Capital *Flight Risk*

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Natural-resource-rich countries risk capital flight as multinational corporations seek to avoid taxes

THE Democratic Republic of the Congo, widely considered among the world's richest countries in terms of mineral deposits, also regularly sits high on various lists of the world's poorest countries. Each year, it loses billions of dollars in tax revenue as wealthy individuals and multinational corporations take advantage of weak tax legislation and enforcement to funnel profits abroad, including to foreign financial centers. A similar situation plays out repeatedly in many countries in Africa and other parts of the world.

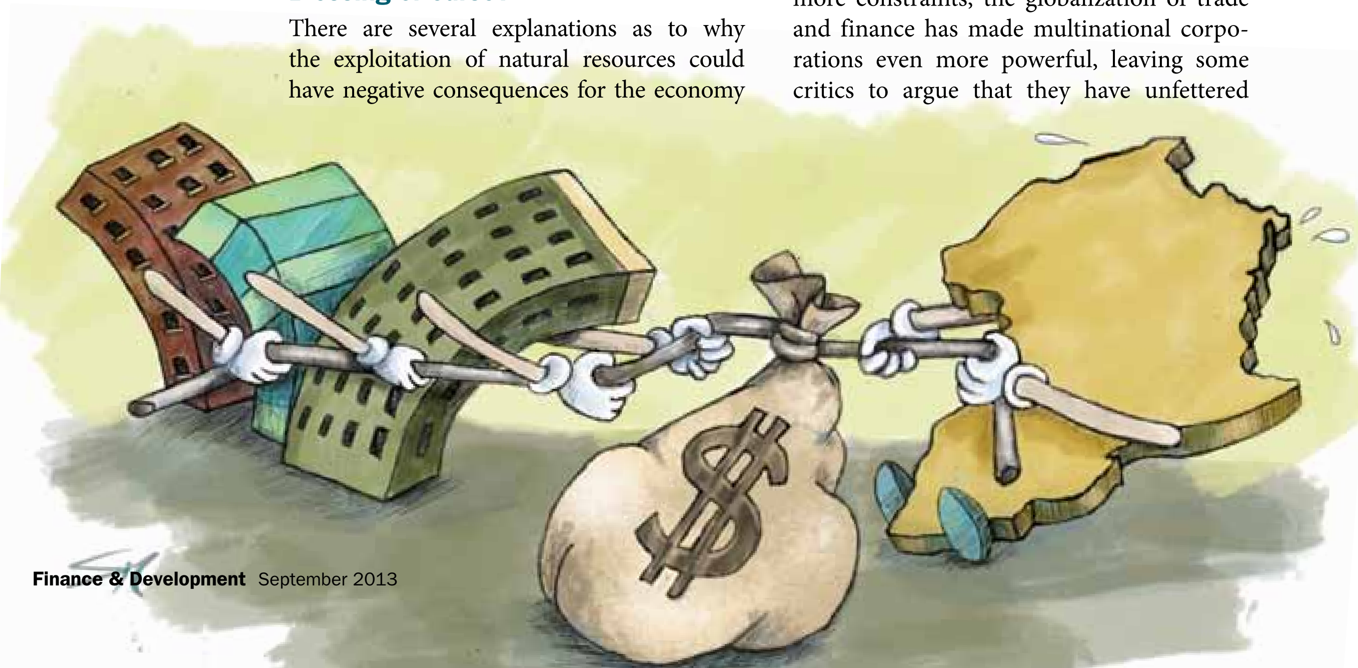
Natural resources are indeed a window of opportunity for economic development. In principle, revenues derived from their exploitation can help alleviate the binding constraints that governments in developing countries often face when attempting to transform their economies, boost growth, and create jobs. The experiences of resource-rich countries (especially those rich in hydrocarbon and minerals), however, suggest that resource wealth is not always a blessing. It can, in fact, be a curse. Over the past few decades, economic growth in resource-rich countries has, on average, been lower than in resource-poor ones (Frankel, 2012).

Blessing or curse?

There are several explanations as to why the exploitation of natural resources could have negative consequences for the economy (Frankel, 2012). One is the corruption of political and public administration elites. Because revenues derived from natural resources in many cases flow directly through the government's coffers, these elites may be able to take advantage of weak checks and balances to misappropriate those riches for themselves and channel them abroad.

Capital flight, here defined broadly as money or securities flowing out of a country, can take several forms. One form of capital flight for good reason has received a lot of attention in both academic and policy circles: illicit financial outflows. Global Financial Integrity, a research and advocacy organization working to curtail such flows, estimates that those from developing countries amounted to $5.9 trillion from 2001 to 2010. In comparison, major donors disbursed $677 billion in net official development assistance over the same period. Over the past decade, the democratization process in developing countries and the subsequent increase in transparency and accountability suggest that illicit financial outflows may be on the decline.

But while governments may be seeing more constraints, the globalization of trade and finance has made multinational corporations even more powerful, leaving some critics to argue that they have unfettered



access to capital, labor, and natural resources at the expense of the citizenry. In contrast to illicit financial flows instigated by political elites, the form of capital flight brought on by multinational corporations that manipulate prices and take advantage of loopholes in tax codes has received less attention. However, the latter may have far-reaching consequences for developing countries—especially the resource-rich ones whose wealth is concentrated in one sector.

In response to mounting criticisms, the Group of Twenty advanced and emerging economies (G20) has placed tax avoidance and profit shifting in general at the top of its agenda. In July 2013, the group adopted an action plan to rein in tax avoidance by multinational corporations, drawing from recommendations in a report by the Organisation for Economic Co-operation and Development (OECD, 2013). The IMF is now engaged in a major effort to monitor the macroeconomic implications of cross-country spillovers from national tax design and practices (IMF, 2013).

Movers and shifters

Because multinational corporations operate in different countries and sometimes on different continents, they can readily pick and choose from varying regulations and tax laws across countries to avoid paying taxes both in the countries where they extract the wealth and where their headquarters are located. Specifically, some multinational corporations practice what is known as "transfer pricing" or "profit shifting," which involves attributing a corporation's net profit or loss before tax to opaque jurisdictions where taxes are low—so-called tax havens. Tax havens serve as domiciles for more than 2 million companies and thousands of banks. Some analysts estimate the wealth in those tax havens to be on the order of $20 trillion (*The Economist*, 2013)—yet it is hard to know with certainty given the secrecy prevailing in tax havens.

Multinational corporations can shift profits in a variety of ways. One of the most widely used methods is through "thin capitalization," when a company chooses to be more indebted than similar independent entities. Indeed, companies are typically financed (or capitalized) through a mixture of borrowing (debt) and stock issuance (equity). The way a company structures its capital will often significantly lower the amount of profit it reports for tax purposes, because tax rules typically allow a deduction for interest paid, but not for remuneration of equity (dividends). This debt bias is exacerbated for multinational corporations, which are able to structure their financing arrangements in such a way that their affiliates in high-tax countries pay deductible interest to their affiliates in low-tax countries, or tax havens, thereby minimizing their global tax burden.

What's at stake?

The resource sector is the main game in town in many developing countries. Governments should thus try to collect as much revenue as they possibly can from the hefty profits generated in this sector while remaining attractive to investment (see "Extracting Resource Revenue," in this issue). But striking the right balance to generate the most economic gains is often fraught with peril not least because the exploitation of natural resources, particularly minerals, oil, and gas, requires much technical expertise, which multinational corporations are not keen on sharing.

Tax avoidance, including through profit shifting by multinational corporations, is a serious problem for many developing countries, especially those rich in natural resources. For example, the Zambian government estimates that it loses $2 billion a year—15 percent of GDP—to tax avoidance by corporations operating copper mines within the country. Profit shifting erodes the tax base in the countries in which multinational corporations operate but also in the countries where they are headquartered.

An important aspect of profit shifting is the loss of positive spillovers that natural resource exploitation can bring to a country, including through the development of the domestic financial system. Preventing capital flight that stems from multinational corporations operating in the resource sector would help the development of a domestic financial system, particularly an equity market with its attendant benefits in risk sharing and liquidity provision. This in turn would aid in the financing and development of the nonresource sector to diversify their economies and avoid economic growth supported only by nonrenewable natural resources.

The historical development of South Africa's stock market illustrates the potential benefits from discoveries of natural resources. In 1886, the discovery of gold was rapidly followed by the establishment of the Johannesburg Stock Exchange. The stock exchange helped raise money for the then-booming mining and financial industry. Today, the Johannesburg Stock Exchange has a capitalization of more than $800 billion and 411 listed companies, including an overwhelming majority in the nonresource sector.

Policy response

It is legitimate for developing countries endowed with natural resources to require affiliates of multinational corporations involved in the exploitation of their resources to pay a fair amount of tax and to avoid manipulating their capital structure for tax purposes. To prevent such practices, several countries have put in place a so-called thin capitalization rule, which essentially specifies a "safe haven" debt-to-equity ratio that limits the amount of deductible interest for tax purposes. It is designed to counter cross-border shifting of profit through excessive debt and thus aims to protect a country's tax base. The rule was first introduced in 1972 in Canada and is now in place in about 60 countries. It is often implemented in countries with large resource sectors in which multinational corporations operate and was most recently introduced in resource-rich developing countries in Africa, including Sierra Leone, Uganda, and Zambia.

But trade-offs exist. Although the rule is designed to prevent excessive tax avoidance, the potential negative impact on foreign direct investment is the price countries may have

to pay to avoid the erosion of their tax base and help their domestic financial system to develop. The implementation of the rule affects the financing of company operations by increasing their cost, because it limits the tax benefit resulting from deducting the interest paid on borrowed funds. In addition, in the absence of a well-functioning domestic financial

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system, the company's domestic cost of equity capital would be higher. In that regard, the thin capitalization rule may, to some extent, deter foreign direct investment. However, these multinational corporations are likely to generate large internally generated funds from domestic profits, and they can channel them to investments at a lower cost of capital rather than shifting profits to foreign affiliates.

A thin line

Establishing whether the thin capitalization rule promotes more equity finance in the resource sector can also help determine if it improves the prices of countries' natural resource assets (and therefore helps with the development of a domestic stock market). Of equal interest is whether the sensitivity of host countries' external debt to the resource tax rate is altered by the presence of such a rule. To get some answers, we conducted an event analysis using cross-country variation in the timing and size of large oil, gas, and mineral discoveries for more than a hundred countries during 1970–2012. Our empirical framework controls for time-invariant factors, including the quality of institutions, that can play an important role in the development (or the lack thereof) of a stock market.

Results suggest that following a resource discovery, stock market capitalization decreases. This result is consistent with the work of Beck (2011), who found evidence that resource-rich countries tend to have less developed financial systems. However, our findings show that the presence of a thin capitalization rule allows countries to reverse the negative effect on capitalization of the resource discoveries. That effect is large in terms of its impact on the economy. Our results hold for mineral, oil, and gas discoveries, although the timing varies by the type of discovery. Following a large discovery, stock market capitalization increases by up to 20 percent of GDP in the presence of a thin capitalization rule, and the sensitivity of countries' external debt to the resource sector tax rate decreases. This occurs because the tax subsidy provided to corporations paying interest on their foreign debt is lower in the presence of the rule.

Changes afoot

The thin capitalization rule is a unilateral response to one of the main practices in aggressive tax optimization behavior by multinational corporations and looks to be the most viable option right now. It not only protects the tax base of resource-rich countries, but also helps link the financial development of these countries with the exploitation of their resources.

Yet other alternatives have been floated. Based on the U.S. experience, Nobel laureate Joseph Stiglitz recently proposed taxing the global profits of multinational groups and redistributing a proportion of those tax receipts to the country in which the value is created. This would be analogous to converging to a source-based tax system, which many multinational corporations are vehemently lobbying against. While Stiglitz's proposal is conceptually appealing, it might be impractical given the limited level of disclosure now required of such corporations, not to mention the difficulty in coordinating all the actors involved, including tax havens.

Several recent initiatives have contributed to the increase in the level of disclosure of multinational corporations operating in the resource sector. More disclosure is certainly an important step in the right direction. It will help make multinational groups more accountable to tax authorities in the countries where they operate and to the broader public. However, increasing transparency is only a first step toward tax base protection and does not deter tax avoidance through such tax optimization methods as thin capitalization.

Overall, the concern over massive capital flight from developing economies, particularly those rich in resources, should go well beyond illicit financial flows and consider the seemingly legitimate behavior of corporations and their growing ability to shift profits and minimize the tax base. Thus, effective mechanisms, such as a thin capitalization rule, should be in place to deter massive outflows stemming from tax avoidance schemes. ■

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