Taxation and Financing for Development

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Domestic tax revenues are an essential source of financing for development. However, compared to other key development financing topics such as trade, aid, and debt, taxation has only received limited attention so far. This paper describes some of the main problems that undermine direct tax revenues in developing countries, with a focus on tax evasion and aggressive tax avoidance by multinational corporations (MNCs).

Introduction

The follow-up International Conference on Financing for Development will be held in Doha from 29 November until 2 December 2008. The goal of this conference is to review implementation of the Monterrey Consensus, which was the outcome document of the first Financing for Development conference in 2002.

The Monterrey Consensus embraces six areas of Financing for Development:

1. Mobilising domestic financial resources for development
2. Mobilising international resources for development: foreign direct investment and other private flows
3. International trade as an engine for development
4. Increasing international financial and technical cooperation for development.
5. External debt
6. Addressing systemic issues: enhancing the coherence and consistency of the international monetary, financial and trading systems in support of development

Taxation is inseparably bound up with these issues, considering that a fair and efficient taxation system is a *sine qua non* for the improvement of the financial situation of developing countries. This is recognised in the Monterrey Consensus, stating that tax systems are important for raising domestic resources.[1]

The link between development and taxation has come up on other occasions too, such as in the Millennium Development Goals (MDGs). Strangely enough, however, taxation is still not getting the attention it deserves. This is surprising given the potential of domestic tax revenues to reduce poverty and promote sustainable development. The call for attention is now becoming louder. The Tax Justice Network (TJN), for one, works to analyse and explain the link between taxation and development and to expose harmful tax practices in order to encourage reform at the national and international levels.[2] In May 2008, Christian Aid drew attention to the subject, with striking country examples, in the report 'Death And Taxes: The true toll of tax dodging'.[3] In addition, Greenpeace has exposed tax fraud in the logging industry.[4]

The aim of this briefing paper is to inform civil society and policymakers about the importance of a fair international tax system that is supportive to development. The paper provides an overview of recent developments in the areas of taxation and development. It deals with issues relating to taxes paid by corporations only, not taxes paid by individuals. The structure of the paper is as follows. The next section explains the purpose of taxation and the link between taxation and development. Subsequently, a recap of taxation problems and their influence on developing countries is given. These problems are divided into three parts: problems arising from the characteristics of developing countries, problems arising from capital flight, and problems arising from corporate tax avoidance. The last section explains the role of international forums and organisations relevant to taxation, and provides concrete policy recommendations.

Why is taxation important for development?

Sustainable government finance is key to sustainable development. After all, the provision of social protection, infrastructure and basic services such as education and health care is crucial for development. Sustainability requires that the means to finance these public goods and services should come, as much as possible, from the government's own resources, that is, tax revenues. This explains the close link between taxation and development. For several reasons, developing countries have difficulty collecting these domestic revenues adequately.

If developing countries were able to collect sufficient tax revenues, they might be able to increase their independence. The reason is that they would need less financing through foreign loans, which reduces debt problems, and they would be less dependent on foreign aid.[5] This independence would increase stability of the government budget, as tax revenues are much less volatile and unpredictable than aid flows.[6] It could also increase the policy space for governments because of the economic policy conditions frequently attached to foreign aid and loans. Furthermore, enhanced tax revenues could strengthen democratic accountability and provide opportunities for cuts in high marginal tax rates in many countries.[7]

In brief, tax systems can serve four main goals, called the four Rs:[8]

1. Revenue generation: A first goal is to raise government revenues, as stated above.
2. Redistribution: A second goal is to redistribute income and reduce inequality. This is generally achieved through progressive taxes. This means that higher tax rates apply to higher incomes.
3. Re-pricing: A third goal is to re-price economic alternatives, that is, the use of taxes and subsidies to ensure that market prices better reflect social costs and benefits.
4. Representation: A fourth goal is to strengthen political representation. When governments are more dependent on tax revenues and less on income from natural resources, aid or debt financing, this generally stimulates accountability to citizens regarding the use of government funds. The effect is strongest for direct taxes on personal and corporate income.
   Aid dependence, on the other hand, stimulates accountability to external donors.

Governments around the world recognise that revenue mobilisation is also central to achieving the MDGs. Tax issues relate directly to Millennium Development Goal 8: to develop a global partnership for development. Two of the seven more concrete targets that have been set for MDG 8 look in greater depth at the importance of tax income:[9]

- *'Further develop an open trading and financial system that is rule-based, predictable and non-discriminatory (includes a commitment to good governance, development and poverty reduction).'*
- *'Deal comprehensively with developing countries' debt problems through national and international measures in order to make debt sustainable in the long term.'*

These targets are crucial for reaching the other seven MDGs, and indicate that the whole range of issues referred to in the MDGs cannot be tackled unless developing countries secure their own tax revenues.

What are the problems?

Tax problems are common around the world and not just in developing countries. However, some tax issues are of greater concern to developing countries, and on top of that, developing countries are confronted with problems all of their own.

Problems arising from characteristics of developing countries

Tax revenues are, on average, lower in developing countries than in rich countries; the average revenue in low income countries was approximately 13% of GDP in 2000[10], less than half of the average level of 36% for Organisation for Economic Co-operation and Development (OECD) member countries.[11] The ability to obtain direct tax revenues, which are often progressive in nature and can be used for effective redistribution, is especially low: 2 to 6% of GDP in poor countries compared to 12 to 18% for developed countries.[12]

This is partly due to features that characterise developing countries:

The large informal economy
The informal economy refers to the economic activity that is not captured in official statistics. Most developing countries have a large informal economy, which is under-taxed or completely untaxed. The average size of the shadow economy as a proportion of official GDP was estimated for 2002-2003 at 43% in African countries, 30% in Asian countries, and 43% in Central and South American countries. In OECD countries the shadow economy is approximately 16%.[13] Another source provides a figure of 33% for low-income countries, compared to 19% in the members of the European Economic and Monetary Union.[14]

These data indicate that on average the level of tax evasion due to the informal economy in developing economies is about twice that of developed countries. This gives the impression that developing countries miss out on a considerable amount of tax revenues because of these informal activities. It is important to emphasise, however, that many of the people whose incomes are not recorded live below the poverty line. A significant rise of tax revenues might therefore not occur if unrecorded activity were to be reduced in developing economies. Nevertheless, bringing workers into the formal sector is important in order to enhance their legal rights and entitlements to social benefits.

Limited capacity of revenue authorities
Tax leakage in developing countries is often worsened by poorly functioning tax authorities, due to a variety of reasons:[16]

- Under-resourced or under-trained administrations
- Poor tax collection systems
- Failure of legal enforcement mechanisms for tax collection
- Small penalties for non-payment

These factors create opportunities for domestic and foreign entities to abuse the tax system since tax officials frequently lack the required technical skills to unravel complex international fiscal structures that are used to escape taxation, and because potential penalties are insufficient to stop tax evasion.

Tax competition
It is increasingly possible for companies to shift their business activities across national borders. In some sectors (such as extraction of natural resources) companies are tied to certain countries, but in others (e.g. manufacturing) companies can change their location easily and are able to move to the most attractive country. The economic attractiveness of a country depends on factors such as political stability, adequate skills, good infrastructure, etc. Countries with a comparable economic, political and social situation may compete with each other in order to attract foreign direct investment (FDI). Because of the comparable circumstances, these countries need specific advantages through which they stand out to foreign investors. Tax competition means that countries compete against each other by using tax-related or financial incentives to attract FDI.[17] These incentives include:

- Lower tax rates on profits and capital
- Tax holidays (reduction or elimination of tax for a certain period of time, for the purpose of attracting FDI or stimulating growth in selected industries)
- Accelerated tax allowance for spending on capital assets (see 'Tax planning', '*where the company will locate its assets*')
- Subsidies
- Relaxation of regulations, including with regard to financial disclosure
- The absence of withholding taxes
- Tax inducements for mobile labour required for an investment project

Urged by the major international financial institutions (IFIs) to adopt development strategies to attract foreign direct investment, and by MNCs that use tax advantages as a condition for investment, many governments now routinely engage in tax competition by offering some or all of the above incentives. However, this does not always enhance foreign investments.

Corporation tax rate data reveal that wealthier countries cut their tax rates more than lower income countries between 1997 and 2004.[18] However, high income countries are capable of defending their tax base (taxable profit) better than developing countries that are far less able to adjust to the pressures of tax competition. This leads to lower average corporate tax revenues for developing countries, resulting in a shift of the tax burden towards wages and consumption. This harms employment generation and increases inequality. Consequently, tax competition increases poverty and inequality in the long run and, contrary to the original aim, slows economic growth.

In addition, tax competition can be seen as a form of harmful competition, because it involves countries competing by offering lower taxes, but nothing is done to improve efficiency. It can even promote inefficiency, as the advantage gained by one country by lowering its taxes is often short term and is quickly offset by similar moves in neighbouring countries. This leads to long-term revenue losses in all countries. The revenue loss ends, remarkably enough, in an investment loss rather than an attraction of FDI, as multinational companies prioritise the quality of infrastructure, a well-educated workforce and a local dynamic market far higher than tax advantages when investing in countries.[19] Nevertheless, companies do ask for tax breaks and financial advantages when deciding to invest in a country, and are able to obtain these because of their strong negotiating position.

The result is clear. The non-payment of taxes in rich countries undoubtedly has severe negative repercussions, but the impact is invariably higher and starts from a lower base of revenue in developing countries.

Example of revenue loss through tax incentives

After the privatisation of the mining industry in the late 1990s, the economy of Zambia is highly dependent on mining for export revenues. Because of this dependency, the government has committed itself to some of the world's lowest tax rates on mining, and therefore received very limited revenues from mining. According to the World Bank's 2004 report on taxation in Zambia, (foreign) mining companies contribute only around 12% of all corporate tax revenues, despite accounting for nearly 70% of export revenues.[20]

Bribery

In the last 15 years, there has been growing recognition that corruption – including bribery of public officials – has a particularly harmful impact on developing nations. It distorts markets and competition, creates cynicism among citizens, impedes the rule of law, damages government legitimacy and harms the integrity of the private sector. It is therefore a significant obstacle to development and poverty reduction. Bribery also sustains failed states, which are incubators of terrorism, money laundering, and other types of global crime. The essential approach to combating corrupt activities requires developing nations to create durable, transparent and accountable institutions, which can regulate fundamental economic, political and legal affairs free from illicit influences.[21]

Trade liberalisation

Little doubt exists that international trade has the capacity to have a significant positive impact on development. Yet there is an aspect of trade liberalisation that has received little attention, the impact on tax revenues of the significant cuts in trade taxes that are central to the liberalisation process. Import duties are amongst the easiest taxes to administer and have therefore contributed significantly to revenue income for many developing countries, in some cases 30 to 50% of total government revenue.[22]

However, in the last two decades the World Bank and the International Monetary Fund (IMF) have promoted a trade liberalisation agenda which involved sharp reductions of import tariffs. High income countries, which derive only a small share of tax revenue from trade taxes, have been able to recover revenue from other sources, principally consumption taxes, such as Value Added Tax (VAT). Middle income countries have fared less well, recovering between 45 to 65% of the fiscal revenues they lost. The situation has been dramatically worse, however, for low income countries. They have only been able to recover about 30%.[24]

The trade liberalisation currently negotiated in the context of Economic Partnership Agreements (EPAs) between the European Union (EU) and African, Caribbean and Pacific (ACP) economies may be expected to have significant revenue effects as well. Estimates reveal that, overall, trade liberalisation under an EPA is expected to have a significant negative impact on fiscal revenues for most ACP countries as a result of the elimination of customs duties on imports of most EU products. In the case of the EPAs with the SADC region in Southern Africa and Cariforum in the Caribbean, SADC loses 19% in customs revenue and 5% in public revenue, and Cariforum loses 14% in customs revenue and 3% in public revenue. On average, Least Developed Countries (LDCs) are expected to experience larger losses than the non-LDCs; they may lose 38% in customs revenue and 8% in total public revenue.[25]

Problems arising from capital flight

Capital flight is treated separately here because of the great significance it has on development. As an example, foreign public aid from rich to poor countries totals $50 billion annually while developing countries lose $500 billion every year in illegal private outflows that are not reported to the authorities and on which no tax is paid.[26]

Capital flight

Capital flight involves the deliberate and illegal disguised expatriation of money by companies or individuals taxable within the country of origin. Developing countries lose more money through private capital flight than they receive in public aid. This is a major challenge for developing countries. While the international community commits to increasing aid and debt relief, these efforts are jeopardised by the enormous flows from the South towards the North.[27] This outflow of private capital reduces the domestic savings and tax revenues available for the financing of investments and public expenditures. Capital flight therefore has a negative effect on development. Raymond Baker, a senior fellow at the US Center for International Policy, describes capital flight as *'the most damaging economic condition hurting the poor in developing and transitional economies. It drains hard-currency reserves, heightens inflation, reduces tax collection, worsens income gaps, cancels investment, hurts competition and undermines trade'*.[28]

There are several reasons for the flight of capital, of which tax evasion is the most important. Other motives are, for example, seeking a secure location for capital, the avoidance of local currency risk or the avoidance of other legal obligations within the state from which capital flight takes place. It is therefore important to realise that to a certain extent capital flight would remain a problem even if there were no tax incentives implicit within it.[29]

Capital flight often occurs through similar channels to those used for the legitimate transfer of money. Legitimate international payments have certain characteristics that make it possible to distinguish them from capital flight:[30]

- The source of the wealth being transferred abroad is legitimate
- The outflows represent fair payments in a commercial transaction
- The transfer does not violate any laws of the country of origin
- The taxes relating to the transfer of the capital have been paid in the country of origin
- The flows are reported, documented and recorded in the official statistics of the country involved

Not all the money that leaves a country due to capital flight stays out. Part of the money can come back in the form of what appears to be foreign direct investment. This refers to capital belonging to a country, which leaves the country through capital flight and is then reinvested in the form of FDI. This is known as round tripping. Because of the beneficial treatment foreign investors often receive, companies may find many incentives to do this, such as tax benefits, greater administrative support, and easier access to financial services.

Example of revenue loss through aggressive tax strategies

The UNRISD report 'The "Pay Your Taxes" Debate' describes the case of the Compañía Minera Disputada de Las Condes, a mine previously owned by Exxon. Exxon bought Disputa de Las Condes in the 70s from the Chilean State for $ 80 million. In the 23 years afterwards, Exxon seemed to operate Disputa de Las Condes at a loss. It therefore never paid tax. Instead, it accumulated $575 million in tax credits, which were offset against the activities of the mine. Surprisingly, however, Exxon sold this mine in 2002 for $ 1.3 billion, a price that proved that the operation was profitable.

Exxon achieved this by exporting the mining operation's profits through huge interest payments from the company to Exxon Financials, a subsidiary in Bermuda. The vice-president of Disputa de Las Condes recognized this by stating that 96% of liabilities corresponded to loans from headquarters or the Bermuda subsidiary, which is why Exxon withdrew interest payments rather than profits.[31]

Problems arising from corporate strategies

Companies can be taxed in various ways. The main form of direct taxation for companies is corporation tax, paid as a percentage of profits. Companies may also be subject to taxes on imports and exports, capital gains tax and withholding taxes. Capital gains tax (CGT) is a tax charged on capital gains, which is the difference between what a company paid for an investment and what the company received when it sold that investment. Withholding tax (WHT) is a tax on payments made to foreign entities. Inside multinationals, these payments are often dividends but also royalties and interest. Management fees can be subject to withholding tax as well. In tax treaties, countries often agree on lower levels of withholding tax on a bilateral basis.

Multinational companies have numerous possibilities to structure their activities and financial affairs in order to avoid the taxes referred to above. They use several legal and illegal tax strategies, as explained below. These strategies are not isolated, but are closely linked. They overlap one another and can be part of one and the same activity.

Tax evasion or tax avoidance

Tax evasion is the general term for efforts by individuals, firms, trusts and other entities to evade taxes by *illegal* means. It usually entails taxpayers deliberately misrepresenting or concealing the true state of their affairs to the tax authorities in order to reduce their tax liability. This includes, in particular, dishonest tax reporting. Examples are:

- when a company fails to declare all or part of its income,
- when a company makes a claim to offset an expense against its taxable income which did not occur or which is of a type not authorised for tax relief in the country concerned,
- when a company makes a tax claim that seems legal only because relevant facts have been suppressed.

Tax avoidance entails the *legal* utilisation of the ambiguities and indeterminacies of tax rules and regulations to one's own advantage, in order to reduce the amount of tax that is payable, by means that are within the law. Aggressive tax avoidance occurs when companies exploit loopholes and flaws in tax laws and international arbitration opportunities. Even though this may be legally allowed, such behaviour is in conflict with tax compliance. Because a company does not aim to pay the right amount of tax at the right time and the right place, it abuses the spirit of the tax laws.

The use of tax havens

Most of the 'tax escapes' take place secretly through tax havens. In fact, as much as 50% of world trade is reported to pass through these havens.[32] Transnational corporations use tax havens in order to escape tax burdens and regulation as well as to disguise their accounts and debt levels. Germany's crackdown on secretive bank accounts in Liechtenstein has put the spotlight on tax havens, which combine low taxes, strict banking secrecy rules and an unwillingness to cooperate with tax authorities of other countries. Around 40 countries are viewed as tax havens by the OECD. Tax Justice Network recognizes more than 70 tax havens in the world, as they also qualify certain OECD countries or financial centres within them as tax havens, something the OECD fails to do. The OECD defines tax havens, or 'harmful preferential tax regimes', as having the following key features:[33]

1. No or only nominal tax rates
2. A lack of transparency
3. Lack of effective exchange of information
4. The absence of a requirement that the activity is substantial

Company presence in tax havens

The Cayman Islands is best known for its sunny beaches and blue waters. Next to the presence of many tourists, the archipelago in the Caribbean is home to about 47,000 people. But it is also the fifth-largest financial centre in the world; its banking privacy laws and the lack of income taxes attract many companies. For example, 45 of the world's top 50 banks have subsidiary or branch operations in Cayman. Indeed, there are more than 65,000 companies registered in the islands. The Cayman Islands therefore have more companies than residents!

Apart from small island tax havens, there are also various European countries that offer special tax regimes and tax facilities that are used by multinational corporations to escape taxes elsewhere. Ireland and Cyprus offer low tax rates that encourage the reallocation of profits to be taxed there, for example. Other European countries, including Belgium, Switzerland, Luxembourg and the Netherlands, offer special low-tax regimes for specific corporate activities, or facilitate conduit arrangements. The latter allow dividends, royalties, and capital flows to move through those states with almost no tax arising, often on their way to or from an offshore tax haven.[34] It has been estimated that the tax haven features of the Netherlands alone, facilitate a loss of more than € 100 million in tax revenue in developing countries.[35]

Tax planning

Any company has the option of carrying out tax planning in order to minimise tax liability within the law of the territory in which it operates. International tax planning is done by multinational companies that exist of a parent company and one or more subsidiaries in other countries. Double tax treaties prevent the income of these subsidiaries of one company being taxed in several countries.
The arrangements in these treaties are complex and this complexity gives companies the opportunity to plan their tax liabilities by making choices that affect the amount of tax that needs to be paid in a positive way. Such decisions include:[36]

- *In which country the company will establish its head office*
  This decision is important, as a company usually has to pay tax in the country in which it is established. This is most apparent in Australia, Canada, the United Kingdom and the United States where a tax credit system is in force, which means that the home country taxes the income of a multinational worldwide. In order to escape residual taxes on profits in low-tax countries, many multinationals set up intermediate holding companies. These companies are owned by the parent and in turn own the operating subsidiaries. No activities take place in these holdings, except that they collect dividend income from the subsidiaries and then re-invest this or lend the receipts onwards to the parent. The intermediate location is chosen for exempting foreign dividend income from taxes, for having many tax treaties with other countries, and for a favourable regime for taxing interest income. Examples include the Netherlands, Ireland, Luxembourg and Switzerland.

- *Where the company will incorporate its subsidiaries*
  MNCs typically consist of hundreds of affiliated companies. Because of tax law and other regulations, multinational companies almost always have subsidiary companies in each territory in which they operate. In addition, many of the affiliated companies are non-operating subsidiaries that exist for administrative, legal, historical or tax purposes. By way of these numerous subsidiaries, companies can relocate profits from the place they were really earned to other places in which they may be declared, with lower taxes being paid in consequence. To achieve this, companies incorporate subsidiaries in tax havens, territories with low tax rates, such as Jersey or the British Virgin Islands.

- *Whether the company will use tax havens or not*
  See 'The use of tax havens'.

- *Which companies will or will not be included in the group structure*
  Companies sometimes choose to hide transactions by creating companies that are theoretically not owned by the group, but ownership of which is placed in a charitable trust located in a tax haven. This happens for example with liabilities the company would rather not recognise since it would make its financial position look worse.

- *What terms of trade will be used between group companies*
  This is called transfer mispricing. See 'Abusive transfer mispricing'.

- *Where the company will record its sales*
  Companies can relocate where a sale is recorded in order to create favourable outcomes for taxation. This is particularly the case with software and other such products sold online. The aim is to shift sales to low tax areas.

- *Where the company will incur its costs*
  Here the aim is to shift costs to high tax areas, where the company will benefit from the greatest value of tax relief.

- *Where the company will locate its assets*
  A company has to buy certain physical property to undertake its activities (for example drilling equipment in the mining industry). Logically, this property is owned in the country in which it is used. Countries can give tax relief to companies that invest in capital assets, however. For example, some countries give tax relief to companies that lease assets, while other countries give tax relief to the party that rents out the asset. Companies can exploit these rules by a process known as 'tax arbitrage'; companies choose to locate the transaction so that they trade off the rules of one country against the rules of the country that taxes the other side of the arrangement. This is why assets are frequently legally owned in locations far removed from where they are actually used.

- *Where the company will employ its staff*
  This mostly concerns the senior management of an MNC. They are internationally mobile and will be willing to participate in tax planning for their own and their employer's benefit. The result is that these senior managers might be employed in locations which suit tax planning even if their duties are undertaken elsewhere (locations with a favourable tax treatment for the earnings of the manager, low employment taxes, etc.).

- *Where the company will borrow money*
  Interest is much more favourably treated for the calculation of tax duties than dividends, as interest is deducted from a company's profits for tax purposes but a dividend payment is not. As a result, companies have a bias towards borrowing a larger proportion of their capital. For example, a company can finance a foreign subsidiary mainly with loans and almost no share capital (equity). This is known as 'thin capitalisation'. The following example shows how a multinational can shift profits through internal loans. Suppose a parent company has a fully-owned foreign subsidiary that is facing a higher tax rate than the parent. The subsidiary has a total of € 4 million in assets, which yield a return on investment of 15%

or € 600,000. If the parent finances the subsidiary with 25% debt and 75% equity, and the interest on the loan is 10%, the parent receives € 100,000 in interest and the subsidiary has € 500,000 earnings before tax left. If instead the parent finances the subsidiary with 75% debt and 25% equity, the parent's interest revenues increase to € 300,000 and the subsidiary's earnings before tax decrease by 40% to € 300,000. In this way, debt shifting can substantially affect the location of profits within a firm. Tax treaties play an important role in the decision how to shift debt within a company, because they alter the withholding tax rates between countries, influencing the optimum financing of foreign subsidiaries. If internal interest rates are set at artificially high levels, this is a form of transfer mispricing. In developed countries this practice is normally well regulated, but in developing countries this is generally not the case.

- *Where the company will locate its intellectual property*
  Intellectual property comprises patents, on which royalties are paid, and copyrights and trademarks, on which licence fees are paid. Intellectual property may have been created by a multinational or acquired from a third party. It is very difficult to prove the value of intellectual property and it is therefore a popular mechanism for shifting the location of profits from both developed and developing countries to low tax locations. Again, tax treaties in which tax rates are stated have a big influence on the decision where to locate intellectual property most profitably.

- *Whether the company will seek special tax privileges*
  Companies can also simply ask the state for special tax concessions. These are given by means of grants, subsidies, tax holidays, special tax rates, fiscal stability clauses, etc.

The strategies mentioned above bring together a number of choices; where to incorporate, where to borrow and where to place subsidiaries and intermediate holding companies. These decisions are viewed collectively by MNCs because they seek to create a structure for their MNC which minimises tax. The strategies can be legal or illegal, but mostly they fall in a grey area in between. It is therefore an ethical choice for a MNC whether to use these tax advantages or not.

Misinvoicing of trade transactions
This can be done in several ways, with the common thread between them that the import or export of goods are not reported truthfully or are even completely fictional. The different ways of misinvoicing are:

- Under-invoicing the value of exports; the goods are then sold on at full price once exported. The excess earned in this sale is the value of the capital flight.
- Over-invoicing the value of imports; the excess part is the value of the capital flight and is deposited in the importer's offshore bank account.
- Misreporting the quality or grade of imported products with the purpose of achieving over-valuation or under-valuation for the reasons listed above.
- Misreporting quantities with the purpose of achieving over-valuation or under-valuation for the reasons noted above.
- Creating fictitious transactions for which payment is made.
- These are all illicit ways of avoiding tax.

Abusive transfer mispricing
Transfer pricing involves determining the prices for sales between different entities within a multinational. It is estimated that more than 60% of international trade is now intra-firm trade between subsidiaries of the same multinational.[37] Transfer pricing is a legitimate practice, as long as it is undertaken using the 'arm's length principle', that is to say, the price should be equivalent to the open market price that would apply between unrelated and independent companies.[38] Normally, trading parties (companies, customers, suppliers) want to get the best price for themselves. However, when two companies trade that are under common ownership they do not want the best price for the individual company but a price that creates the best overall result for the multinational corporation to which they belong. The companies will therefore often allocate the profit between the two subsidiary companies in such a way that a minimal amount of tax has to be paid.

Transfer mispricing is the manipulation of prices of transactions between subsidiaries of multinationals, or more specifically, the sale of goods and services by affiliated companies within a multinational corporation to each other at artificially high or low prices. The motives and mechanisms are the same as those for misinvoicing. Christian Aid calculated that as a result of transfer mispricing and false invoicing alone, the loss of corporate taxes to the developing world is currently running at US$ 160 billion a year. That is more than one-and-a-half times the combined aid budgets of the whole world (US$ 104 billion in 2007).[39]

Some concrete examples of transfer mispricing are plastic buckets imported at $973 per unit, or toilet gloves imported at $4,122 per kg. The other way around, video cameras sold at $13 per unit or missile launchers sold at $52 per unit.[40]

International initiatives

When going over the problems with the current taxation system it is clear that the global reach of the issues is demanding an international approach. It is also evident that developing countries come off worst and need extra attention in the search for solutions. Tax issues therefore deserve a prominent place on the financial and development agenda.

Donor countries and international organisations have an important role to play here. Harmful tax practices are already a much-debated issue internationally, but more attention needs to be paid to the consequences for developing countries. Only then can more effective ways of oversight and regulation be found, and can a tax system be developed that is less sensitive to abuse. The section below describes existing policies, initiatives and guidelines of international organisations and forums. It also presents concrete policy recommendations for moving towards a fairer international tax system that is more supportive to development.

OECD

The Committee on Fiscal Affairs (CFA) directs the work of the OECD in the area of taxation. The CFA has developed the OECD Model Tax Convention and OECD transfer pricing guidelines.[41] The OECD Model Tax Convention forms the basis for many double tax treaties. For most types of income, especially business profits and investment income, double taxation is avoided in such treaties by allocating taxing rights between the resident and source countries and by requiring the former to eliminate double taxation where there are competing taxing rights.
The OECD transfer pricing guidelines emphasize the use of the arm's length principle of treating related enterprises within a multinational group and affirm traditional transaction methods as the preferred way of implementing the principle.

In 1998, the OECD issued its seminal report 'Harmful Tax Competition: An emerging global issue'. At the same time, the OECD started a programme against Harmful Tax Practices to encourage fair competition, and developed the OECD's Proposals on Harmful Tax Practices with requirements primarily on transparency and exchange of information.[42] These OECD Proposals have been analysed and debated within the structure of the OECD, mainly in the OECD's Forum on Tax Administration (FTA), the fourth meeting of which was held in January 2008 in South Africa. However, the OECD's Proposals on Harmful Tax Practices have not been fully implemented because some OECD members were not willing to accept the obligations, forcing the OECD to change it into a voluntary program.
In addition, the proposals do not address the problem of tax evasion or capital flight in non-OECD countries.
The proposals also require exchange of tax information between countries upon request only, which is no effective exchange of information.[43]

The 2000 Progress Report of the programme against Harmful Tax Practices identified 47 potentially harmful preferential tax regimes in OECD member countries.
A few regimes were later removed from this list because they were found not to be harmful on further analysis, several other regimes were abolished and some were amended to remove their potentially harmful features.
In the 2006 Progress Report, only Luxembourg's holding regimes were still considered to be harmful tax regimes.[44]
In addition, the OECD identified 41 tax havens outside the OECD. Three of these tax havens were later excluded from the list. 35 jurisdictions identified by the OECD have 'committed to work under the auspices of the OECD's Global Forum on Taxation to improve transparency and establish effective exchange of information in tax matters'. Andorra, Liechtenstein, and Monaco remain uncooperative tax havens.[45]

The Committee on Fiscal Affairs is establishing the improvement of exchange of information both from a legal and a practical perspective in bilateral Tax Information Exchange Agreements (TIEAs) between OECD countries and tax havens. At the time of writing, seventeen of such TIEAs have been signed since the beginning of 2007 by jurisdictions committed to work with OECD countries. Other negotiations are ongoing and are expected to lead to further new agreements in the near future.[46]

In summary, the OECD works to build support for fair competition so as to minimise tax-induced distortions. The main focus of this work is on improving transparency and exchange of information so that countries can fully and fairly enforce their tax laws.

Recommendation: To achieve effective exchange of information in tax matters, the OECD Committee on Fiscal Affairs should promote automatic exchange of information between all tax authorities. The current approach of exchange upon request between tax havens and OECD countries is less effective and does not help developing countries.

United Nations

Governments agreed at the 2002 Financing for Development conference to work towards: *'an enabling domestic environment'* for *'mobilizing domestic resources, increasing productivity'* and *'reducing capital flight'*. Since this Monterrey Consensus of 2002, the massive capital flight from third countries into OECD financial centres and into tax havens, and the resulting tax evasion and loss of tax revenue in developing countries, has severely undercut the ability of developing countries to mobilise domestic resources. At the 2005 World Summit it was agreed that the UN should *'support efforts to reduce capital flight and measures to curb the illicit transfer of funds'*.[47] However, too little is being done to implement these and other commitments. According to the Tax Justice Network, developing countries and countries which are not financial centres should emphasise this issue to the UN and adopt a more dynamic and forceful position at the UN and its departments.[48]

The UN has a Financing for Development Office (FfDO), which provides secretariat support for follow-up to the Monterrey Consensus and related outcomes of other UN conferences and summits.[49] The Follow-up International Conference on Financing for Development to Review the Implementation of the Monterrey Consensus will be held in Doha, Qatar, from 29 November to 2 December 2008. The UN also has a Committee of Experts on International Cooperation in Tax Matters (UN Tax Committee). ECOSOC (the Economic and Social Council) originally established this group in 1968 to develop the UN tax treaty model. The name and mandate of the group was changed in 1980 and again in 2004.The Committee currently consists of 25 tax administrators from 10 developed and 15 developing and transition countries. Apart from tax treaties, the Committee also examines tax evasion, tax avoidance, and capital flight, and promotes international tax cooperation and capacity building of tax administrations in developing countries.

At the end of 2007, the Committee discussed a proposal for a voluntary 'UN Code of Conduct on Cooperation in Combating International Tax Evasion and Avoidance'. This code would set minimum standards for countries on cooperation on measures to combat capital flight and international tax evasion and abusive tax avoidance, providing guidance to governments and private actors. Although the idea of the proposed code was widely supported, it was suggested that the focus should only be on tax evasion and not on tax avoidance. The proposed code is currently being revised.[50] In September 2008, the European Parliament expressed its support for the Code of Conduct and the UN Tax Committee, by calling upon the European Commission and Member States to *'ask that the Code (…) be annexed to the Doha declaration (on Financing for Development) and to support the transformation of the UN committee of Experts on International Cooperation in Tax Matters into a genuine intergovernmental body equipped with additional resources to conduct the international fight against tax evasion alongside the OECD'*.[51]

Recommendation: The UN Committee of Experts on International Cooperation in Tax Matters (UN Tax Committee) should be upgraded to an intergovernmental body in order to enhance international cooperation in tax matters, including between developed and developing countries. The committee should adopt a UN Code of Conduct on Cooperation in Combating International Tax Evasion.

IMF & World Bank

To tackle tax problems, apart from stronger cooperation and sharing of information between countries, there is also a need for regulatory measures. However, the IMF continues to advise its member governments not to use capital controls. Instead, the IMF encourages capital account liberalisation and financial sector liberalisation in developing countries. Capital account liberalisation involves the removal of controls on both domestic residents' international financial transactions and on investments in the home country by foreigners. Financial liberalisation involves the elimination of government intervention in financial markets, essentially allowing the market to determine who gets credit and at what price.[53] In addition, the World Bank and the International Monetary Fund (IMF) have advised developing countries to recover losses in trade tariff revenues by introducing consumption taxes, which has largely failed, as explained in the section on trade liberalisation.

In 2007, the World Bank launched the Stolen Assets Recovery Initiative (StAR). This is an important step in tackling the sensitive issue of capital flight from developing countries. However, the StAR does not consider the fact that there should be a shared responsibility on the part of the banks and financial centres that host stolen assets. Another very important downside is the fact that the World Bank focuses exclusively on the corruption-related illicit flows, and ignores the far more extensive commercial flows through tax evasion schemes used by transnational corporations.

The World Bank and the IMF are also engaged in capacity building activities. The IMF has regular missions to developing countries to provide technical assistance to tax revenue bodies. The World Bank provides loans for technical assistance, including in the area of tax administration.[54]

Recommendation: The World Bank and the IMF should pay more attention to the loss of trade tariff revenues as a consequence of trade liberalisation. They should stop advising developing country governments to increase revenues via consumption taxes, such as Value Added Tax (VAT), and stop promoting the use of tax incentives to attract foreign investment. The Stolen Assets Recovery Initiative (StAR) of the World Bank should be broadened to include illicit commercial flows related to tax evasion.

European Union

The European Union (EU) adopted a Code of Conduct for Business Taxation in December 1997. This Code provides criteria to identify harmful tax measures. EU member states have committed to end previously existing harmful tax measures ('rollback') and refrain from introducing new ones ('standstill'). A Code of Conduct Group, also called the Primarolo Group, has been established to monitor implementation of the Code. The Group meets four times a year and reports to the Ecofin Council. In November 1999, the Group identified 66 potentially harmful tax measures in EU member states and dependent territories. Many of these have since been abolished, altered, or judged not to be harmful.[55] In September 2008, the European Parliament adopted a report outlining the joint EU position for the Doha conference on Financing for Development.[56] In the report, the European Parliament calls on the Commission *'to include measures to prevent capital flight in its policies (…), with the goal of closing down tax havens, some of which are located within the EU or operate in close connection with Member States'.* [57]

In September 2004, the European Commission adopted a Communication on Preventing and Combating Financial and Corporate Malpractice, which provides a strategy for co-ordinated action in the financial services, company law, accounting, tax, supervision and enforcement areas to reduce financial malpractice. In the tax field, the Commission suggests more transparency and information exchange so that tax systems are better able to deal with complex corporate structures. The Commission also emphasises coherent EU policies concerning offshore financial centres, to encourage these jurisdictions to move towards transparency and effective exchange of information as well.

Recommendation: The EU Code of Conduct Group should continue to address harmful tax measures in the EU, including in the Isle of Man and Jersey. EU governments should enhance coherence between development policy and tax policy, as tax facilities for multinationals can have negative effects for developing countries and therefore be inconsistent with objectives for development cooperation.

International Accountings Standards Board (IASB)

The International Financial Reporting Standards (IFRS) are a set of agreements about what the content should be of an annual report of a company with a reporting obligation. These standards are managed by the International Accounting Standards Board (IASB) and were published for the first time on the 13th of October 2003. The IFRS are composed of the International Accounting Standards (IAS), expanded with some additional requirements. Since 2005 the IASB standards have the power of law within the European Union. The Internal Market and Services Directorate General of the European Commission shows the progress of the implementation of the standards in the European Union on its website.[58]

Tax Justice Network and Publish What You Pay[59] (a campaign promoting accountability in the management of revenues from the oil, gas and mining industries) want more amplification and are promoting country-by-country reporting as published accounts do not show intra-group trade and give little information about where a company made its profit.[60] This preserves the circumstances favourable to tax evasion, transfer mispricing, tax haven abuse, etc. After all, multinationals use subsidiaries to shift profits and risks between different jurisdictions – often to tax havens – yet current international accounting standards do not require them to publish relevant country-specific information on corporate income, profits, taxes, investments, assets and liabilities. Instead, the global standards set by the IASB permit companies to combine results from different countries into a single global (or regional) figure, and it is impossible to use company accounts to unpick these numbers for each country. All the trade between group companies disappears from view in the consolidated accounts that current IASB standards endorse.

At present the governments of developing countries cannot use company accounts to work out what taxes are properly owed by multinationals, and citizens of corrupt countries cannot work out what deals their rulers are making with multinationals. Additionally, small businesses and ordinary individuals worldwide pay more tax, and public services lack funding, because multinationals can use the opacity in company accounting to shift profits and minimise taxes, leaving others to pay instead. Also, important economic analysis essential for basic policy-making is made harder, and often impossible, by the lack of information on company activities.[61]

Country-by-country reporting would provide the information needed. The transparency that would be created as a consequence is essential for clean and efficient markets, and it underpins democracy and a respect for the rule of law. In addition, this expansion in transparency is important for investors because it provides them with crucial company information, information they need in order to know where exactly they invest in. It also creates a 'level playing field' for companies, making it easier for them to be more open about how they manage their responsibilities and contribute to society.

In November 2007, the Economic & Monetary Affairs Committee of the European Parliament requested the preparation of country-by-country reporting standards for the extractive industries. The European Commission and the IASB are to develop these standards. The TJN stated at that time that country-by-country reporting should apply to all multinational companies using International Accounting Standards, and not just the extractive industry. A major improvement in accounting transparency of multinational corporations requires transparency about all countries where they operate, what names they trade under, and financial performance in the countries in which they operate, including tax payments, TJN argued.[62] With regard to the Doha conference on Financing for Development, the European Parliament called on the Commission *'to ask the IASB to include (…) a country-by-country reporting requirement on activities of multinational companies in all sectors'*.[63] The guidelines for sustainability reporting of the Global Reporting Initiative (GRI), which are broadly supported by multinational corporations, already prescribe to *'report taxes paid by country'*,[64] but very few companies have fully implemented this core indicator.

Recommendation: The country-by-country reporting standard for the extractive industries, currently being developed by the International Accounting Standards Board (IASB), should require the disclosure of sufficiently detailed financial information per country to determine whether companies are paying a fair share of taxes in the countries in which they operate. Building on the standard for the extractive industries, country-by-country reporting should become mandatory for all other multinational corporations.

TG-7 and the Task Force on Illicit Financial Flows

In early 2004, a meeting of the presidents of France, Chile, and Brazil, together with UN Secretary General Annan, led to the signing of the 2004 Geneva Declaration and the initiation of the 'Technical Group on Innovative Financing Mechanisms'.[65] The Technical Group later grew to include Algeria, Brazil, Chile, France, Germany, South Africa and Spain and was called the 'Technical Group of Seven' (TG-7). The task of the TG-7 is to identify innovative sources of financing to fight hunger and poverty, identified as two of the most urgent issues within the MDGs. One key issue for the TG-7 is promoting international cooperation in tax matters with the aim of reducing tax evasion and avoidance through the use of tax havens.[66]

Two papers that form the basis of the TG-7 program are the 'Lula Report' on action against hunger and poverty, released in September 2004, and the 'Landau report' released in December 2004 and commissioned by President Chirac.[67] Both reports state, among other things, that taxes on financial transactions, arms trade and profits of multinational corporations can improve progress on the MDGs. Innovative financing for development has since become a regular feature in the agenda of important international forums.

In September 2005, 79 countries signed the Declaration on Innovative Sources of Financing for Development, and in 2006, 93 countries met in Paris on the occasion of the ministerial conference on Innovative Financing for Development.[68] During this ministerial conference, the Leading Group on Solidarity Levies was born, consisting of the TG-7 countries together with some 30 other countries. The Leading Group on Solidarity Levies in turn established the Task Force on Illicit Financial Flows during the follow-up conference on Innovative Financing for Development in Oslo in February 2007. This Task Force, with the aim of combating tax havens and capital flight, held two meetings assessing the problem of illicit financial flows and their development impact as such. In that process a wide range of proposals for action have emerged. The third and final meeting took place on 21-22 October 2008, at which a list of recommendations for the short and long term, important for the upcoming Doha summit, was to be discussed.[69]

The specific recommendations will ideally be agreed upon in time to be presented at the plenary meeting of the Leading Group, tentatively scheduled for 4-7 November 2008. The recommendations are, preliminarily, focused on the need for more and improved data, increased transparency, better information exchange in order to fight tax evasion and the use of tax havens, and measures to stop transfer pricing.

Recommendation: The TG-7 should also give attention to themes like information exchange between tax authorities, transfer pricing and its abuses, and the nature of tax treaties.

The Task Force on Illicit Financial Flows should continue to be active after the third meeting at the end of October in the form of a coordinating mechanism. Coordination is desirable in order to avoid overlap and to maximise synergies and flows of information.

More information

Websites:

- *Bretton Woods Project: www.brettonwoodsproject.org*
  The Bretton Woods Project is an initiative created by a group of British NGOs. It scrutinises and influences the World Bank and IMF by working as a networker, information-provider, media informant and watchdog.
- *Christian Aid: www.christianaid.org.uk*
  Christian Aid is an organisation that believes in the just and sustainable use of the earth and its resources. It tells governments, companies and institutions what should be done to address poverty, also with regard to fairer taxation.
- *Eurodad: www.eurodad.org/debt/?id=2190*
  EURODAD (European Network on Debt and Development) is a network of 54 NGOs working on issues related to debt, development finance and poverty reduction. Attention is being given to, among other things, capital flight and financial regulation.
- *Publish What You Pay: www.publishwhatyoupay.org*
  Publish What You Pay (PWYP) is a global civil society coalition that helps citizens of resource-rich developing countries hold their governments accountable for the management of revenues from the oil, gas and mining industries.
- *Tax Justice Network: www.taxjustice.net*
  TJN is an independent organisation dedicated to high-level research, analysis and advocacy in the field of tax and regulation. It works to analyse and explain the link between taxation and development and expose harmful tax practices in order to encourage reform at the national and international levels.

- *OECD: www.oecd.org/tax*
- *UN Financing for Development Office: www.un.org/esa/ffd*
- *Millennium Development Goals: www.un.org/millenniumgoals*
- *IMF: www.imf.org*
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- *European Commission: http://ec.europa.eu/taxation_customs/taxation*
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- *International Tax Dialogue: www.itdweb.org*
- *GRI: www.globalreporting.org*

Reports:

- *A rich seam: Who benefits from rising commodity prices?, Christian Aid*
  This report shows that despite spectacular rises in the commodity prices in oil, copper and gold, the 'equation' is still weighted very much in favour of the companies, with developing countries scarcely benefiting at all. This is partly due to the low amounts of tax that companies pay, as a result of tax competition.
- *Addressing development's black hole: Regulating capital flight, Eurodad et al.*
  This report sets out evidence on the impacts of unregulated finance on developing countries, arguing that increased regulation and different policies are needed as a matter of justice and to improve stability for citizens in richer and poorer countries.
- *Closing the Floodgates, TJN*
  The report is written with the purpose of providing the most comprehensive review ever published of the nature and scale of the tax problems, and a series of recommendations for how governments and international agencies might tackle them.
- *Conning the Congo, Greenpeace*
  This report shows how the German owned, Swiss-based logging multinational Danzer Group, one of the largest players in the Congo logging sector, is using an elaborate profit-laundering system designed to move income out of Africa and into offshore bank accounts, thereby appearing to evade tax payments in the countries in which its companies operate.
- *Death and Taxes, Christian Aid*
  This new Christian Aid report seeks to expose the scandal of a global tax system that allows the world's richest to avoid their responsibilities while condemning the poorest to stunted development.
- *Heavy Mittal?, Global Witness*
  This report is (partly)a case study of a well-established pattern of behaviour by MNCs around the world: to maximise profit by taking advantage of a regulatory void, which allows MNCs to structure their trade and investment policies through capital flight and aggressive tax avoidance or evasion strategies. This report was published in 2006, and has been updated in 2007.
- *Tax Revenue and (or) Trade Liberalization?, T. Baunsgaard & M. Keen*
  The purpose of this paper is to address the empirical question of whether countries have been able to compensate, from domestic sources, any loss of revenue from trade taxes that they have experienced as a consequence of trade liberalisation.
- *The 'Pay Your Taxes' Debate, UNRISD*
  This paper identifies and examines the relevance of certain corporate practices that undermine social, sustainable and economic development, in relation to foreign mining companies. These practices include non-payment of taxes, transfer pricing and intracorporate financial flows.
- *The Precarious State of Public Finance, J. Martens*
  This working paper provides an outline of what needs to be done in order to increase state revenues, reduce capital flight, and ensure that public expenditures are spent on appropriate development strategies. It also introduces different civil society networks and initiatives that focus on tax justice.
- *The tax consensus has failed!, A. Cobham*
  This paper briefly sets out the nature of the tax consensus, summarises its failings and then explains why these were inevitable.
- *From whom the windfalls?, Civil Society Trade Network of Zambia*
  Between 1997 and 2000, the state-owned company Zambia Consolidated Copper Mines (ZCCM) was divided into several smaller companies. The process took place under the supervision of the World Bank and IMF. Production and profits have significantly increased, but problems have arised too. This report highlights six problems, including harmful tax agreements.

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Colophon

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