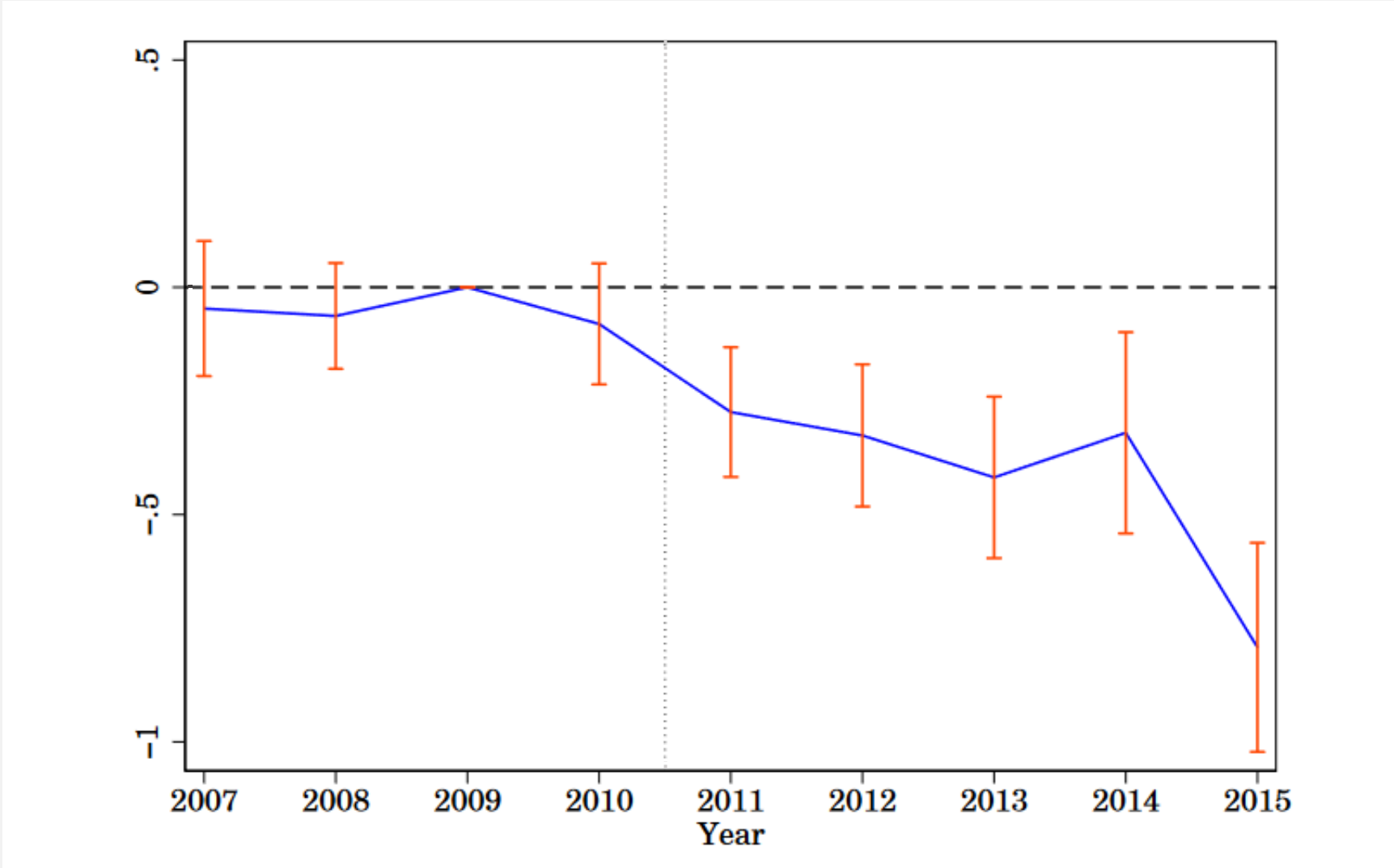
Tax planning strategies

4) A common tax planning advice was to centralize cost centers in fewer locations

- Optimized both from a tax-reduction and business costs perspective
- E.g. marketing, distribution, HR, and other in-house services

→ We can test this pattern in the quantitative data

Reduction of cost centers: number of countries to which multinationals make intra-group payments



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Impacts on the tax consulting industry

5) Tax administrators are outmatched by consulting firms both in the number of transfer pricing specialists and their salaries

- Hard for government to retain qualified experts
- Revolving door of transfer pricing experts between government and consulting

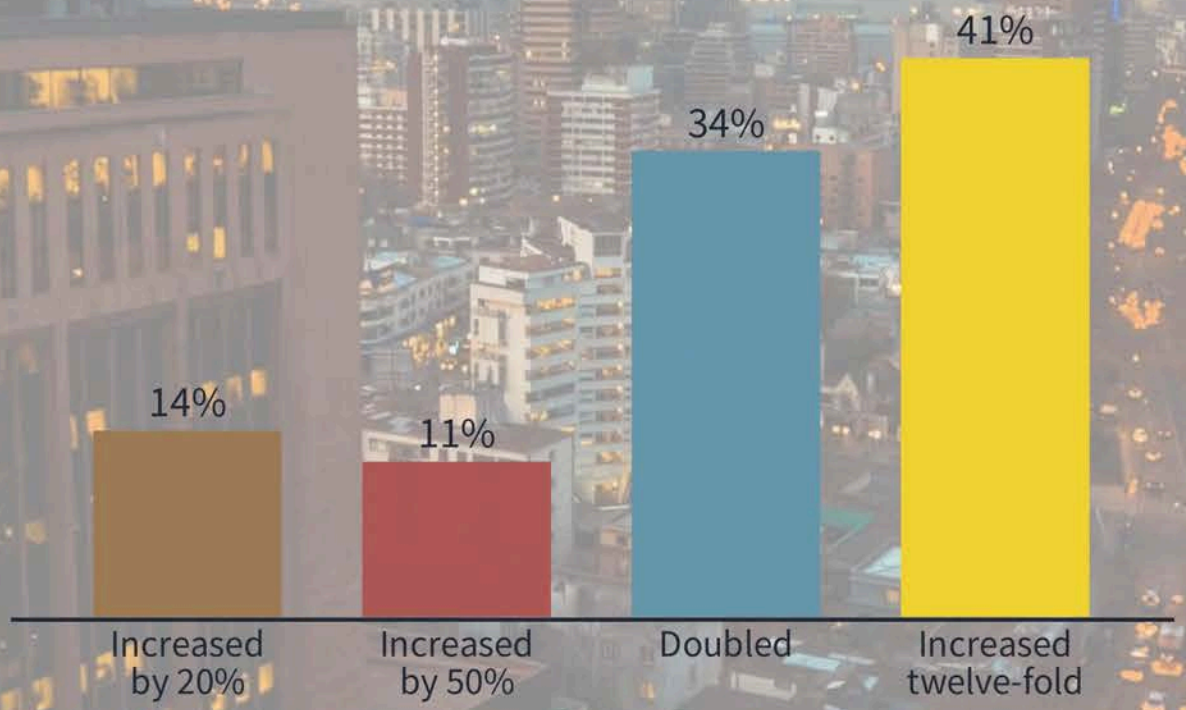
> *"The guy who wrote the regulation for Chilean transfer-pricing reform was subsequently hired for a very high salary by a Big Four."*

→ Is the solution to hire more staff and/or pay them more?

- Or will this just fuel the arms race?
- Consulting firms see additional enforcement by government as business opportunity

> *"The Big Four of course benefit when the tax authority audits. The more audits, the better it is for the Big Four."*
>
> Big 4 consultant

How did the number of transfer-pricing tax consultants change following the reform?



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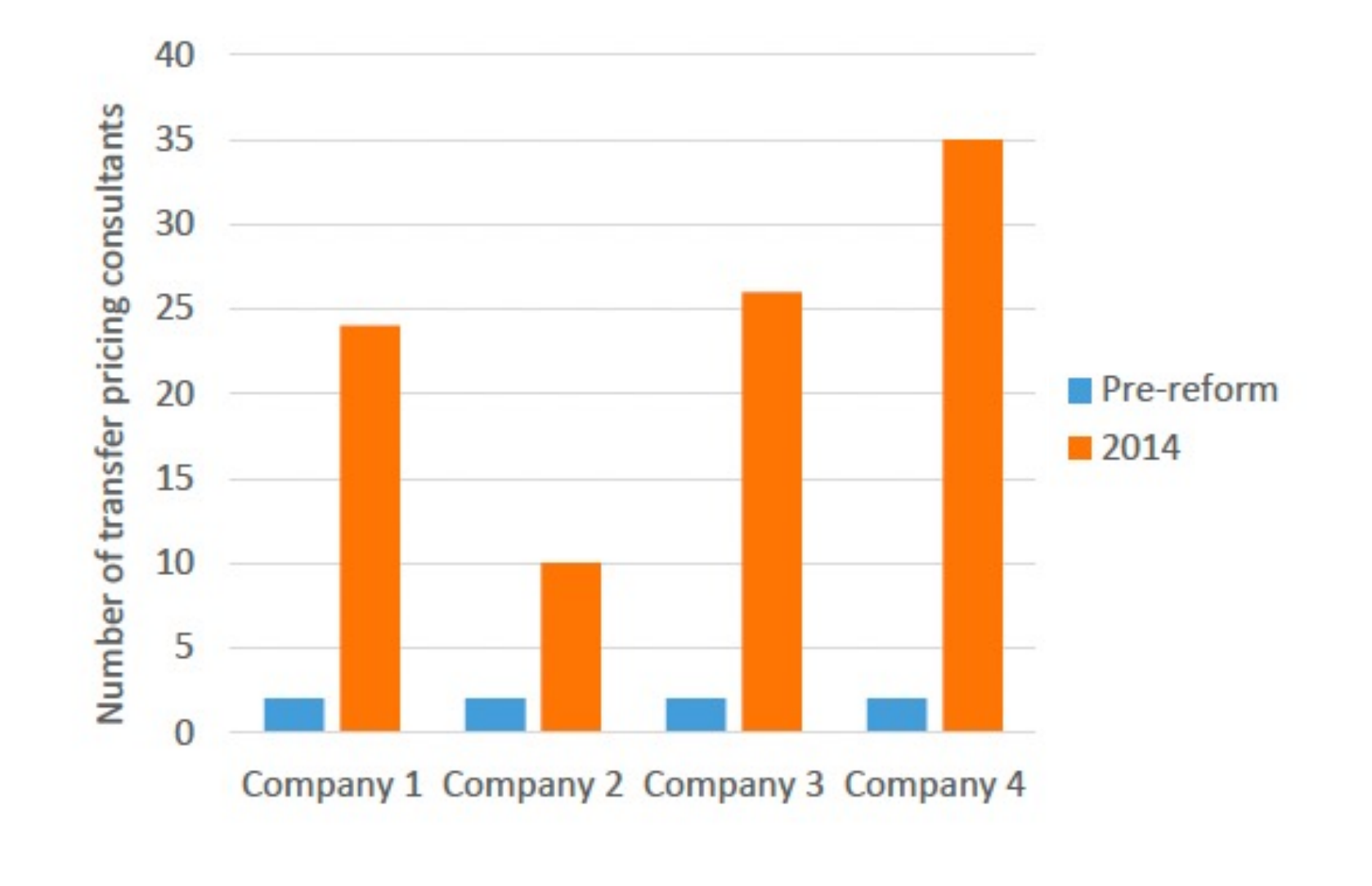
Twelve-fold increase transfer pricing consultants in top four consulting companies in Chile: from 8 to 95



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Summary

- Chile implemented OECD-based reform of tax enforcement on multinational firms
- Reform did not reduce propensity to shift profits to low-tax countries
- No significant increase in tax collection
- Large benefits for tax advisory services

→ In the race between tax enforcement and tax planning: it appears that tax planning won

Thank you!

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Watch replay on YouTube