

Fair Taxes

Providing opportunities for developing countries!

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The focus of development cooperation is usually on the amount of money transferred as aid from the North to the South. However a tremendous amount of money is leaving developing countries in the form of illegal financial flows. There is actually more money leaving developing countries than is received by overseas development aid. Estimates vary, but recent research shows that in the period 2000-2008 developing countries lost between \$725 billion and \$810 billion annually through illicit financial outflows.¹ The local governments are thus missing out on many funds, which they could spend to stimulate development. Therefore on one hand the EU is supporting developing countries by its development policy and aid programmes, but on the other hand the EU and in particular its Member States are enabling corporations to escape their tax responsibilities in developing countries. This is a flagrant case of incoherent policy.

Taxes are the most sustainable way of creating income for a government, because it is a stable and predictable form of revenue, especially compared to foreign loans or aid. Raising tax income in developing countries would increase their independence, since they would need fewer loans and aid and they could invest more in sectors like education, healthcare and infrastructure, which are traditionally financed from tax revenues. Therefore taxation has many benefits and contributes to a more sustainable and accountable government.

Why developing countries have difficulties to generate taxes

When it comes to generating taxes in developing countries, there are internal and external difficulties to be identified.² The focus of this policy case study will however be on the external factors having an impact on generating taxes in developing countries, as here the European Union (EU) can make a huge difference!

There are several reasons why external factors (factors from outside developing countries) make it difficult for developing countries to generate tax income. One reason is market liberalisation. The IMF and the World Bank have for instance introduced strict conditions on loans for developing countries. One of these conditions is the elimination of tariff barriers. Besides the IMF and the World Bank, the EU in terms of its trade agreements with developing countries, is forcing developing countries to liberalise great parts of their economies. For developing countries this means they can no longer

¹ Dev Kar and Karly Curcio, Illicit Financial Flows from Developing Countries: 2000-2009. Update with a Focus on Asia, Global Finance Integrity (http://www.gfip.org/storage/gfip/documents/reports/IFF2010/gfi_iff_update_report-web.pdf), p. 29.

² For a recent researched example of this, [click here to go to Action Aids report on Sabmiller](#). This brewery is avoiding to pay taxes in Ghana.

generate taxes from tariffs or export taxes (please see our case studies on the EPAs and the Raw Materials Initiative). Along with market liberalisation comes Foreign Direct Investment (FDI), which of course does provide for important opportunities for developing countries. FDI does not only provide more inflow of foreign currency, but it also transfers skills and provides jobs for the local population. However, as many developing countries are very eager to attract FDI, they have started to compete with one another, in order to attract more investments. By introducing tax holidays (a period in time when tax rates are lower) or tax-free areas (a specific area in which taxes are lower) developing countries try to pursue Multinational Corporations (MNCs) to invest in their country. Yet these incentives only have a short term effect, because neighbouring countries are likely to reduce their tax rates as well, creating a race to the bottom between various developing countries. Besides, it has been estimated that the positive effect of FDI can in most situations not exceed the loss in tax revenue.³

The existence of tax havens and the practice of tax evasion are another reason why developing countries generate fewer taxes. Tax havens are territories with low tax rates, where transferred money is being protected from the scrutiny of foreign tax administrations. There are many different definitions used for a tax haven, making it difficult to deal with them on an international level. The definition of the OECD is most commonly referred to; tax havens are harmful preferential tax regimes that have no or only nominal tax rates, lack transparency, lack effective exchange of information and do not require activities to be substantial (i.e. transactions are allowed without the requirement of adding value).⁴ In the light of this definition, there are 40 countries considered as tax havens. However these countries have all disappeared from the OECDs blacklist, because they promised to become more transparent and introduce exchange of information.⁵ Other sources, like the Tax Justice Network, actually recognise over 70 tax havens world wide.⁶ In the EU, Ireland, Belgium, Luxembourg and the Netherlands are the main tax havens. Other EU countries have offshore islands that are used for the same reasons, examples are Jersey and the Cayman Islands.⁷ The practice of Tax evasion is more complicated to describe and is explained in more detail below.

³ Thijs Kerckhoffs, International barriers to raising tax revenues in: Research papers supporting developing countries ability to raise tax revenues, International barriers to raising tax revenues, p. 12.

⁴ Tax haven criteria, Organisation for Economic Co-operation and Development (OECD) (http://www.oecd.org/document/23/0,3343,en_2649_33745_30575447_1_1_1_1,00.html).

⁵ Identifying tax havens and offshore finance centres, Tax justice network (http://www.taxjustice.net/cms/upload/pdf/Identifying_Tax_Havens_Jul_07.pdf).

⁶ Ibid.

⁷ Ibid.

Tax Evasion by Multinational Corporations

Multinational Corporations are responsible for 64% of the illicit financial flows, and are thus taking advantage of the above explained situation in developing countries.⁸ Because of the eagerness of many developing countries to receive FDI, MNCs have a strong negotiation position. The motives for a company to move towards a specific country are diverse and taxes are not always decisive.⁹ However MNCs do put pressure on developing countries to reduce their tax rates and to give other fiscal advantages. By paying fewer taxes companies are maximizing profit, which is their ultimate goal. MNCs are thus avoiding to pay taxes, but this is not illegal. Though one can argue it is morally incorrect.

Tax evasion however is illegal. This is when companies deliberately use illegal schemes to evade paying taxes at all in the country where the profit is being made. Large MNCs have many daughter branches all over the world, they sell their products from one to another, and manage to shift money from one place to the next. It is estimated that 60% of international trade occurs within MNCs.¹⁰ In international trade, when selling to a daughter company the arms length principle should be applied, meaning that the price paid should be similar to the price on the world market. It is often unclear which daughter branches belong to which MNC. The same owners usually have many other companies, trust funds, foundations, and charities. This makes it difficult to see if a genuine transfer is being made, or money is just being shifted from one branch to another.

Obviously it is much more attractive to manipulate the price to a level which creates the highest fiscal advantage. This is known as transfer pricing. By paying an unrealistic price the money is transferred abroad.¹¹ Transfer pricing is very hard to trace back in the accounting figures of a company, but sometimes the crime is obvious. Like in 2004 when 400.000 ton of platinum was imported in the United States (US) from the Dominican Republic. The price paid was only just over three-thousandths of the market price, while the Dominican government would have taxed the export for more than US\$4.5 million if

⁸ International barriers to raising tax revenues, p. 14.

⁹ While granting tax incentives to attract investment, particularly foreign direct investment, is common in developing countries, evidence suggests that effectiveness of incentives in attracting incremental investments is questionable. Tax incentives can be abused by existing enterprises disguised as new ones through nominal reorganisation. Foreign investors base their decision to enter a country on a whole host of factors (natural resources, political stability, transparent regulatory systems, infrastructure, a skilled workforce) of which tax incentives are frequently far from being the most important one. - Vito Tanzi and Howell Zee, "Tax policy for Developing countries", in IMF Economic issues, N° 27, March, 2001.

¹⁰ Transfer pricing, Tax Justice Network (http://www.taxjustice.net/cms/front_content.php?idcat=139).

¹¹ International barriers to raising tax revenues, p. 16.

the normal price had been paid.¹² Transfer pricing is only one example of tax evasion, companies can also use false invoices to import or export goods at manipulated prices. Once the money is out of the country it moves through different companies in various countries, until it reaches its final destination in a tax haven. According to the World Bank 60% of all international financial and trade transactions involve tax havens.¹³ The money will not always be placed on a bank account in a tax haven. Because many countries offer tax incentives for FDI when it is entering the territory, it is attractive for companies to reinvest money that previously left the country illegally, which then also distorts the FDI figures.¹⁴

European Taxation Policy

The EU has implemented several policies and initiatives on taxation. These will be described below and could be seen as a starting point for a common European taxation policy. It is however important to keep in mind that for now the system is based on minimal harmonisation.

In 1997 an EU Code of Conduct for Business Taxation was created. Although this was a voluntary initiative, it helps to identify harmful tax practices within the EU, and many of them have been abolished. The Primarolo Group was created as a monitor for the code, however the operation and functioning of this group is not transparent.¹⁵ The EU Joint Transfer Pricing Forum was created in 2002.¹⁶ This forum consists of experts from the Member States and the field of business. They work within the framework of the OECD transfer pricing guidelines, and the goal is to create non-legislative solutions to practical issues. The primary focus is on arbitrage in transfer pricing cases.¹⁷

The European Savings Directive (ESD) introduced in 2005, is another example of EU policy in taxation matters. The directive introduced an automatic exchange of information on interest paid by paying agents, like banks, on savings of citizens of European Member States. In order to be able to tax a person or company properly, governments need the necessary information. For many years people stashed their money in countries that did not exchange information with third countries. Due to the savings directive this is no longer possible for personal savings. Countries that historically had bank secrecy, like

¹² A rich seam. Who benefits from the rising commodity prices, Christian aid (http://www.christianaid.org.uk/Images/a_rich_seam.pdf), p. 10.

¹³ Magnitudes: dirty money, lost taxes and offshore, Tax Justice Network (http://www.taxjustice.net/cms/front_content.php?idcat=103).

¹⁴ International barriers to raising tax revenues, p. 16-17.

¹⁵ Ibidem, p 13.

¹⁶ International barriers to raising tax revenues, p. 24.

¹⁷ Ibid.

Luxembourg, have implemented the directive over several years. However, the directive has loopholes and it is still possible to avoid paying taxes.¹⁸

More financial markets transparency is a next step on which the EU wants to take action. The European Commission published the report Operation of Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market.¹⁹ Transparency is key in the battle against tax evasion, and this initiative taken by the Commission to force European companies to disclose periodic financial data should be welcomed, although more radical action is needed.

Next to the Operation of Directive 2004/109/EC, in 2010 the Commission also published a Communication on Tax and Development Cooperating with developing countries on promoting good governance in tax matters. In this Communication, the EU shows willingness to support third countries in good governance on tax matters, meaning transparency, exchange of information and fair tax competition. The Commission proposes to create coherence between tax and development policies in order to assist developing countries in creating sustainable domestic tax systems to increase the tax-to-GDP-ratio, also the Commission gave its support to the establishment of a country-by-country reporting standard for MNCs, notably in the extractive industry.²⁰

European Development Policy

Development stands high on the EU's political agenda. The central basis is laid down in article 208 of the Treaty on the Functioning of the EU (TFEU). Here it is stated that the main goal of the European development policy is to reduce and eventually eradicate poverty world wide. Furthermore the EU has committed itself to the Millennium Development Goals (MDGs), which function as the political framework in which the EU's development policy is executed. MDG objective 8 aims to develop a global partnership for development, of which target A is to further develop an open, rule-based, predictable, non-discriminatory trading and financial system. Yet out of all the MDGs this one unfortunately receives least attention.

Policy Coherence for Development, both has a political (European Consensus on Development) and legal basis in the EU. In article 21 of the Treaty of the European Union (TEU) it given a legal status, by stating that *The Union shall ensure consistency between*

¹⁸ A European agenda to fight capital flight, Eurodad (2008) p. 1.

¹⁹ COM(2010)243.

²⁰ COM(2010)163.

*the different areas of its external action and between these and its other policies.*²¹

Moreover in article 208 on development policy it is also stated that *The Union shall take account of the objectives of development cooperation in the policies that it implements which are likely to affect developing countries.* However when the EU's taxation policy and development policy are put next to one another, there is still little coherence.

In the framework of its development policy, the EU provides development aid to many developing countries in the form of assistance programmes. In 2009, the EU spent € 4.084.49 million on social infrastructure and services, this is 39% of the total budget for Official Development Assistance (ODA). Of this total € 905.96 million was spent on education and € 424.25 million was spent on health in developing countries.²² These are sectors which are traditionally financed from tax revenues. To compare, it is estimated that in 2009 developing countries missed out on € 569.268.81 million through transfer pricing alone.²³ This clearly shows that on one hand the EU is supporting developing countries by its development policy and aid programmes but on the other hand the EU and in particular its Member States are enabling corporations to escape their tax responsibilities in developing countries. A clear case of incoherence!

More Fair Policies!

European policy is failing to truly address the problem of illicit capital flight and tax evasion. First of all, there is still a lack of transparency within the EU. In the Transparency Directive the Commission fails to mention some suggested initiatives that would make the financial sector truly transparent for both European and third countries, like the country-by-country reporting. Country by-country reporting would force companies to disclose what taxes are paid per country.²⁴ This would oblige companies to disclose what taxes should be paid in which country. If a MNC is doing honest business, this will not have any effect on the company, since the taxes are already paid. Yet at the moment this is not obliged, and therefore tax evasion cannot be traced back in the companies accounting figures. If this were to be introduced, both developing countries as well as European countries, would be able to tax the companies what they are required to pay in their territories. It would also give insight in what money is transferred to tax

²¹ Consolidated versions of the Treaty on European Union and the Treaty on the Functioning of the European Union (<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:115:0001:01:EN:HTML>).

²² Annual report 2010 on the European Unions development and external assistance policies and their implementation in 2009 (http://ec.europa.eu/europeaid/multimedia/publications/documents/annual-reports/europeaid_annual_report_2010_en.pdf).

²³ Kar and Curcio, *Illicit Financial Flows from Developing Countries: 2000-2009*, p. 11.

²⁴ Country-by-country reporting is an accounting tool that would enhance the quality of the comparable data which would, in turn, help developing country tax administrations and civil society to raise red flags regarding potential abuse worthy of further investigation. This level of transparency would assist in the efficient operation of markets and the enforcement of current international standards on transfer pricing as well as potential alternative methods of taxing multinational companies.

havens.²⁵ The Commission has recently held a public consultation on country-by-country reporting and is expected to publish new communications on this and the Transparency Directive in the second half of 2011.²⁶ This would be the perfect opportunity to present new policy initiatives to tackle the issues raised above.

Secondly, the Member States are not forced to expand the current system of automatic exchange of information, let alone share information with third countries. The European Savings Directive (ESD) has many loopholes which make it easy for citizens to transfer their money to trusts or companies. Decisions on tax matters within the EU have to be taken by consensus, and the Member States whose main business often depends on bank secrecy are against possible improvements, therefore the current discussion on improving the directive is stuck. The fact that there are Member States depending on bank secrecy indicates that there are still tax havens on European territories. There have not been any policy initiatives on a European level to dismantle the tax havens, moreover most Member States are denying the allegations of being or supporting tax havens. It has been proven by the US that it is possible to introduce more fair tax policies. In July 2010 the Dodd Frank Wall Street Reform and Consumer Protection Act was introduced. Next to reforming Wall Street, this act also included clauses on the extractive industries and Congo Conflict Minerals. Companies listed in the US and active in the extractive industries are now obliged to publicly disclose how much taxes they (or subsidiaries and partners) paid to the US government and foreign governments on a country-by-country and a project-by-project basis. Some EU based companies active in the extractive sector are listed in the US and will therefore be subject to this Act. If the minerals were extracted in the Democratic Republic of Congo (DRC), the company must also disclose the measures taken to introduce due diligence on the origins and chain of custody of the used raw materials. To conclude, the US government introduced country-by-country reporting for the extractive industries. In addition, if conflict minerals were used it will be traceable for governments and consumers.²⁷ This US bill represents an important step in the right direction and is certainly an example to be followed.

Conclusion

Tax evasion is a large threat to development. Raising taxes is the most stable and sustainable way for a government to receive income, yet compared to developed countries, developing countries are raising significantly fewer taxes. In addition, up to ten

²⁵ Country-by-country reporting: how to make multinational companies more transparent, Tax justice briefing (http://www.taxjustice.net/cms/upload/pdf/Country-by-country_reporting_-_080322.pdf).

²⁶ Consultation on Financial Reporting on a Country-by-Country Basis by Multinational Companies (http://ec.europa.eu/internal_market/consultations/2010/financial-reporting_en.htm).

²⁷ Brief summary on the Dodd-Frank Wall Street reform and consumer protection act, (http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf).

times more money is leaving developing countries than is received in terms of aid. This problem should be addressed in order to give development a chance. Developing countries have to deal with their large informal sector, a weak internal taxation system, as well as the consequences of the liberalisation of the world market, the competition for FDI, and the existence of tax havens. These all set the stage in which MNCs have the possibility to evade taxes. The EU claims solutions for these problems should be taken on a global level. However not acting is no option for the EU when the impact on development is this large. More coherence between European tax and development policy is necessary in order to make development work.

POLICY RECOMMENDATIONS:

- The European Savings Directive needs to be extended by the European Member States. The automatic exchange of information should include companies and trust funds as well. This creates the opportunity to get information on MNCs as well as individuals, and it would make it more difficult to evade taxes.
- The European Commission should be mandated to impose strict penalties on Member States which do not comply with good governance in tax matters, like the Member States that still support tax havens on their territories.
- The European Union, on behalf of the Member States should oblige country-by-country reporting for MNCs enlisted in the EU.
- The European Union should oblige MNCs to disclose the beneficial ownership, which would create transparency on transfers between companies, and increase the chance of ending transfer pricing.²⁸

²⁸ A call by global civil society on France as the host of G20 in 2011, (<http://xa.yimg.com/kq/groups/3546395/1666751075/name/Tax+havens+and+development+-+CSO+call+on+France+for+G20+2011.doc>) p. 2.

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