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KEY POINTS

- Financing for development requires that developing countries staunch leakages of financial resources, including leakages through a new channel – cryptocurrencies.
- The international community needs to act fast and launch a comprehensive global cryptoregulation and information-sharing system.

The cost of doing too little too late: How cryptocurrencies can undermine domestic resource mobilization in developing countries

Financing for development requires that countries simultaneously mobilize resources from various sources while tackling financial leakages. This policy brief discusses how cryptocurrencies have become a new channel undermining domestic resource mobilization in developing countries. While cryptocurrencies can facilitate remittances, these same digital technologies may also enable tax evasion or avoidance through offshore flows whose ownership is not easily identifiable. In this way, they may curb the effectiveness of capital controls, a key instrument for developing countries to preserve their policy and fiscal space and macroeconomic stability. This policy brief recommends policies to reduce the financial leakages from cryptocurrencies. Given the global nature of cryptocurrencies, it highlights the importance and urgency of international cooperation regarding cryptocurrency tax treatments, regulation and information sharing as well as of redesigning capital controls to take account of the decentralized, borderless and pseudonymous features of cryptocurrencies.

Introduction

Developing countries face significant mobilization challenges to promote structural transformation and sustainable development while achieving the 2030 Agenda for Sustainable Development. According to UNCTAD estimates before the war in Ukraine,[1] developing countries need around US$3 trillion per year from 2020 to 2025 – to close their financing gaps. Financing for development requires a two-pronged approach. On the one hand, developing countries need to mobilize additional resources from several domains: international and domestic, public and private. On the other hand, they need to tackle financial leakages.

Two crucial channels drain resources from developing countries: illicit financial flows and persistent net financial outflows.[2] These channels erode tax revenues, shrinking developing countries' fiscal space and capacity to provide essential public services and infrastructure. Moreover, they broaden the external financing needs of developing countries, leaving these countries on a debt treadmill. The emergence and the popularity of cryptocurrencies in developing countries has been associated with facilitating remittances and financial inclusion.[3] This policy brief addresses how cryptocurrencies can undermine domestic resource mobilization in developing countries.

Illicit financial flows: Old problem, new channels

At their broadest, illicit financial flows are defined as "financial flows that are illicit in origin, transfer or use, that reflect an exchange of value and that cross country borders".[4] Illicit financial flows not only include resources that originate from criminal activities (e.g. drug dealing, or trafficking in people) or for illicit activities (e.g. financing terrorism), but also to transfer income and profits legally generated but illicitly transferred abroad to avoid or evade taxes. It is estimated that illicit tax and commercial practices by multinational enterprises and wealthy individuals account for up to two thirds of total illicit financial flows.[5] According to this source, in 2021 alone, close to US$500 billion were lost in tax revenues worldwide due to cross-border tax abuse by multinational enterprises and individuals. These lost resources, which, for example, would be sufficient to vaccinate the global population more than three times, harm low-income countries most, as they have fewer options to mobilize resources.

Since the 2008 global financial crisis, several measures to reduce commercial and tax-motivated illicit financial flows, through trade mispricing, financial instruments or use of shell companies, have been undertaken at the multilateral and national levels.[6] However, these efforts do not include cryptocurrencies, which have become a new channel for tax-motivated illicit financial flows.

While attention has been given to the attractiveness and potential use of cryptocurrencies for criminal activities,[7] estimates suggest that this represents a relatively small share of cryptotransactions, showing that less than 10 per cent of total transactions in Bitcoin could be attributed to criminal activity in 2020.[8] But from the point of view of financing for development, cryptocurrencies remain problematic even when not related to criminal activity as the erosion of the tax base and the undermining of capital controls are crucial problems for developing countries (see below).

Tax havens version 2.0

Tax havens are jurisdictions where foreign earnings are typically not subject to taxation (or minimally so) and the anonymity of account holders is maintained. In the last 10 years, tax authorities and Governments have collaborated to encourage regulated banks to deliver information about account holders in order to protect the tax base and domestic resource mobilization.[9]

Cryptocurrencies share all the characteristics of traditional tax havens – the pseudonymity of accounts, and insufficient fiscal oversight or weak enforcement. The key difference is that international transfers of cryptocurrencies do not rely on banks or related legal and accounting services. Instead, cryptocurrency transactions are often channelled through unregulated cryptoexchanges. Hence, cryptocurrencies are under-regulated, enabling individuals to bypass tax authorities' efforts to address offshore tax evasion. In effect, cryptocurrencies can serve as tax havens version 2.0 or super tax havens.[10]

1 Given the impact of the conflict in Ukraine on the cost of food, finance and finance, financing gaps are expected to be larger than $3 trillion per year. See UNCTAD, 2022, Financing for development: Mobilizing sustainable development finance beyond COVID-19, TD/B/EFD/5/2, Geneva, 11 January.

2 UNCTAD, 2020, Topsy-turvy world: Net transfer of resources from poor to rich countries, Policy Brief No. 78.

3 See UNCTAD Policy Brief Nos. 100 and 101, available at https://unctad.org/publications.

4 For a definition of illicit financial flows, see UNCTAD, 2021, Methodological guidelines to measure tax and commercial illicit financial flows. Version 2.16. For an overview of issues concerning illicit financial flows, see https://unctad.org/meeting/intergovernmental-group-experts-financing-development-first-session.

5 Tax Justice Network, 2021, *The State of Tax Justice 2021.*

6 UNCTAD, 2019, *Trade and Development Report 2019: Financing a Green New Deal* (United Nations publication, Sales No. E.19.II.D.15, Geneva).

7 See, for instance, https://www.europol.europa.eu/cms/sites/default/files/documents/Europol%20Spotlight%20-%20Cryptocurrencies%20-%20Tracing%20the%20evolution%20of%20criminal%20finances.pdf and https://www.ucl.ac.uk/jill-dando-institute/sites/jill-dando-institute/files/ucl_cryptocurrencies_and_future_crime_policy_briefing_feb2021_compressed_1.pdf.

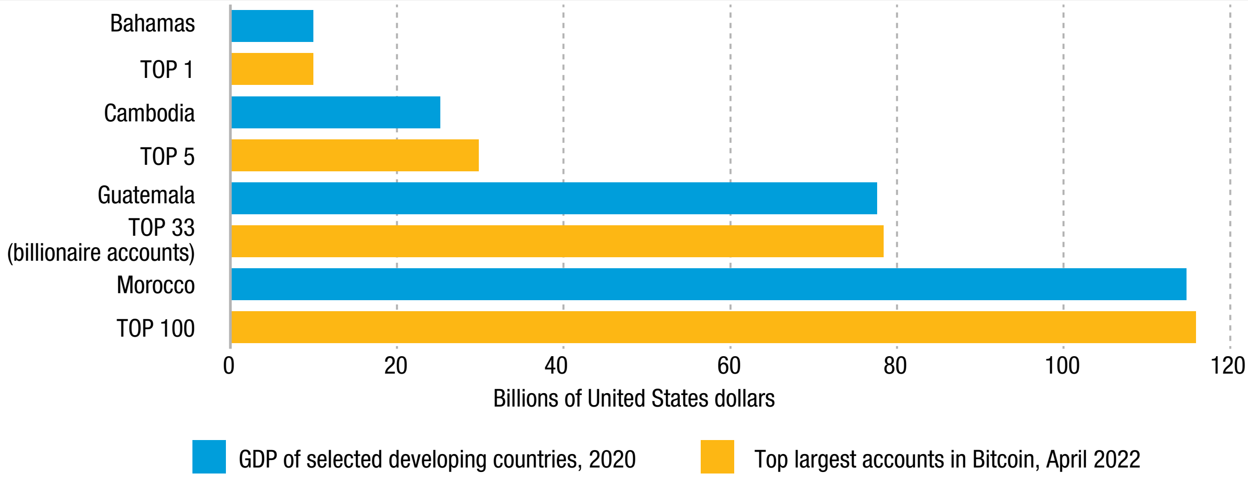
8 Financial Action Task Force, 2021, *Second 12-Month Review of Revised FATF Standards - Virtual Assets and VASPs*, Paris, available at https://www.fatf-gafi.org/publications/fatfrecommendations/documents/second-12-month-review-virtual-assets-vasps.html.

9 Marian O, 2013, Are cryptocurrencies super tax havens? *Michigan Law Review First Impressions*, 28, vol. 112; and Alm J et al., 2020, New technologies and the evolution of tax compliance, University of California, Legal Studies Research Paper Series No. 2020-42.

10 Ibid.

Cryptocurrencies have quickly attracted the interest of wealthy individuals and firms. Taking Bitcoin as an example (the first cryptocurrency among the existing 19 thousand),[11] over 80,000 Bitcoin accounts (referred to as "addresses") hold a balance of at least $1 million. While some of these accounts may belong to trading platforms, others pertain to wealthy individuals and firms. As the figure below shows, the size of the largest Bitcoin account (as at April 2022) is equivalent to the 2022 gross domestic product (GDP) of the Bahamas, and together the biggest 33 Bitcoin accounts with over $1 billion each correspond to the GDP of Guatemala (US$78 billion in 2020). The top richest 100 Bitcoin addresses account together for US$115 billion, equivalent to the GDP of Morocco (US$114 billion in 2020) and greater than the GDP of 135 individual countries.

Top largest accounts in Bitcoin and gross domestic product of selected developing countries



Source: bitinfocharts.com and World Economic Outlook database of the International Monetary Fund.

Balances kept in cryptocurrencies are essentially untaxed. Despite recent regulatory tightening in developed countries (67 jurisdictions applied tax laws on cryptocurrencies by November 2021),[12] most developing countries do not have tax regulation on cryptocurrencies, including with regards to the legal status of these private digital currencies. Moreover, even in countries where tax regulation exists, its efficacy is not assured as the lack of a universally agreed approach to cryptocurrency tax treatments creates a patchwork system that is prone to regulatory arbitrage. Finally, users of cryptocurrency have little or no incentive to report their holdings. The underlying reason is the current lack of a third-party tax reporting system (i.e. through banks), which has been identified as a highly effective tool to increase tax declaration compliance.[13] Contrary to the widely held view that cryptocurrencies are not intermediated, but function using automated protocols,[14] there are countless service providers, including cryptoexchanges, digital wallets, and decentralized finance (DeFi) platforms, that enable the use and holding of cryptocurrencies. Once regulated, these service providers could contribute to improved tax reporting.

Cryptocurrencies undermine capital controls

The popularity of cryptocurrencies in developing countries, including among middle-class households (see UNCTAD Policy Brief No. 100), means that the use of these digital assets is not limited to wealthy individuals. In cases of political or macroeconomic instability, a broad range of households could potentially use cryptocurrencies as a hedge against exchange rate and inflation risk[15] and as a channel for capital flight. This situation is potentially damaging in developing countries which typically rely on the use of capital controls to deal with the draining of domestic resources through capital flight. As long advocated by UNCTAD, capital controls are also a key instrument for developing countries to prevent the boom-bust cycles of international capital flows and to broaden policy space.[16]

The decentralized, borderless and pseudonymous features of cryptocurrencies pose challenges for the effectiveness of capital controls for three main reasons. First, capital controls work through regulated intermediaries that are required to verify the nature

[11] See https://coinmarketcap.com.

[12] Law Library of Congress, 2021, Regulation of cryptocurrency around the world, November update, Washington, D.C., available at https://www.loc.gov/item/2021687419/.

[13] Lederman L and Dugan J, 2020, Information Matters in Tax Enforcement. *Brigham Young University Law Review, Volume 145.*

[14] Aramonte S and Wenqian H 2021 DeFi risks and the decentralization illusion. *BIS Quarterly Review*, December, available at https://www.bis.org/publ/qtrpdf/r_qt2112b.htm.

[15] International Monetary Fund, 2022, Capital flow management measures in the digital age: Challenges of crypto assets. Fintech Note, 2002/005. May.

[16] See UNCTAD, 2014, *Trade and Development Report, 2014: Global Governance and Policy Space for Development* (United Nations publication, Sales No. e.14.ii.D.4, New York and Geneva).

of transactions and to identify transacting parties. Second, in many countries the legal status of cryptocurrencies is often unclear, and regulatory bodies may currently not have a mandate to regulate these transactions and cryptoexchanges, e-wallet providers and DeFi platforms. Third, supervision and enforcement of these cryptoservices providers are more difficult since they operate cross-border.[17] Bitcoin, for example, was used to circumvent Chinese capital controls prior to the country's ban on cryptocurrencies. Moreover, cryptocurrency miners are usually remunerated in cryptocurrencies while their mining costs (particularly energy) are incurred in domestic currency, thus enabling capital outflows.

Recommended policies

While not exhaustive, the following policies provide the potential to halt the financial leakages via cryptocurrencies:

1. To improve taxpayer compliance rates and combat tax evasion, tax authorities should clearly define the legal status of cryptocurrencies and require cryptoexchanges, e-wallet providers and DeFi platforms to report gross inflows and outflows on all business and personal accounts.
2. Given the fast-evolving nature of cryptocurrencies and their ecosystem, countries urgently need to agree and implement a global tax cryptocurrency regulation that considers the needs and challenges of developing countries and gives them adequate representation.
3. Apart from global tax coordination, a comprehensive system of information sharing on cryptocurrency holding and trading is necessary, such as through a common reporting standard. Such measures would support countries to detect evasion of capital controls and enforce taxes.

These three recommended policies are also crucial to the effectiveness of two other initiatives:

4. Although cryptocurrencies may facilitate remittances, given the negative socioeconomic impact these private digital currencies bring about, countries should consider imposing higher taxes on them in comparison to other financial assets to discourage holding and transacting cryptocurrencies.
5. Countries should redesign their capital controls to include flows channelled through cryptocurrencies. Alternatives include imposing financial tax on cryptocurrency trading and limiting the amount of individual transactions on cryptoexchanges. Moreover, central bank digital currencies could be designed to allow for the functioning of capital controls. Without adapting to new digital alternatives, the effectiveness of these controls may be undermined.

[17] International Monetary Fund, 2022.

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