

JUSTICE DEMANDS VALIANT INTERNATIONAL TAXATION REFORM

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ABSTRACT

In The Economy of Francesco, Pope Francis calls for just economic relations. On many previous occasions, the Holy See has also spoken against tax evasion. This article supports this call and provides background information on the high level of tax evasion that benefits from profit shifting, tax havens and other weaknesses in the current international taxation architecture. Based on the work and proposals of the Holy See, as well as international financial organizations such as the Organization for Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF), the article reviews some of the problems and current solutions being analysed by international policymakers and the governments of leading nations. It also advocates for valiant leadership that levies taxes at the national level on flows related to phantom FDI and on digital transactions, as these effectively reduce evasion and catalyse international cooperation.

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1. INTRODUCTION: THE CALL OF THE HOLY SEE

In his opening address at The Economy of Francesco, Pope Francis calls on the young to engage the future: “The future will thus prove an exciting time that summons us to acknowledge the urgency and the beauty of the challenges lying before us. A time that reminds us that we are not condemned to economic models whose immediate interest is limited to profit and promoting favourable public policies, unconcerned with their human, social and environmental cost” (Francis, 2020). He elaborates about the costs: “Favouring, when necessary, fiscal evasion, lack of respect for the rights of workers, and the possibility of corruption by some of the largest world businesses, not infrequently in collusion with the governing political sector”. In this reference, when the Supreme Pontiff refers to “fiscal evasion” he refers to tax evasion and avoidance. He has called innumerable times for more just economic relations

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and has spoken frequently about corporate behaviour that is detrimental to justice, including not fulfilling duties toward the public sector, sometimes even in connivence with public officials.

In 2018, the Congregation for the Doctrine of the Faith and the Dicastery for Promoting Integral Human Development issued “Considerations for an ethical discernment regarding some aspects of the present economic-financial system” (Ladaria and Turkson, 2018). In this document, the Holy See warns against operations that may be detrimental to the common good. Among them, it cites transactions made with the purpose of avoiding regulation, to circumvent anti-money laundering regulations, or to finance illegal activities. It states that “it is not possible to ignore the fact that those offshore sites, on more occasions, have become usual places of recycling dirty money, which is the fruit of illicit income (thefts, frauds, corruption, criminal associations, mafia, war booties [sic] etc.)” (*ibidem*). It also warns that the use of offshore jurisdictions to avoid regulators is also objectionable, and it points out that when these activities have the purpose of tax evasion and tax avoidance they are also unethical, censuring “persons that cut down their tax burden by moving the revenues from one site to another according to their convenience, transferring the profits into fiscal havens, and the costs into the countries of higher taxation” (*ibidem*). Moreover, it warns that the use of fiscal havens to avoid legitimate taxation is unethical: “Tax avoidance [...] is damaging for the civil society as a whole” (*ibidem*). Additionally, it is stated that the authorities have the right, and sometimes the duty, to control financial flows with special restrictions when it comes to tax havens or offshore financial institutions that do not comply with minimum regulations. It calls for courage on behalf of the authorities to tax the flows that pass through tax havens. Finally, it is stated that international cooperation in this regard is praiseworthy. It notes that “[...] it is worth mentioning that more often different international institutions have denounced these practices and many governments have rightly [sic] tried to limit the flow of the offshore financial bases. Many positive efforts have been undertaken in this regard, especially in the last decade. However, they could not successfully impose accords and norms adequately efficient until now. On the contrary, the normative frames proposed even by the international authoritative organizations in this regard have been often unapplied, or made ineffective, because of the notable influence that those bases are capable of exercising towards many political powers, thanks to the large amount of capital in their possession” (*ibidem*).

The condemnation is clear: “All this, while contributing grave damage to the good functionality of the actual economy, indicates a structure that, as it is formed today, seems to be totally unacceptable from the ethical point of view. Here it is necessary and urgent to prepare at the international level the suitable remedies to those unjust systems. Above all, practicing financial transparency at every level, (for example, the obligation of public accountability for the multinational companies of the respective activities and the taxes paid in each country in which they operate through their subsidiary groups) along with incisive sanctions, imposed on those countries that repeat the dishonest practices (tax evasion and avoidance, recycling of dirty

money) mentioned above” (*ibidem*). The call to action, in each country and through concerted action, is also clear.

2. PHANTOM FOREIGN DIRECT INVESTMENT

The International Monetary Fund has warned about the problems with foreign direct investment (FDI) and how it influences international finance and taxation. Phantom FDI allows tax evasion through several mechanisms: i) by recording income and property in low-tax jurisdictions; ii) by facilitating the creation of artificial interest expenditure that reduces profits; and iii) by postponing tax payments through the late repatriation of profits and the circumvention of cross-border taxes. A recent working paper finds that “phantom investment into corporate shells with no substance and no real links to the local economy may account for almost 40 percent of global FDI” (Damgaard, Elkjaer and Johannesen, 2019). The countries involved are many, but a few make significant contributions to the problem, as “most of the world’s phantom FDI is in a small group of well-known offshore centers: Luxembourg (\$3.8 trillion), the Netherlands (\$3.3 trillion), Hong Kong SAR (\$1.1 trillion), British Virgin Islands (\$0.8 trillion), Bermuda (\$0.8 trillion), Singapore (\$0.8 trillion) and the Cayman Islands (\$0.7 trillion)” (Damgaard, Elkjaer and Johannesen, 2019). These seven countries account for about 75% of the reported \$15 trillion in phantom FDI.

The sheer size of phantom FDI shows that the problem is large. Given that tax evasion may be the main motivation for this phantom FDI, the losses for tax authorities are deemed to be huge. Given that most of the problem involves only a few well-known countries, there is a solution through actions that already have a clear path: tax capital flows to and from phantom FDI in the jurisdictions where phantom FDI is large. The tax authorities need to tackle the problem, as the benefits are significant. Certainly, there are operational problems, but these can be overcome. For example, current reporting may be insufficient to distinguish phantom FDI from other FDI. The solution to this would be requiring more detailed reporting for FDI to those jurisdictions. Resources may be lacking for a more detailed supervision of these flows. One solution could be to mildly tax all flows with those jurisdictions, in order to identify the FDI that demands higher taxation. Given that tax evasion presents a cost to society, it is reasonable to place some of the cost on the transactions that are more likely to be detrimental. The political decision must be made, as the benefits are real.

3. CHALLENGES ARISING FROM THE DIGITAL ECONOMY

The International Monetary Fund has also warned of the risks to public finance stemming from the base erosion coming from digital technologies. “Digital platforms raise the risk of base erosion from informality and internationalization” (IMF, 2018). “The main risks are base erosion by shifting transactions and profits from established formal commerce to informal ones or abroad. Transactions done in the formal sector

of the economy can be shifted to other sectors with lower or fewer taxes or to the informal sector and paying no taxes at all” (*ibidem*). With this warning, the institution also proposed a way forward: “Proper legislation can, however, enable digital platforms to share valuable data, formalize informal transactions, and withhold taxes”. Digitalization then presents a challenge as profit shifting to low-tax jurisdictions and away from where the economic activity is based is the natural development to be expected and what actually happened as the digital economy grew. At the same time, digital platforms consolidate information and payment processing in ways that frequently reach sectors that were previously informal and outside the reach of tax authorities. Then the risk can be turned into an opportunity, as legislation can be enacted to demand payment of sales taxes that can be very comprehensive in their reach and very effective in their collection. Digital Services Taxes (DST) have the ability to turn around a losing situation. Countries and their national tax authorities have the possibility of implementing them successfully, and they should not hesitate in doing so.

4. INTERNATIONAL COOPERATION TO REDUCE TAX EVASION

For several years, the Organization for Economic Development (OECD) has been leading an initiative to reduce tax evasion through international financial and commercial flows. In a joint effort with the G-20, 141 countries have now joined the Inclusive Framework (IF) on Base Erosion and Profit Shifting (BEPS). These countries are implementing 15 actions aiming to equip governments with domestic and international rules and instruments to address tax avoidance, ensuring that profits are taxed where economic activities generating the profits are performed and where value is created.

In October 2021, the IF agreed on a two-pillar solution to address the challenges arising from the digital economy (OECD, 2021). The Two-Pillar Solution aims to ensure that multinational enterprises (MNEs) are subject to a minimum tax rate of 15% and to re-allocate profit from the largest and most profitable MNEs among countries. The international cooperation and the objectives are certainly praiseworthy.

Pillar One aims to ensure a fairer distribution of profits and taxing rights among countries with respect to the largest MNEs, which are the winners of globalization. However, the agreement to re-allocate profit under Pillar One includes the removal and standstill of Digital Services Taxes (DSTs) and other relevant, similar measures. This removal is an unfortunate provision. The DST provides a useful correction to the profit shifting that was at the centre of the problems with the digital economy.

Pillar Two puts a floor on tax competition through the introduction of a global minimum corporate tax of 15%, which countries can use to protect their tax bases. This floor is a very important agreement, as much of the profit shifting is motivated by the desire of companies to allocate profits to low-tax jurisdictions. Again, the initiative is praiseworthy and the international cooperation should prove to be of great value.

This agreement is only making things partially better, however, and does not resolve many of the issues. All tax evasion related to phantom FDI seems to be unaffected by this initiative. There is a way to solve this, however, and it is similar to how the DST proved effective and a catalyst to Pillar One. The solution is to tax capital flows to and from phantom FDI in tax havens, and most notably, the seven jurisdictions that account for 75% of phantom FDI. A tax on those flows would certainly prove to be a game changer that could restore justice. Courage is needed.

5. CONCLUSION

Pope Francis asked the people participating in *The Economy of Francesco* to work for just economic relations. This is a repeated exhortation from many pontiffs and lies at the centre of Catholic Social Doctrine. In many other instances, the Church has also spoken against tax evasion. This article discusses problems with tax evasion related to the abuse of transfer pricing, FDI and digital platforms, which present a great challenge for national authorities and are used at odds with justice by those evading their fiscal responsibilities. Phantom foreign direct investment (FDI), which serves to hide tax liabilities and relies on open capital accounts, enables many practices that are intrinsically wrong. The sheer size of FDI passing through shell companies is a clear manifestation of the size of the problem and the losses to tax authorities. The Inclusive Framework of Base Erosion and Profit Shifting Project of the OECD and the G-20 is a praiseworthy initiative to reduce tax competition but may be detrimental as it opposes Digital Services Taxes. These digital taxes are the solution to the problem of insufficient taxation of the digital economy. Unilateral national tax measures can quickly and effectively improve fairness in international taxation. At the root of all of the problems described here is the lack of courage of national authorities to tax more assertively, aggravated by a failure of policy coordination at the international level. However, this failure may be easier to solve than previously thought – with the right leadership and, especially, with a handful of valiant national leaders that are ready to implement the necessary corrective actions in their own jurisdictions, which would at the same time bring crucial revenue to national treasuries and impose losses on the international players that are gaming the international tax system. Catholic social doctrine calls to action national political leaders, and market participants more generally, to recognize the problem, give it priority in policy discussions and take individual action whenever possible, in order to foster a more just international taxation.

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