UNITED NATIONS

E

ECONOMIC AND SOCIAL COUNCIL

Distr.
LIMITED
E/ESCWA/C.9/2021/5
10 September 2021
ORIGINAL: ENGLISH

Economic and Social Commission for Western Asia (ESCWA)

Committee on Financing for Development in the States Members of the Economic and Social Commission for Western Asia
Second Session
Cairo, 8-9 December 2021

Item 6 of the provisional agenda

Arab tax systems: tax revenue leakages and tax challenges arising from the digital economy

Summary

Over the past decade, Arab States have introduced several tax reforms. Most of these reforms are a step in the right direction but have not done enough in terms of raising tax revenues or improving equity and progressivity. Tax systems remain in a quagmire unable to break loose from their high dependence on indirect taxation or to forge radical income tax reforms to ensure compliance of high net worth individuals, professional service providers and multinational corporations. This document provides a synopsis of the in-depth assessments undertaken by the Economic and Social Commission for Western Asia (ESCWA) on Arab tax systems, which will be the focus of a flagship publication to be released by the end of 2021.

Based on this assessment, this document argues that any credible tax prescriptions to improve the fairness, efficiency, transparency and effectiveness of tax systems – under increased conditions of digitization and international mobility of capital – requires a thorough review and consideration of tax regulations, tax incentives, tax expenditures, tax deductibles, tax leakages and tax abuses, including tax evasion and avoidance. Policymakers may consider that in reality, national tax reforms are not national, and that the Arab region no longer has the luxury of designing and enforcing its tax systems in isolation, or setting its tax incentives unsynchronized, especially as a plethora of tax abuses permeate tax systems and bring about harmful tax competition, tax arbitrage and a plethora of other tax ails. The document seeks to provide the first regional assessment of the implications for the Arab region of the global tax reforms proposed by the Group of 20 (G20) and the Organisation for Economic Co-operation and Development (OECD) and the considerations that Member States ought to have in addressing the tax challenges arising from digitization as the new world tax order is put in place and begins rolling out in 2023.

Contents

Introduction

1. Taxation is a key component of fiscal policy (given its redistributive role and its effect on production and consumption patterns) and domestic resource mobilization (for its revenue creation potential and their effective use). Both policy strands, in turn, influence the design of medium-term revenue and expenditure strategies and act as functional components of integrated national financing frameworks (INFFs). INFFs serve as effective planning tools that enhance the delivery of public goods and finance the Sustainable Development Goals (SDGs). They do so by strengthening public financial management and by furnishing financing strategies to meet national sustainable development priorities and support the transition to SDG-centric budgeting and tagging.

2. Taxation is therefore a prime consideration that permeates across different policymaking domains and several development financing configurations. The design of tax policies and their enforcement, however, no longer follows the linear demarcations that once separated international and national policymaking. At the same time, under conditions of increasing digitization and capital mobility, a country's taxing rights and its potential tax base are no longer defined by traditional geographical boundaries. The same holds true in the context of clamping down on tax evasion and avoidance, addressing tax competition and defining the new taxing rights that ought to be applied over digital services when providers no longer maintain a physical presence in the tax jurisdictions where consumptions take place.

3. For these reasons, ESCWA undertook an extensive analysis of the state of taxation and tax reforms in the past decade from 2010 to 2020 in the Arab region. This analysis will be the focus of a forthcoming flagship publication to be released in 2021; it offers the needed regional and national anchors to support the implementation of the menu of options and related tax considerations advanced, at the global level, through the Financing for Development in the Era of COVID-19 and Beyond Initiative.

4. The first section of this report provides a synopsis of the tax analysis undertaken by ESCWA to optimize the revenue-generating role of taxation in the Arab region. An assessment of the scale of tax leakages is then provided to highlight the tax abuses that continue to undermine tax certainty and the integrity of Arab tax systems. The third section of the document highlights some of the salient tax challenges arising from digitization, including the possible implications of the G20/OECD proposed tax reforms on the Arab region. Finally, the document sheds light on the salient tax policy interventions needed in the region considering recent tax developments and the new world tax order in the making.

I. The state of taxation in the Arab region

5. Current levels of public revenues in the Arab region neither match the scale of SDG investment requirements nor their long-term sustainability horizons. Revenues as a share of GDP have witnessed an overall decline compared to 2008, and this trend has been amplified by COVID-19.

6. Tax systems in middle-income Arab economies, which rely on taxation as a main source of public revenue, are slanted towards indirect taxes, albeit their buoyancy remains, with few exceptions, frail as GDP growth does not trigger a proportional increase in revenues. The efficiency of indirect taxes such as VAT remained lower than benchmarks and has been declining for most countries over the last decade, even in countries that increased VAT rates.

7. Indirect taxes continue to be favoured for their ease of enforcement and ability to quickly generate revenues, but come at a cost of placing more of the tax burden on the poor and the middle class. This is evident in settings with narrow tax nets and high informal activity where more productive capacities, particularly high net worth individuals, and professional services are slipping further into informality.

8. In contrast, and despite the several personal income tax reforms, their share of tax revenues is not improving in most Arab countries. Immovable property and income derived from it remain largely untaxed,

although such taxes are useful tools to correct imbalances and generate direct revenues. The high variations between personal and corporate income taxes coupled with the asymmetric treatment of capital gains, dividend income and interest tax deductibles create a utility bias driving tax arbitrage.

9. The high reliance on regressive taxes on goods and services, the large number of exemptions and low efficiency of value-added taxes and the high incidence of taxes on the middle class indicate that fairness and progressivity in taxation remain major challenges for several countries.

II. The scale of tax revenue leakages in the Arab region

10. Tax abuses, be they in the form of illegal tax evasion or unethical tax avoidance, permeate all types of taxes (direct and indirect), tax structures (progressive or regressive), tax brackets (low and high) and tax jurisdictions (developed and developing). Tax abuses by individuals (nationals or non-residents) and firms (public or state-owned, private, domestic and multinational) impair the efficiency and fairness of tax systems. These abuses operate by complex schemes, use various conduits (legal and illicit) and undermine public resource mobilization efforts, fiscal space, the quality of governance and the rule of law.

11. Different tax systems/instruments are prone to distinct forms of tax abuse. Indirect taxes such as trade taxes can quickly generate revenues, but may provoke counterfeit and carousel trade and effectively undercut the potential revenues accrued from these taxes. Tariffs or other fiscal charges with equivalent effects on trade may provoke tax fraud and trade misinvoicing. Excise taxes and other border taxes may score high on equity, but not when they are set higher than adjacent jurisdictions, as this creates incentives for smuggling and contraband. Tax exemptions on broad-based consumption taxes can provoke tax non-compliance, raise the cost of enforcement and increase incentives for tax evasion. Highly progressive direct income taxes may score high on equity but are not necessarily efficient, as the high marginal tax rate may prompt top earners to shield or shift their wealth to avoid the tax liability.

12. Experience shows that even the most admirable tax structures on paper are of little value if inefficiently administered or if enforcement is undermined by significant tax leakages. Governments lose significant revenues to tax avoidance, arbitrage and illegal tax evasion, and by no means is the Arab region an exception. The figures speak for themselves: between $8.7 and $36 trillion of private wealth is hidden in tax havens;[1] 10 per cent of the world's GDP is held in untaxed offshore assets; $1.3 trillion in annual corporate profits are shifted from countries where economic activity takes place to a small number of tax havens[2] causing $500 to $600 billion in corporate tax revenue losses[3] of which low-income countries account for $200[4] to $240 billion per year in fiscal revenues[5] or *nearly a quarter of the estimated annual SDG financing gap in developing countries*,[6] and $8.8 trillion lost to trade misinvoicing of which the Arab region accounts for an annual $77.5 billion.[7]

---

[1] Damgaard, Elkajaer, and Johannesen (2018). Piercing the veil. *Finance and Development*, vol. 55, No. 2 (June). Available at https://www.imf.org/external/pubs/ft/fandd/2018/06/inside-the-world-of-global-tax-havens-and-offshore-banking/damgaard.htm.

[2] Alecci, S. (2021). Tax Havens. *International Consortium of Investigative Journalists* (April). Available at https://www.icij.org/investigations/paradise-papers/multinationals-shifted-1-trillion-offshore-stripping-countries-of-billions-in-tax-revenues-study-says/?utm_campaign=Sprout&utm_content=Panama+Papers,PP+Case&utm_medium=social&utm_source=twitter.

[3] FACTI panel report. Available at https://www.factipanel.org/.

[4] Shaxson, N. (2019). Tackling tax havens. *Finance & Development*, vol. 56, No. 6 (September). Available at https://www.imf.org/external/pubs/ft/fandd/2019/09/tackling-global-tax-havens-shaxon.htm.

[5] OECD. (n.d). Combating international tax avoidance. Retrieved on April 13, 2021. Available at https://www.oecd.org/about/impact/combatinginternationaltaxavoidance.htm.

[6] Doumbia, D., & Lauridsen, M. L. (2019). Closing the SDG Financing Gap.

[7] UN DESA (2019). *Financing Sustainable Development Report.* Figure: *Non-oil trade misinvoicing, Arab Region, 2008-2015*. Available at https://developmentfinance.un.org/chart/1764.

13. In its first regional assessment of tax leakages in the Arab region, ESCWA found that 4 Arab countries account for half of the $7.5 billion annual tax revenue losses associated with corporate tax abuse. These revenue losses can amount to 30 per cent of corporate tax revenues for some middle-income Arab countries. The tax abuse estimates rendered for the Arab region resonate with the tax losses reported by the Organisation for Economic Co-operation and Development (OECD) through country-by-country reporting. These findings are also broadly indicative when analysed in conjunction with several media investigative reports on corporate tax evasion. Under these conditions, tax authorities are neither able to estimate their tax nets with a high degree of confidence nor able to secure a steady stream of public revenues to implement the SDGs, let alone establish and appreciate the effects or outcomes of a given tax reform. Indeed, traditional tax analyses often fail to give enough consideration to the pressures stemming from insufficient, imperfect and distorted tax information, although the quality of tax information has a direct bearing on the effectiveness and progressivity of tax systems.

III. Tax challenges arising from the digital economy

14. The digitization of the global economy has allowed providers of digital services to profit from sales without necessarily having a physical presence in countries where consumption takes place. Under the contemporary tax treaties, many countries are therefore left with no taxing rights over the profits of digital platforms, as income from the sale of automated digital products is exclusively taxed by the tax jurisdiction in which an enterprise is resident or where it maintains its headquarters. The broader problem of profit mobility, however, is not limited to digital multinationals. The growing use of intra-group payments for both intellectual property and financing means that an increasing share of the global profits of all multinational corporations (MNCs) are moved out of the jurisdictions where the underlying economic activity takes place.

15. The G20/OECD Inclusive Framework on Base Erosion and Profit Shifting (BEPS) has advanced a two-pillar blueprint for global tax reform with potentially far-reaching implications for Arab economies. Under ‘pillar one’, the proposed blueprint seeks to assign new taxing rights to re-allocate a defined threshold of the residual profits of MNCs’ global profits based on a profit allocation rule rather than arm’s length pricing. Under this approach, MNCs would be taxed on a consolidated unitary basis under an agreed apportionment that allocates group profits for MNCs among countries based on real economic activity as measured by factors like sales, employment, resources and digital users. The apportionment of profits in such a manner makes the tax liability independent of a legal residence and identity of an MNC (subsidiary, affiliate, non-resident branch). The corporate revenue effects of formula apportionment on individual Arab countries remain sensitive to the following factors:

(a) The threshold used to determine the MNCs that would be subject to pillar one rules;

(b) The country nexus threshold applied to determine whether market jurisdictions will receive part of the apportionment of MNCs’ profits;

(c) The level of routine profits that would be reallocated and the weights given to the agreed formula apportionment (assets, sales and employment).

16. Under ‘pillar two’, a Global Anti-Base Erosion (GloBE) tax would be applied. Where pillar one is intended to make profit shifting harder, pillar two would make it less attractive by putting a floor under the rate that MNCs could achieve. If a company books its profits in a low or zero tax rate jurisdiction, the tax authority of the countries where the MNC operates would have the right to collect taxes up to the difference between the effective tax rates paid in the market country and the global minimum, removing the incentive to shift profits. The OECD argues that developing countries have much to gain from the introduction of the GloBE tax, but this assessment is somewhat skewed as the economic impact assessment undertaken by the OECD is based on corporate tax rates ranging from 7.5 to 17.5 per cent, which is below the rates applicable to extractive industries in the Arab region, to prevent downward pressure on statutory rates applied to hydrocarbons and extractive industries. The 2020 Financing for Development Report therefore questions the wisdom of agreeing to new rules without full and accurate national and regional economic impact assessments.

17. An alternative proposal, advanced by the Tax Justice Network and supported by the Independent Commission for the Reform of International Corporate Taxation (ICRICT), suggests the application of a uniform minimum effective tax rate (METR). The METR establishes that headquarters and host countries should be treated equally in the redistribution of undertaxed profits for each MNC, which would instead be apportioned between all countries in which a MNC operates, according to the share of its economic activity in each country. For the Arab region, the METR proposal could generate annual revenue gains ranging from $2 billion to over $8 billion per year, when the METR is evaluated at minimum rates of 15, 20 and 25 per cent.[8]

18. The United Nations Committee of Experts on International Cooperation in Tax Matters on its part adopted a new article (article 12B) to the United Nations Model Tax Convention that grants source/market countries greater taxing rights on income from certain digital services paid to a resident of one or several other contracting States on a gross basis at the rate negotiated bilaterally. This new article would require foreign providers of automated digital services to pay income tax at source employing either (a) a withholding on gross income (with the rate to be agreed upon by the parties to the treaty) or (b) a withholding on net income pursuant to an apportionment formula.

19. In applying this new article, countries should account for several factors, including:

(a) The possibility that a high withholding tax may provoke service providers to pass the cost to customers;

(b) A tax rate higher than the incentives granted to non-resident service providers or above the foreign tax credit limit in the residence country might deter trade in the source country;

(c) The scope of digital services does not include customized professional services, online teaching, broadcasting services and online sale of goods and services other than automated digital services;

(d) A withholding tax on business-to-customer services (B2C) would be difficult to enforce and would raise compliance issues as individuals dodge the tax liability from the use of automated digital services supplied remotely by non-resident entities.

IV. Tax base protection and compliance in the Arab region

20. Combatting tax evasion, avoidance, tax competition and administering tax incentives and their spillover can no longer be tackled along the linear demarcations that once separated international and national tax policymaking. Corporate tax regimes are under pressure due to the increased sophistication of cross-border tax evasion and aggressive tax planning schemes. As deeper forms of Arab integration ensue, and as more goods and services are supplied through digital platforms, considerable revenue losses can be expected if appropriate legal frameworks are not in place.

21. The Arab region should consider the proposed global reforms to eliminate the utility bias created by tax exemptions and deductions to address tax arbitrage and reduce incentives for aggressive tax planning. A number of legislative and policy reforms would be needed following the review of tax and investment treaties to re-establish taxing rights and permanent establishment requirements, re-define digital presence, reconcile tax liabilities and re-asses how extractive industries are taxed, be it through royalties, windfall taxes on profits, withholding taxes, corporate income taxes, production sharing agreements, tariffs or licensing fees, as well as consider ways to effectively tax capital gains and reduce overlapping deductibles.

22. Another set of national reforms are needed for tax incentives. Tax exemptions and holidays need to be consistently applicable, quantified and made conditional on achieving defined development targets with the

[8] Cobham, Faccio, Garcia-Bernardo, Janský, Kadet, & Picciotto, (2021). A Practical Proposal to End Corporate Tax Abuse: METR, a Minimum Effective Tax Rate for Multinationals, *IES Working Paper* 8/2021. Available at https://ies.fsv.cuni.cz/sci/publication/show/id/6412/lang/en.

possibility of replacing them with direct transfers to the extent admissible by multilateral and preferential arrangements (in order not to trigger countervailing measures or distort competition). Moreover, they should be periodically evaluated if they are to do more good than harm.

23. At the regional level, Arab States may consider establishing or mandating existing mechanisms to coordinate tax incentives, improve tax certainty and fast-track tax dispute resolution, especially as tax expenditures can be construed as a form of harmful State aid or subsidy that distorts competition, thereby providing grounds for retaliatory action or countervailing measures. It should be noted that the binding dispute settlement and resolution mechanism currently being negotiated as part of the G20/OECD Inclusive Framework may obstruct or nullify the role of several Arab courts established for this purpose.

24. As economic integration continues within the Arab Customs Union (ACU), administering, collecting and distributing indirect taxes may become more cumbersome once goods and services are in free circulation within the union. Tax administrations will also find it harder to tax MNCs as they can operate in different markets without triggering tax residency rules. Arab States can also consider developing regional digital tax directives to avert possible tax abuses. Here, the Arab region may consider establishing a common consolidated corporate tax base and apportioning the taxable profits of MNCs across ACU Member States according to an agreed formulary approach.

25. Arab States may also consider launching the necessary intergovernmental process to revisit several Arab legal instruments in light of the negotiations advanced within the G20/OECD and in light of global tax developments, including unilateral digital taxes being imposed to address the tax challenges arising from digitization. It should be noted that none of the specialized ministerial councils established by the League of Arab States is uniquely poised to address fiscal and tax policy cooperation, be it to combat tax evasion, address aggressive tax competition, align Arab bilateral tax treaties or support regional integration, which requires aligning several facets of contemporary tax systems, including how taxes and fiscal charges are collected and allocated within the customs union.
