Accounting for poverty

How international tax rules keep people poor

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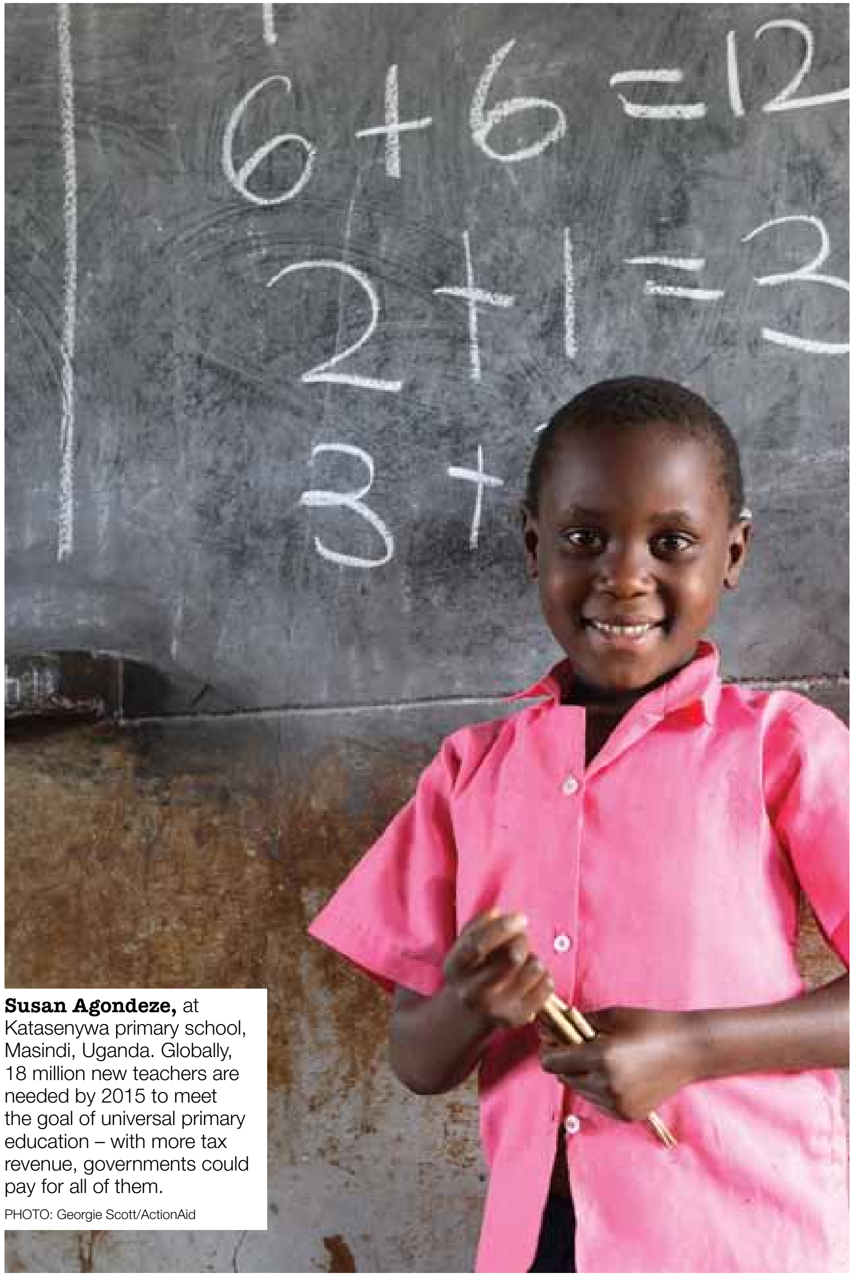


Susan Agondeze, at Katasenywa primary school, Masindi, Uganda. Globally, 18 million new teachers are needed by 2015 to meet the goal of universal primary education – with more tax revenue, governments could pay for all of them.

PHOTO: Georgie Scott/ActionAid

Foreword

The first half of 2009 brought with it an extraordinary and unexpected burst of activity concerning international tax matters. Tax havens found themselves in the eye of a proverbial perfect storm. A new US president with a track record of seeking to "stop tax haven abuse"; an unprecedented banking crisis with some of its roots in offshore finance; a global recession and a Keynesian response to it that meant governments needed to eke out every last pound of tax revenue; high-profile examples of tax evasion uncovered in Liechtenstein and Switzerland – all seemed to coalesce around the sequence of G20 meetings and in particular the London Summit in April 2009.

But the London Summit represented another important milestone. It was the first time that the governments of the major economies – following the lead taken by the UK – acknowledged the impact of international tax rules on developing countries. This began with British Prime Minister Gordon Brown's promise in advance of the summit that,

> "we will set out new measures to crack down on the tax havens that siphon off money from developing countries – money that could otherwise be spent on bednets, vaccinations, economic development and jobs."

Until this point, few would have predicted the summit's ensuing commitment to, "developing proposals, by end 2009, to make it easier for developing countries to secure the benefits of a new cooperative tax environment," a process which, at the time of writing, is still ongoing.

The centre of gravity of the current global political debate rests with the G20 and OECD, both groups of some of the world's richer countries. Many small states have been branded 'non-compliant' and told that they must meet an international standard of information exchange. These states have the option of doing the minimum possible to meet this standard, but alternatively they could choose to become an important part of the solution by championing the need for real, improved transparency.

The new UK government policy was subsequently enshrined in its International Development White Paper, which acknowledged both that "tax systems in developing countries are undermined by international banking secrecy, including in tax havens," and that "ineffective taxation undermines countries' ability to provide the basic services that underpin fairness as well as growth."

This shift in government policy was in part the result of nearly a decade's campaigning and research, by academics, activists and charities in the Tax Justice Network.

ActionAid started doing research into this issue in early 2008 and started campaigning on tax shortly before the breakthrough of 2009 occurred. Our staff and partners in developing countries led the way to this area of work. They believe that developing countries should themselves be able to finance more of the services that are essential to tackling poverty, through tax revenue. The problem is that much of this revenue is lost through tax avoidance and evasion, given away in tax concessions to multinational companies, or not raised in the first place because of deficits in tax policy and administration.

This paper sets out some of the steps that ActionAid believes need to be taken, at global and national level, so that developing country governments can effectively fund poverty reduction efforts in a way that reinforces their sovereignty and accountability to their citizens. It builds on the work of our colleagues in the Tax Justice Network and elsewhere, and underpins ActionAid's work in the UK and globally to achieve tax justice for the poor in developing countries. As we publish this report, there are more opportunities than ever before to make such progress: it is up to the leaders of rich and poor countries alike to seize them.

Nurun Nahar Begum, at Naora government primary school, Shahrasti, Chandpur, Bangladesh. The school has 400 students, but only nine teachers. Bangladesh's government wants to reduce the pupil-teacher ratio, but needs more tax revenue to do it.

PHOTO: GMB Akash/Panos Pictures

Executive summary

Keeping poor people poor

Governments in developing countries need to spend more money on essential public services if they are to have a serious impact on poverty.

Take the United Nations Millennium Development Goals (MDGs), a set of targets for halving extreme poverty, providing universal primary education, halting the spread of HIV and AIDS and much more by 2015. Ambitious, yes, but achievable.

To meet many of the MDGs, governments will need to hire more public sector employees, from teachers and doctors to agricultural extension workers. For example, it is estimated that 18 million new teachers will be needed between 2004 and 2015 to achieve universal primary education. As for healthcare, the World Health Organization (WHO) estimates that there is a global shortage of 4.3 million health workers.

In 2010, governments will need US$178 billion (£96 billion) in external assistance to get on track to meet the MDGs, yet in 2008 they received US$120 billion (£65 billion) – leaving a US$58 billion (£32 billion) shortfall. Since then, a number of countries including Italy, France and Ireland have reduced their aid commitments.

Meanwhile, the financial crisis and recession have reduced the chances of meeting the MDGs yet further. For example, ActionAid has calculated that African economies will suffer a real drop in income of US$49 billion (£27 billion) between the start of the financial crisis in 2007 and the end of 2009. As a result, governments will be left with less money to spend on fighting poverty. Predicted tax revenues have fallen by 6.8% in India in a year. African countries as a whole are expected to go from a budget surplus of 1.8% of GDP in 2008 to a deficit of 5.1% in 2009.

Unless this gap is filled, many people will continue to live in poverty.

"One of the most pressing issues facing our continent is to embark on a path to free African countries from their dependence on foreign assistance and indebtedness. An indispensable condition of this is the strengthening of our capacity to mobilise domestic resources."
African Tax Administrators' Forum, Pretoria, 2008

"Pay your taxes and set your country free."
Kenya Revenue Authority slogan

"Taxation is key to increasing our legitimacy and ability to make our own decisions."
Mary Baine, Commissioner General, Rwanda Revenue Service, 2009

What better tax rules could do

Low-income countries – and most middle-income countries too – raise a much smaller proportion of their national income in taxes than rich countries. The average for low-income countries as a whole is just less than 15% of national income, but many raise a much smaller proportion; in contrast, the world's richest countries raise on average 37%.

Although it will be a long time before developing countries can match their richer counterparts in terms of tax revenue, experience shows that with adequate political will and external assistance, a lot can be achieved within a few years:

- Rwanda quadrupled the amount of tax it raised between 1998 and 2006
- Uganda raised its tax-to-GDP ratio from 7.2% to 12.6% in just over a decade
- South Africa now raises 29% of its GDP in tax, compared to 24% in 2001

ActionAid has calculated that, if all developing countries were able to raise just 15% of their national income as tax revenue – a commonly accepted minimum figure – they could realise at least an additional US$198 billion (£99 billion) per year. This amount is more than all foreign development assistance combined, and enough to meet and exceed the annual MDG funding gap.

Stealing from the poor

The globalisation of financial flows has created many new opportunities for companies and individuals to evade taxes in developing countries, undermining the revenue base desperately needed for development.

Many multinational groups of companies are complex structures with hundreds of subsidiaries, a substantial number of which may be located in tax havens. Profits are allocated between subsidiaries through internal trading, a complicated process that is hard for tax authorities to police. It allows for profits to be allocated to subsidiaries in tax havens, reducing a group's overall tax liability. *The Guardian* calculated in 2007 that the world's three biggest banana companies paid on average 14% tax on their profits, despite all three having their head offices in the US, where the corporate tax rate is 35%.

Some companies further take advantage of the system through transfer mispricing, manipulating the prices at which internal trading takes place. Global Financial Integrity (GFI), a research institute based in Washington, DC, has estimated the amount of money that leaves developing countries as a result of transfer mispricing. For 2006, it put the figure at between US$471 billion and US$506 billion (£262 billion and £275 billion).

8%: the amount of Bangladesh's national income raised in tax;

37%: the amount of the UK's national income raised in tax

US$160 billion (£89 billion): the estimated annual cost to developing country governments of tax evasion by multinational companies

Christian Aid estimates that developing countries collectively lose US$160 billion (£89 billion) in tax revenues as a result of transfer mispricing and other international tax evasion by multinational companies. This is only one aspect of international tax evasion: in total, the South African Revenue Service estimates that it loses up to R64 billion (£4.7 billion) each year in revenue because of tax evasion in tax havens. The Tax Justice Network estimated that governments across the globe lose $255 billion (£140 billion) annually in tax revenues from high net worth individuals, based on the likely income earned on some $11.5 tillion (£6.3 trillion) of assets held offshore.

Recommendation: a county-by-country financial reporting standard

Spotting potential cases of transfer pricing abuse is made harder than it might otherwise be by international financial reporting standards (IFRS), which only require multinational groups of companies to report on a consolidated basis – that means one set of accounts showing the overall financial activities and results for the group, without breaking them down for each country. Introducing a country-by-country reporting standard into IFRS would help civil society, the media and tax authorities to uncover potential cases of tax avoidance and evasion.

The Organisation for Economic Cooperation and Development (OECD) has been asked to study the feasibility of a country-by-country reporting standard. It should report back to the G20 and United Nations during 2010, and these bodies should formally request that the International Accounting Standards Board, which sets IFRS, adopts it.

Recommendation: better tax information exchange

Tax authorities in developing countries need to be able to gather information from their counterparts in other countries, so that they can build up a picture of a company's profit-making activities and financial transfers – or indeed an individual's income generation – across the globe. At present, even if they have an information-sharing agreement with another state, tax authorities have no automatic right to this information – ie currently they must demonstrate that the information they are requesting is 'foreseeably relevant' to their administrative or enforcement work, and provide a prohibitively large amount of information to prove this.

Ongoing discussions at the G20 and OECD should result in a fully global, multilateral tax information exchange agreement, which lays the foundation for an eventual automatic tax information exchange system. It should incorporate multilateral countermeasures for non-compliance and, if they request it, support for developing countries to develop their technical capacity so that they can adhere. A robust review mechanism will be essential to evaluate benefit to developing countries.

Taxing across borders

When a company's supply chain – or an individual's income-generating activities – spans several countries, which government should benefit from the tax revenues they owe? Countries tackle this question differently, and many – including developing countries – have signed double taxation agreements to clarify the situation. Yet this global system of different treaties and tax rules has created opportunities for businesses and individuals to exploit the system, by arranging their dealings and the way they distribute their income to avoid tax payments.

An important example is the channelling of investments through tax havens, to reduce the taxes paid by subsidiaries in developing countries. This is why in 2002 (the most recent year for which data is available), 46% of Foreign Direct Investment (FDI) flowing into Brazil came from tax havens. Similarly, 43% of India's FDI between April 2000 and March 2009 came from Mauritius.

Double taxation agreements (DTAs), which are a necessary part of the picture to prevent the same income being taxed twice, can contribute to such tax avoidance measures. For example, Mauritius – an important source of investment for African countries – has DTAs with a large number of countries, including 10 African states. The DTAs prevent African countries from taxing capital gains made within their borders by Mauritius-based investors, and put a maximum ceiling on the taxes that African countries can apply to dividends earned by Mauritius-based investors. The result: developing countries miss out on tax revenues from multinational investors.

Recommendation: stronger taxing rights for developing countries

A system of taxation that confers more taxing rights on the country in which income arises, and insists that tax residence be more closely linked to economic activity, would be of more benefit to developing countries. Governments should therefore ensure that double taxation agreements into which they enter strike an optimal balance between raising revenue and attracting investment that benefits poor people.

Developing countries should work together to promote and improve the United Nations 'model double taxation convention', a double taxation treaty that better takes developing countries' needs into account, especially through the United Nations Committee of Experts on Tax Matters that developed it.

"Aggressive tax avoidance is a serious cancer eating into the fiscal base of many countries."
Pravin Gordham,
South African Finance Minister, 2009

"These times call for a tougher attitude from employers, workers and governments. We cannot go on living with tax havens."
Luiz Inacio Lula da Silva,
Brazilian President, 2009

"We should endorse sharing information and bringing tax havens and non-cooperating jurisdictions under closer scrutiny."
Manmohan Singh,
Indian Prime Minister, 2009

The great tax giveaway

The use of tax incentives to compete for investment has been a cornerstone of development plans for many years. The doctrine of 'tax competition' casts countries in the role of competitors in a marketplace for investment, despite the numerous problems with this analogy. Perhaps the most high-profile example is the World Bank and PriceWaterhouseCooper's annual 'Doing Business' indicators, which since 2006 have included a ranking of countries according to an estimate of the 'total tax rate' incurred by companies. "Lower tax burdens for businesses lead to more economic activity," is the philosophy espoused by its creator.

The principal long-term incentive offered by developing countries is a reduction in the corporate tax rate. Africa's low-income countries reduced it from 44% in 1980 to 33% in 2005. Others include tax holidays, typically a reduction in or exemption from profit taxes, royalty fees and/or trade tariffs for the first few years of an investment. A recent IMF survey of sub-Saharan African countries shows a remarkable increase in these tax incentives: in 1980 less than half offered tax holidays; by 2005, more than two thirds did.

There is conflicting evidence on the effectiveness of tax incentives. While there is some evidence to suggest that tax rates affect investment decisions, the quality and quantity of the investment that tax incentives attract is questionable. "Foreign investors, the primary target of most tax incentives, base their decision to enter a country on a whole host of factors… of which tax incentives are frequently far from being the most important one," says an IMF paper from 2001.

Tax incentives can cost developing countries dear. In 2008-09, India gave away 11.4% of its entire tax revenue – £8.8 billion – through concessions to businesses. Reductions in mining royalty payments in Zambia cost US$63 million (£35 million) in foregone revenue between 2004-6.

Recommendation: tax business fairly

It is the responsibility of national governments to design tax systems that will raise enough revenue to finance public investments and redistribute wealth equitably. Governments should aim to strike an optimal balance between raising revenue and attracting investment that benefits poor people when setting corporate tax rates and offering tax incentives, and refrain from granting tax incentives unless there is a well established evidence base to demonstrate the benefit for poor people of similar incentives.

In particular, governments should undertake tax expenditure analyses that show the extent of tax incentives as part of the budgetary process; they should refrain from fixed-term tax holidays and from granting discretionary tax exemptions to individual companies. International organisations such as the IMF and World Bank should not encourage countries to put in place tax policies that further the race to the bottom.

Companies should not use economic or political power to extract tax incentives from developing country governments. At a minimum, they should comply with the OECD Guideline II (5): "Refrain from seeking or accepting exemptions not contemplated in the statutory or regulatory framework related to environmental, health, safety, labour, taxation, financial incentives, or other issues."

Tax authorities: a worthwhile investment

Another reason for low tax revenues in developing countries is that tax administrations are poorly resourced and lacking in staff capacity. In Bangladesh, for example, for resourcing and political reasons the National Board of Revenue has not been able to hire any new qualified tax officials for over 20 years. Though VAT and customs units are supposed to have 7,326 staff, at least half of these are vacant posts.

Significant investment of resources, expertise and political will in a tax authority can substantially improve the depth and breadth of a country's tax base, and improve compliance. With the help of foreign assistance, Rwanda built the autonomy and capacity of its revenue authority, increasing the amount of revenue it collected fourfold in eight years. Yet in 2005, only 1.7% of the US$7.1 billion (£3.9 billion) in bilateral aid committed for public sector administration went to improving tax administration.

Recommendation: investing in tax authorities
Developing countries should invest time, money and political will in strengthening national tax inspectorates with the aim of substantially increasing the proportion of their national budgets that come from domestic tax revenue, and the overall size of the budget, to meet their international poverty reduction commitments. Rich-country governments and international donors should increase the funding and technical assistance available to developing countries that request it.

All countries need to be involved

Combating international tax competition, avoidance and evasion in a way that benefits developing countries requires a forum that can create and enforce global rules designed to benefit all. Yet at present there is no global body that possesses the political mandate, legitimacy and technical expertise necessary to do this.

Work is proceeding fastest through the G20 and OECD, but both bodies have a big representative problem: they are rich countries' clubs, even though they may invite developing countries to participate in some initiatives. The United Nations Committee of Tax Experts suffers from a lack of political mandate and resources.

Recommendation: more inclusive global cooperation
Tax cooperation should ultimately be tackled by a representative political body with a political mandate from all countries. As a first step, all governments should support the United Nations Committee of Experts on Tax Matters by upgrading it to an intergovernmental body, and by promoting its Model Tax Convention and Code of Conduct on Cooperation in Combating International Tax Evasion.

Tax is a fundamentally political matter, and all governments need to take responsibility for changing a global system that benefits the rich, at the expense of the poor.

US$198 billion (£99 billion): the extra amount governments in developing countries would gain each year if they raised just 15% of their national income in tax

1. What better tax rules could do

Governments in developing countries need to spend more money on public services if they are to have a serious impact on poverty. If current trends continue, the gap between the amount that is available to governments and the amount they need to meet their international poverty reduction commitments will keep growing, especially as public finances the world over take a hit from the global recession.

There is, however, a source of revenue available to the governments of developing countries that, if it were tapped more effectively, could provide them with enough extra finance to meet and surpass their international commitments: tax. Not only is tax a potential source of greater funds to invest in public services, it is also widely preferred to other forms of income because of its relative stability, its intimate link with better governance and accountability, and the opportunity it creates for greater autonomy on the part of developing countries.

Tax revenue already makes up the bulk of most developing-country governments' spending, yet it amounts to a relatively small proportion of their national income. Some have used international funding and technical assistance to invest in better tax administration, and as a result have seen dramatic increases in their tax revenues in the space of a few years, but for many the potential to raise much more remains unexploited.

Many institutions have a role to play in eradicating poverty, but the responsibility for doing so – and the capability to do it – rests first and foremost with governments. It is their role to ensure that the human rights of all their citizens are respected, promoted, protected and fulfilled. Nowhere is this more important than the rights of women and girls in developing countries, frequently the poorest and most marginalised people.

It was in that spirit that the leaders of the world's governments, rich and poor, agreed in 2000 to a set of poverty reduction goals, the United Nations Millennium Development Goals (MDGs), which set a target of 2015 for halving extreme poverty, providing universal primary education, halting the spread of HIV and AIDS and much more.[1] To meet many of the MDGs, governments need to invest much more in public services and hire more public servants, from teachers and doctors to agricultural extension workers.

Fighting hunger

In 2009, more people are going hungry than ever before; over one billion people are going without even one square meal a day.[2] But beyond food security, it is widely accepted that the returns on investment in agriculture are higher than in most other sectors; GDP growth originating in agriculture raises the incomes of the poorest third of the population at least 2.5 times more than growth originating in non-agricultural areas of the economy.[3]

Publicly funded goods and services are often critical for local and regional agriculture. More resources would enable developing country governments to support agriculture through infrastructure in rural areas; inputs to increase sustainable small-holder food production; support for small-scale farmers' organisations; local agricultural and plant breeding research, development and knowledge sharing; and credit and insurance facilities for the poorest farmers, many of whom are women.

Financing education

About 75 million primary school age children around the world are not in school.[4] Almost all of these children are poor. Achieving universal primary education will require a scaling up of investment in most developing countries. In sub-Saharan Africa alone, at least 3.8 million new teaching posts must be created to meet the MDG primary school enrolment target by 2015.[5] Globally, 18 million new teachers are needed between 2004 and 2015 to achieve universal primary education.[6]

Providing healthcare

Developing countries have worse health outcomes, such as high rates of HIV infection, because of lack of public healthcare capacity. The World Health Organization (WHO) estimates that there is a global shortage of 4.3 million health workers.[7] This shortage is more acutely felt in developing countries, where the need for healthcare is also greatest. Africa suffers more than 24% of the global burden of disease but has access to less than 3% of the world's health workers and less than 1% of the world's financial resources.[8]

Overall, to get on track towards fulfilling the MDGs, governments in developing countries will need US$178 billion (£96 billion) in overseas development assistance in 2010 (at 2008 prices), according to a study led by economist Jeffrey Sachs.[9] The total overseas development assistance reported to the Organisation for Economic Co-operation and Development (OECD) in 2008 was US$120 billion (£65 billion) – US$58 billion (£32 billion) short of this figure.[10]

The global recession: developing countries are hurting

The recent financial crisis and ensuing recession have caught most governments in a pincer movement. On one hand, the credit crunch, falling investment and growing unemployment have all placed a greater demand on their resources. This ranges from bailing out banks and other companies to funding the cost of more people drawing on social insurance as they lose their jobs, and putting in place fiscal stimulus packages to counter the recession. On the other hand, government resources have been reduced as lower profits, earnings and consumption reduce tax revenues.

One important impact on developing countries has been a reduction in developed countries' aid commitments, from a starting point that was already below what is needed. A number of countries have announced plans to reduce their spending on development assistance, including Italy and Ireland, which have cut aid by 56% and 22% respectively.[11] France has revised down its aid target from 0.7% of gross national income (GNI) to 0.51%.[12]

Perhaps more significantly, the crisis and recession – though they did not originate in developing countries – have substantially affected their economies, through declines in external private sources of finance such as foreign direct investment (FDI), export earnings and migrant remittances.[13] ActionAid has calculated, for example, that Africa will suffer a real drop in income of US$49 billion (£27 billion) between the start of the financial crisis in 2007 and the end of 2009.[14] This equates to 6% of gross domestic product (GDP) and a drop in financial inflows of more than 13%.[15] Middle income countries across the globe are particularly badly affected, with South Africa seeing a decline in inflows of 47%, Brazil 31%, and India 29%.[16]

Declining national income has led to a fall in tax revenues for developing countries. The OECD's 2009 *Economic Outlook* described how the crisis has sent countries as diverse as South Africa, Chile and Estonia from strong GDP growth to a GDP decline, turning these governments' fiscal balances from positive to significantly negative.[17] The fiscal balance of African countries as a whole is expected to decline from a surplus of 1.8% of GDP in 2008 to a deficit of 5.1% in 2009.[18] In the last year, tax revenues in India are predicted to have fallen by 6.8%, while Kenya's government has revised down its revenue estimates by 2.1% for 2008-9.[19]

"If we want governments to take on the role of guarantor of last resort, which is what they have done, they require the fiscal capability to be able to do so."

Pravin Gordham, South African Finance Minister, 2009[20]

Box 1: Extract from the Pretoria Communiqué of the African Tax Administration Forum[21]

Governments around the world recognise that revenue mobilisation is central to... their ambitions to achieve the Millennium Development Goals (MDGs). More effective tax systems can:

1. Mobilise the domestic tax base as a key mechanism for developing countries to escape aid or single-resource dependency.

2. Reinforce government legitimacy through promoting accountability of governments to tax-paying citizens, effective state administration and good public financial management.

3. Promote economic growth, reduce extreme inequalities, and thereby significantly improve the lives of our citizens.

4. Achieve a fairer sharing of the costs and benefits of globalisation.

Funding public services through tax revenue

If these current trends continue, revenues available to developing countries will keep falling short of those needed to provide essential public services and meet the MDGs. Tax could be the solution: it offers one way to fill that gap, and moreover provides a source of income that is potentially more stable and sustainable than aid flows.

African governments know this, as the statement from the African Tax Administration Forum in Box 1 shows. The UK government, too, noted in a recent International Development White Paper that, "taxes provide the resources to fund public services, leading to an eventual exit from aid dependence".[22]

In fact, as Figure 1 shows, in many developing countries tax revenue already pays for the majority of government expenditure. In Bangladesh, for example, the salaries of teachers and health workers are paid from the 'non-development' budget, which is financed solely through domestic revenue, excluding both foreign grants and loans.[23]

In Bangladesh's new budget, the government plans to increase wages for all public servants to help them cope with the recent food price rises. This will mean more money for teachers and health workers, but if it wants to achieve it, the government will have to raise more tax revenue (see the case study on page 16-17).

The potential of tax revenues

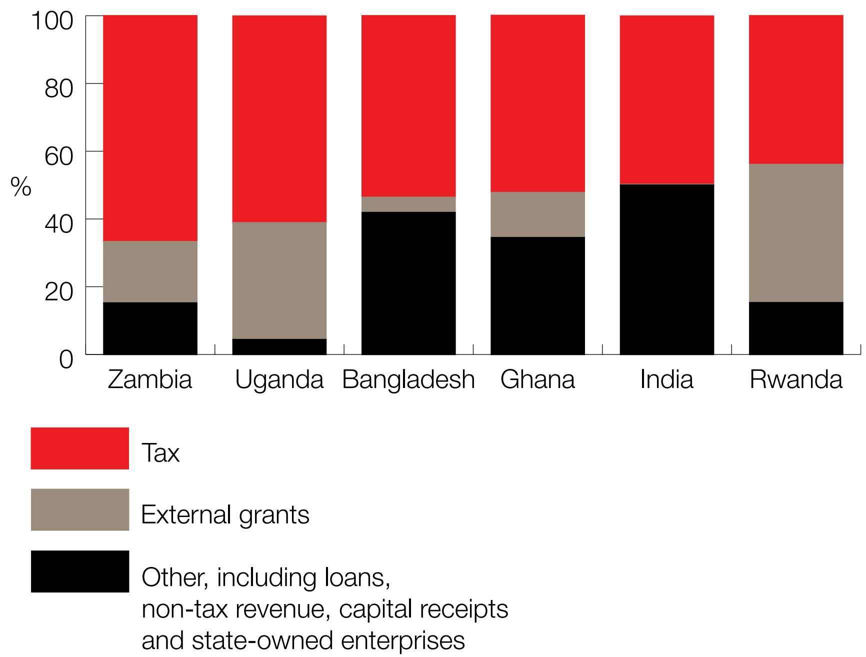
Because tax revenue already provides a significant amount of government revenue in many developing countries, increasing the amount of tax raised could significantly increase the overall amount of resources available. As can be seen from Table 1, most governments in developing countries lag behind those of high-income countries significantly when it comes to the proportion of national income raised in taxes. Low-income countries like Rwanda and Bangladesh do less well than many middle-income countries, such as South Africa and Brazil.

Table 1: Tax as a percentage of GDP in selected countries, 2007

Low income		Middle income		High income	
Bangladesh	8	Brazil	36.6	France	43.6
Kenya	18	India	9.3	Sweden	48.2
Madagascar	11.4	Indonesia	11.3	United Kingdom	36.6
Rwanda	13.6	South Africa	29.1	United States	28.3

Source: IMF/World Bank/OECD[24]

Figure 1: Tax and aid contributions to the 2009-10 budgets of countries featured in this report



Source: national budgets[25]

A commonly cited reasonable minimum for a developing country's revenue-to-GDP ratio is15%,[26] yet as Figure 1 shows, many countries do not attain this level. The average for low-income countries as a whole is in fact just less than 15%, but at least 21 low- and 18 middle-income countries raised a smaller proportion than this in 2007.[27]

Some of the reasons for the gap in tax revenues between poor and rich countries are structural. Rich countries are able to raise more taxes than poorer ones because a much larger proportion of economic transactions take place in the formal economy, where systems and record-keeping facilitate taxation.[28] In addition, more people are earning above the threshold at which they can afford to pay taxes without jeopardising their ability to meet their basic needs.

However, other factors can be addressed more quickly. They include the technology and capacity available to collect taxes, the efficiency and expertise of tax administrations, the breadth of the tax base, the number of loopholes that can be exploited, and the extent to which tax avoidance and evasion strategies are pursued.

ActionAid has calculated that, if all developing countries had been able to turn at least 15% of their GDP into tax revenues, they could have realised US$198 billion (£99 billion) more in 2007.[29] This amount is more than all foreign development assistance combined, and if governments spent it appropriately according to their international commitments, it would be enough to meet and exceed the annual MDG funding gap. For example, in 2007 it would have meant US$63 billion (£31 billion) for the government of India, US$1.0 billion (£510 million) for Ethiopia, US$4.8 billion (£2.4 million) for Bangladesh, and US$16 billion (£8.0 billion) for Indonesia.[30] Of course, 15% is just an arbitrary minimum to illustrate the order of magnitude under discussion. Many countries have the potential to raise more than this in an economically viable manner.

With political will and external assistance, such an increase could be achieved within a decade, as these examples show:

- Rwanda quadrupled the amount of tax it took between 1998 and 2006. [31]
- Uganda raised its tax-to-GDP ratio from 7.2% in 1991 to 12.6% in 2003.[32]
- From 2001 to 2008, South Africa raised the same figure from 24% to 29%.[33]

Addressing social inequalities through taxes

How a state raises taxes is just as important as how it spends them. Providing quality public services can help to redress some of the most extreme inequalities in a society. But this is only half of the puzzle. The tax system a country develops has a profound impact on inequality, and defines the relationship between the state and its citizens. Tax measures are often characterised as progressive or regressive. A progressive tax is one that takes up a greater proportion of the taxpayer's income or wealth as it increases.[34]

For example, most countries operate a progressive system of income tax, with higher rates for higher income bands. A regressive tax, by contrast, takes up a greater share of poor people's income. Without the proper exemptions, consumption taxes such as value added tax (VAT) are regressive, even though they are charged at a flat rate regardless of the level of income or expenditure.[35] This is because spending on goods and services represents a greater share of poor people's income. By putting in place progressive tax systems, governments can redistribute wealth from rich to poor, correcting otherwise growing inequality.

No axis of inequality is more important than gender: women and girls are amongst the poorest in developing countries. Of the 75 million children out of school, more than 55% are girls.[36] In sub-Saharan Africa, where the AIDS pandemic is most prevalent, women account for 61% of those living with HIV.[37] While globally, more than 60% of chronically hungry people are women.[38]

To be truly progressive, a taxation system must therefore take into account its impact on the gender dynamics that characterise poverty. Tax policy can, as a tool for both public finance and social policy, play an important role in alleviating that poverty. On the public finance side, additional revenue finances the public services that poor women and girls rely on most: removing user fees in education for instance, as Uganda did in 1997, has led to a higher increase in girls' enrolment rates in many countries, helping to address girls' underrepresentation in school.[39] And as social policy, tax can sometimes be used to address social problems that the market alone cannot (see Box 2).

However, without careful consideration, tax systems can also exacerbate social inequities even when they are believed to be progressive. For example, income tax laws can discriminate on the basis of gender, sexual orientation, type of household, citizenship, or civil status;[40] similarly, indirect taxes such as VAT can impact men and women differently given their different social and economic roles and responsibilities, which affect their spending patterns (see Box 2).

Box 2: Gender and taxation in South Africa[41]

Since the end of apartheid in South Africa, the government has implemented a set of tax reforms to make the tax system more equitable. Previously it was argued that women should be taxed more heavily because their income was only supplementary to the income earned by male breadwinners. Overturning this policy has today contributed to a more gender-equitable system.

Research on gender and taxation in South Africa shows the differential impact of VAT exemptions. For instance, exemptions on basic foodstuffs and paraffin have benefitted female-headed households, while higher taxes on alcohol and tobacco to discourage their consumption have had a higher tax incidence on male-headed households.

As female-headed households still remain amongst the poorest income groups, the research suggests exempting children's clothing from VAT. This would reduce the government's VAT intake by only 1.2%, but would have a large distributional impact for on these poorest families, predominantly women-headed households.

Taxation and governance

Although political parties differ in their attitudes to tax rates, people who govern countries have long understood that, more than simply being a means of funding the government's expenditure, taxation is instrumental in the exercise of good governance. "Taxes, after all, are dues that we pay for the privileges of membership in an organized society," US President Franklin D Roosevelt is said to have remarked. He came from a country founded with the battle cry of "no taxation without representation". African governments recognise this too, as the declaration by African tax administrators in Box 1 demonstrates.

But developing and institutionalising taxation takes time. The broad tax base of rich countries is a result of centuries of developing institutions and winning consent for taxation. Professor Mick Moore, the Director of the University of Sussex's Centre for the Future State, suggests that under certain conditions this process may generate a "governance dividend":

> "a more negotiated relationship between the state apparatus and society, involving an exchange of (1) greater institutionalized societal influence over revenue raising and expenditure for (2) higher levels of domestic taxation, with substantial quasi-voluntary compliance".[42]

Persuading citizens to pay their taxes is an iterative process that is a key component of building a strong and effective state. It is important that more government revenue in developing countries is spent on essential public services, and taxation plays a role not only in generating that revenue, but also in building a relationship of accountability between the state and its citizens that can influence spending decisions.

ActionAid's work on economic literacy and budget accountability in governance (ELBAG) uses a combination of social mobilisation, community-level education and capacity building, and people-centred lobbying strategies. By involving poor people in projects such as budget analysis and social audits, they can begin to take a more active role in holding the state accountable (and spotting where corruption is occurring), resulting in more effective decision-making and directing spending to where it is actually needed.

As is often suggested, it may be better to say "no representation without taxation".

How to raise more taxes

The rest of this report considers the main ways in which developing and developed countries can work together to help developing countries to raise more tax revenues. These solutions can be described as a three-pronged approach:

- International cooperation between countries to ensure that taxing rights are distributed fairly, as discussed in Chapter 2, and that taxpayers cannot avoid and evade taxes across borders, discussed in Chapter 3.
- Putting in place a progressive, efficient tax system that taxes different actors fairly, in particular through progressive taxation of multinational companies, as discussed in Chapter 4.
- Strengthening tax administrations and building consent among the population as a pathway towards financial independence, discussed in Chapter 5.

"Taxation is key to increasing our legitimacy and ability to make our own decisions."

Mary Baine, Commissioner General, Rwanda Revenue Service, 2009[43]

“Tax provides the long term financial platform for sustainable development, and is the lifeblood of state services.”

Admassu Yilma Tadesse, Executive Vice President, Development Bank of Southern Africa, 2009[44]

Case study

How taxes pay for teachers in Bangladesh

Squeezed between two rice paddy fields lies Changacol Government Primary School. It is a long narrow building with five classrooms and a teachers’ room. Except for the occasional breeze, the air is hot and heavy. The children are dressed in electric blue uniforms seated neatly behind their desks. Saleha Akter, one of the four teachers at the school stands in front of her students as they recite their multiplication tables. She has been teaching at this school for nearly 20 years.

Raised in this village, she now lives only half a mile away with her youngest son and daughter. Her eldest son is enrolled in medical college in the town nearby. The family had to sell their land to pay for his tuition fees, which cost over 10,000 taka (£97).[45] Neither her salary nor her husband’s salary alone could cover these fees every year.

Saleha earns 9,363 taka a month (£91) but it’s just not enough. *“Necessary foods like meat and fish prices are increasing... my salary also increases yearly but it is still hand-to-mouth living. The salary is only enough to meet the daily necessities.”*[46]

Bangladesh has witnessed a steep increase in food prices since 2007, and government wages are struggling to keep up. In 2007, it cost 19 taka (18.5p) to buy a kilo of rice; today it costs 24 taka (23p).[47] With a higher salary, Saleha says she could provide her younger children with a better education as they grow up.

The newly elected government promises to raise salaries for all government officials. In his budget speech, the finance minister stated, *“We would like to see improved living standards and better working conditions of government officials and we would like to provide them with opportunities to live honest and dignified lives.”*[48]

There are 218 students at Saleha’s school, but only four teachers to cover all the subjects from classes 1-5.[49] With so few teachers, as many as 50 children have to be crammed into a classroom for a lesson. The government policy is to assign one teaching post for every 40 students. But the current pupil-teacher ratio at Saleha’s school is 54:1.

In its 2009 budget, the government said, *“We are determined to bring down the teacher-student ratio from 1:50 to 1:40 by 2011-12 in order to remove illiteracy from the country within 2017. From next year, we are targeting to recruit a minimum of five teachers for each primary school in the shortest possible time.”*[50]

But this promise will be difficult to meet. The government has to hire more teachers to meet rising enrolment rates if the 1,371,000 children still not in school are to receive an education.[51] The United Nations Educational, Scientific and Cultural Organization (UNESCO) estimates that Bangladesh will need a total of 452,600 teachers to achieve universal primary education by 2015.[52] At present, the government only employs 258,940 teachers.

In part because it does not have enough resources, the government also relies on non-governmental organisations and religious organisations to provide primary education. Education is free in Bangladesh, but with so many different service providers, the quality of education varies greatly. Teachers working in non-governmental and religious schools receive less training and lower wages then government teachers. Learning outcomes are compromised as a result; only 55% of students

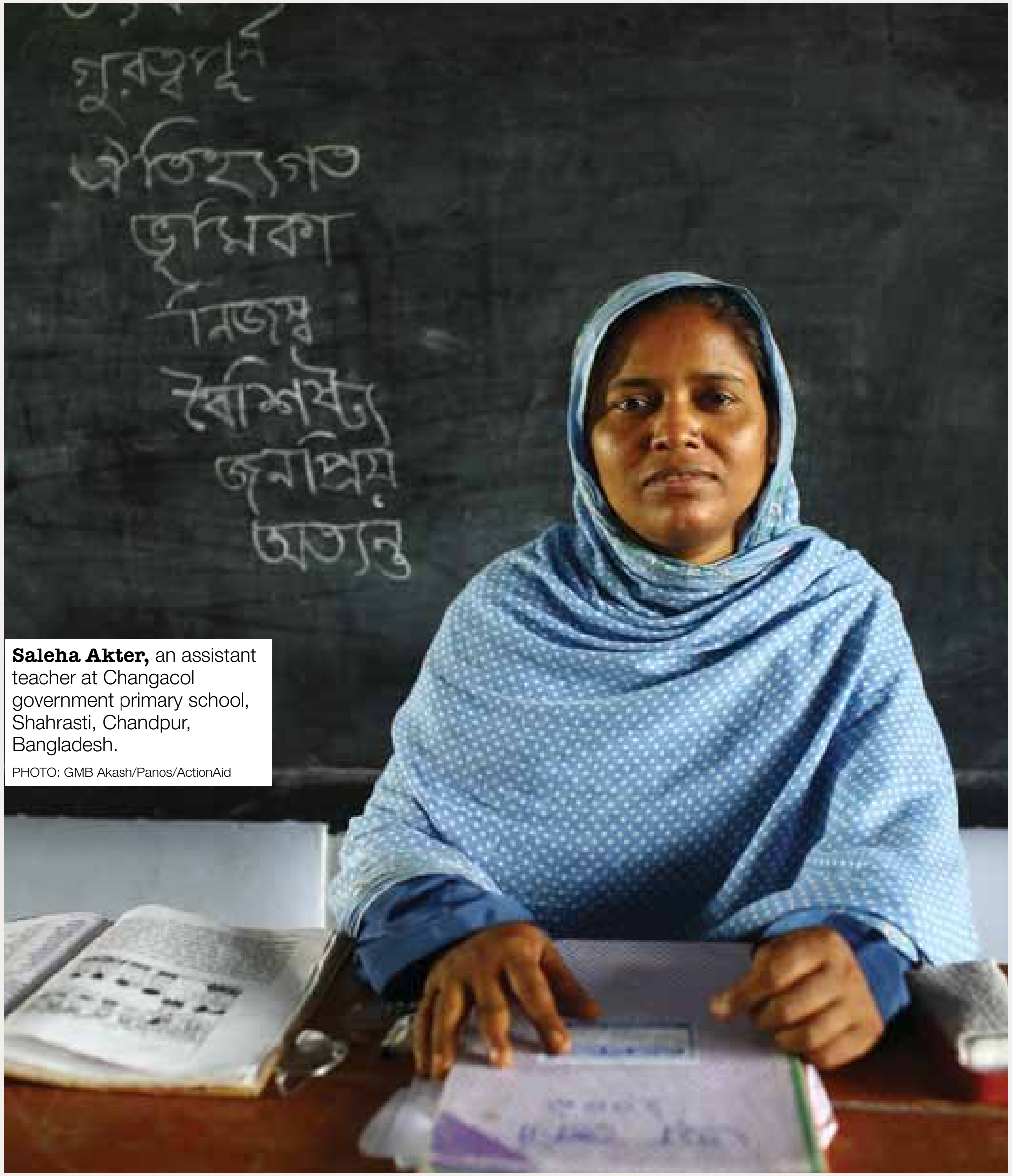
complete a full cycle of primary education – many of them leaving without a basic grasp of reading, writing and maths.[53]

The government has pledged to eradicate illiteracy in Bangladesh by 2017 – doing so will require more government schools with more trained teachers. As we have already seen, teachers' salaries in Bangladesh are paid strictly from tax revenues.[54] Without more revenue, the government of Bangladesh will not be able to pay for these extra teachers. Nor will it be able to raise teachers' salaries as promised. In any case, it will be a significant challenge for the government to get enough money to fulfil both pledges.

Today, Bangladesh's tax-to-GDP ratio is 8%, the lowest in south Asia and one of the lowest in the world.[55] The average tax-to-GDP ratio for developing countries is 15%, while in the UK tax-to-GDP ratio is as high as 37%.[56] But as in other countries, tax revenue in Bangladesh finances the largest share of the national budget and almost the entire public sector wage bill.[57]

Collecting more tax is going to be difficult in the context of the financial crisis as revenue levels are already starting to fall. The country's largest export earnings come from the garment sector. But as rich countries start to feel the pinch, demand for Bangladesh's garment exports is falling. Ready-made garment export earnings dropped 20% to US$2.7 billion (£1.8 billion) in the second quarter of 2009, down from US$3.4 billion (£2.3 billion) in the first quarter of 2009.[58] This translates to a loss of revenue for the government, as more and more companies declare lower profits and pay less tax.

The fall in the price of goods has also reduced import values and therefore import-based taxes. Though there is still some growth in import-based tax revenues, the rate of growth has fallen drastically from 50.8% in July 2008 to 8.7% by February 2009.[59] This may be one reason why the government was not able to meet its original revenue target for last year's budget.[60]



Saleha Akter, an assistant teacher at Changacol government primary school, Shahrasti, Chandpur, Bangladesh.

PHOTO: GMB Akash/Panos/ActionAid

2. Stealing from the poor

The globalisation of financial flows has created many new opportunities for companies and individuals to evade taxes in developing countries, undermining the revenue base desperately needed for development.

The most important obstacle to preventing and uncovering instances of tax evasion is the difficulty in finding information about an individual or company's activities across borders – a result of limited information disclosure requirements and lack of cooperation between tax authorities. These problems are particularly true where tax havens are involved, as they have made secrecy a part of their raison d'etre.

Of particular concern is the shifting of profits between jurisdictions by multinational companies in order to minimise their tax bills. Transfer pricing rules are designed to prevent the abuse of internal trading by manipulating the prices of goods and services. But the application and enforcement of these rules is complex, making it nearly impossible for developing country tax authorities to challenge companies' transfer pricing (and mispricing) practices. The result is a significant tax loss to developing countries.

To clamp down on this kind of international tax evasion, developing countries' tax authorities need to be able to obtain details of the activities of companies and individuals that might owe them tax in other countries. Two ways to help achieve this include a new global information sharing agreement, and the introduction of a country-by-country financial reporting standard for all multinational companies.

A packing factory, Costa Rica. Some multinational banana companies have complex networks of subsidiaries in tax havens to avoid or evade paying taxes in countries like Costa Rica.

PHOTO: Carina Wint/ActionAid

Slipping through the cracks

Individuals and companies have always sought to reduce the amount of taxes they pay, in ways that are sometimes legal, sometimes illegal (Box 4). And in the last few decades, the easier movement of capital across borders has created many more opportunities for taxpayers to arrange their affairs in ways that minimise their tax payments. In the chapter following this one, we will discuss how rules to divide up tax revenue between countries can work against developing countries; first, in this chapter, we look at the ways in which globalisation makes it easier to break or bend those rules.

Different countries' rules about what companies and individuals have to disclose – whether on public record or privately between tax authorities – create opportunities for these taxpayers to hide the details of their arrangements. They might want to do this for two reasons: to avoid public scrutiny, or to prevent tax authorities from uncovering arrangements that break or bend the law.

Some states use secrecy, as well as low tax rates, as a selling point to attract business for their financial services industries. Tax havens – also described by some commentators as secrecy jurisdictions – trade on the banking privacy and confidentiality that their legal systems offer, and require the disclosure of very little information – particularly the ultimate ownership of companies, trusts and other legal structures. This creates conditions in which tax avoidance and evasion are likely to flourish. We discuss tax havens in more detail in Box 5 (page 28).

For example, when in 2008 a bank employee in Liechtenstein leaked information concerning over 1,000 offshore savings accounts to tax authorities around the world, a window was opened on the use of that particular tax haven for tax evasion purposes. From this data, Her Majesty's Revenue and Customs (HMRC) estimated that 300 British residents had used Liechtenstein's banking secrecy to evade some £300 million in tax payments, while the German revenue authority investigated 600 German residents.[61] Recent research based on these figures suggests that just 5% of people placing assets in tax havens declare them for tax purposes in their home country.[62] A subsequent deal between HMRC and Liechtenstein revealed that 5,000 British residents had secret bank accounts containing £2-3 billion in the principality.[63]

This is not just a rich-country issue. Both the Indian and South African revenue services also made use of the Liechtenstein data to investigate their own residents for tax evasion. The country with the largest amount of money saved in Swiss bank accounts is India: Rs.75 trillion (£1 trillion) of Indian nationals' wealth is on deposit there.[64]

"We cannot continue to tolerate large amounts of capital hidden to evade taxation."

G8 summit declaration, 2009[65]

> “We are intensely relaxed about people getting filthy rich, as long as they pay their taxes.”

Peter Mandelson, now UK Secretary of State for Business, Innovation and Skills, 1998[66]

Box 3: Tax compliance – the sliding scale

How much tax a government plans to raise depends on structural factors in the economy, and on the practicalities of tax collection. But the reaction of companies and individuals to tax measures – that is to try to minimise their tax liability – limits a government’s ability to enforce its tax policies as intended. Language used in this area is complex. The starting point is that tax evasion activities break the law, while tax avoidance activities are intended to comply with the letter of the law.

The textbook *Principles of International Taxation* describes the distinction further:

The term tax avoidance usually refers to working within the law, or exploiting the law in order to minimise tax liability, not always with the sanction of the government. It usually entails taking steps to arrange the taxpayer’s affairs before a tax liability arises in such a way that less tax is paid than would otherwise be paid. Tax avoidance can be contrasted with tax evasion where a taxpayer takes steps to avoid paying a tax liability that has already arisen, for example by not declaring all income in an income tax return. Tax avoidance is sometimes subdivided into acceptable and unacceptable avoidance, to distinguish activities that comprise using the tax law to best advantage to minimise tax liabilities (acceptable) from those activities which were not envisaged when the law was put in place, ie that go against the spirit of the law (unacceptable). Unacceptable tax avoidance and tax evasion can be grouped together and labelled as ‘non-compliance’, that is a failure to comply with the requirements of the tax system.[67]

Tax avoidance is a controversial concept. Some commentators regard the courts as arbiters as to whether a tax avoidance practice is acceptable or unacceptable, while others argue that ‘acceptable tax avoidance’ is a contradiction in terms. Tax Justice Network argues that tax evasion and avoidance are both forms of non-compliance with tax rules, where compliance is defined as, “seeking to pay the right amount of tax (but no more) in the right place at the right time where right means that the economic substance of the transactions undertaken coincides with the place and form in which they are reported for taxation purposes”.[68]

Her Majesty’s Revenue and Customs (HMRC) in the UK has estimated that the gap between the corporation tax actually paid in 2005 and “the theoretical tax liability if all taxpayers complied with the letter and the spirit of the law” was somewhere between £3.7bn and £13.7bn.[69] The total corporation tax paid in 2005 was £40 billion, which means the UK’s ‘tax gap’ for corporation tax alone was between 9% and 33%.

Sweden’s National Tax Agency published a ‘tax gap map’ in 2008, in which it estimated that, “the difference between the tax that would have been determined if all those liable for tax reported all their business and their transactions correctly and the tax that actually is determined after the efforts of the National Tax Agency to ensure compliance” represented 10% of tax revenues.[70]

Transferring profits

For individuals, hiding money in another country can be a case of transferring it to a bank account there, and not telling their own tax authority about it. But multinational companies are large operations with many people, and requirements to produce detailed annual accounts. So how do they shift their profits?

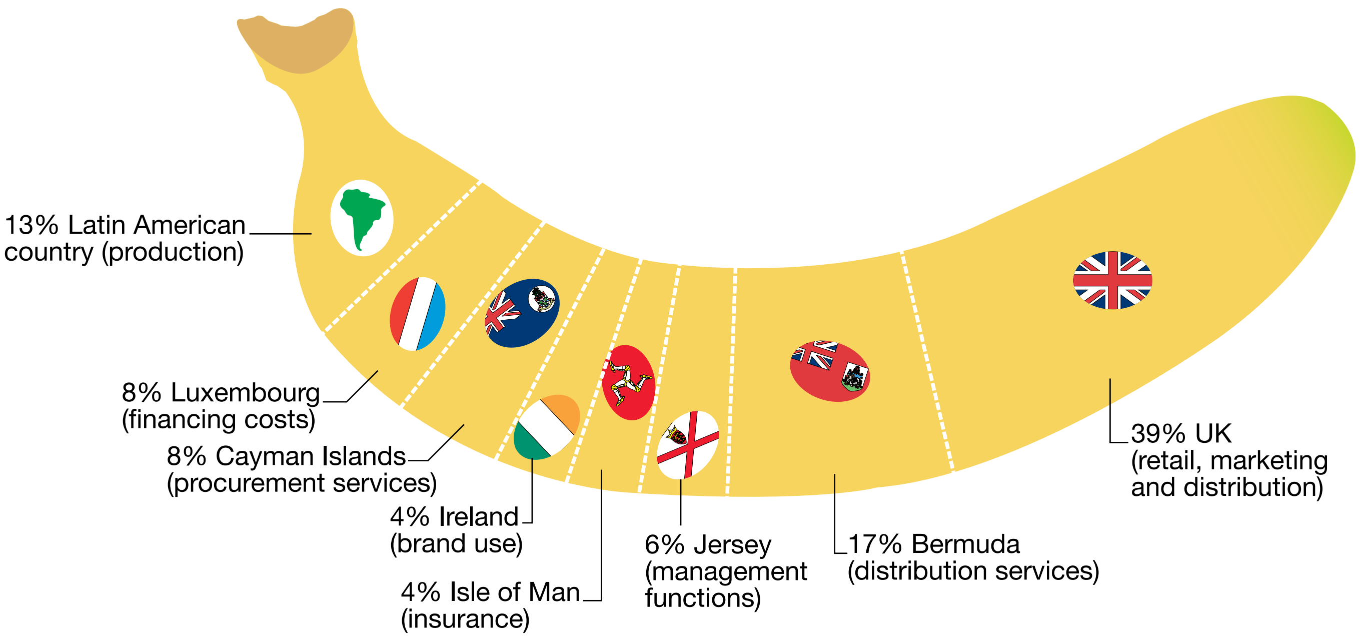
Profits are allocated to different companies within a group through internal trading in goods and services. The process of fixing prices for transactions within a group is called transfer pricing. This system performs a legitimate function by allocating profits across the group's global operations, but it also allows multinational groups to legally shift profits to subsidiaries in tax havens for example, by establishing services companies there that charge fees for intangible resources such as insurance, management and trademarks.

Figure 2 presents an example compiled by *The Guardian* newspaper in 2007, which studied transfer pricing in the banana industry. Around half the proceeds from the sale of bananas do not actually accrue in the producer or consumer country, but instead end up in a number of tax havens that charge other companies in the group for their services. *The Guardian* calculated that the world's three biggest banana companies paid on average 14% tax on their profits, despite all three having their head offices in the US, where the corporate tax rate is 35%.[71]

Other examples of the use of transfer pricing arrangements to reduce tax liabilities include pharmaceutical giants GlaxoSmithKline and AstraZeneca, which have moved the ownership of some of their drug brands to Puerto Rico and Ireland, while oil company Shell's trademarks are held in Switzerland.[72] Earnings on these kinds of intellectual property may come from licensing arrangements with third parties, but frequently companies within the group that use the patent or trademark will pay royalty fees to the sister company that owns them, moving some of the group's earnings into the tax haven.

Transfer pricing can be difficult to regulate – a fact that has led to some lengthy disputes between tax authorities and multinational companies. For example, in 2006 British American Tobacco was ordered to pay 56.8 billion won (£33 million) in back taxes and fines by a Korean court in a case involving transfer pricing abuse: cigarettes imported from a Dutch affiliate company were overpriced, shifting profits out of South Korea.[73] British electrical retail group DSG agreed in 2009 to pay HMRC £52.7 million in taxes owed after it was found to have breached UK transfer pricing guidelines in a long-running dispute concerning warranty schemes and business services.[74] A dispute between the US Internal Revenue Service and another British company, GlaxoSmithKline, about transfer pricing of drugs was settled in 2006 when the company agreed to pay out US$3.1 billion (£1.7 billion).[75]

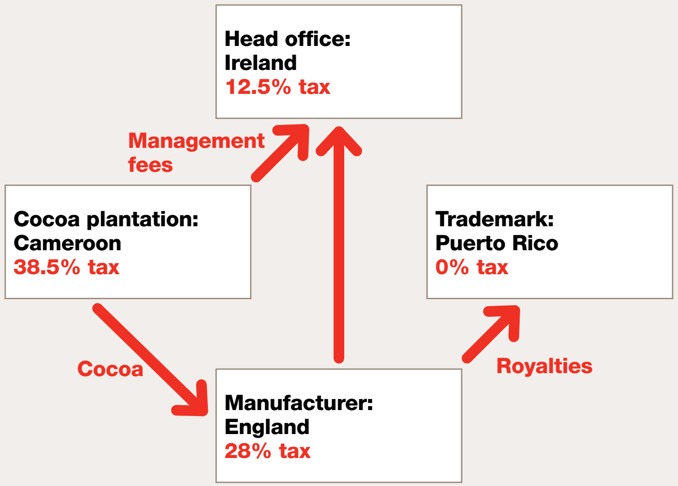
Figure 2: How the money paid for a banana is distributed using transfer pricing



Source: *The Guardian*[76]

Box 4: Transfer pricing and mispricing

Here is a simplified schematic example of a small multinational chocolate company. The group as a whole is registered in Ireland, where a 12.5% tax rate is applied to any overall profits that have not already been taxed. Its main business involves a cocoa plantation in Cameroon, which it owns, and a factory in the UK, which it also owns. The UK subsidiary buys cocoa from its Cameroonian sister company, and both of these companies pay a management fee to the head office, which is to pay for the services provided by the group such as senior management time, accountancy and human resources management. The company's chocolate trade mark is owned by another subsidiary in Puerto Rico, a US territory which is exempt from federal taxes, which charges its British sister company a royalty fee for the use of the trademark.



This example is purely illustrative and makes no suggestion of illegal activity on the part of any particular company, in the chocolate industry or otherwise.

Trade between subsidiaries like this is the norm for most multinational companies. The tricky part of it is how to determine the price that is paid for the cocoa, the management support and the royalties. Independent companies would negotiate a price based on the market value, so that each was happy that they had got a fair deal. But as the companies are part of the same group, the transaction price does not affect the underlying profits of the group as a whole.

Because the tax rates in the different countries vary, however, the company has an incentive to reduce the proportion of its profits that are declared in Cameroon, where they will be taxed at a higher rate, and increase the proportion declared in Puerto Rico and Ireland, where the taxes will be lower. This can be accomplished if the British subsidiary buys cocoa at a below-market rate – giving the Cameroonian subsidiary a raw deal – and if the royalty and management fees are very high, maximising the profits of the companies 'selling' those services.

Governments have developed a number of ways to reduce the abuse of tax havens in this way. Two of these are:

Transfer pricing regulation

Many governments, either unilaterally or through their tax treaties with other countries, regulate the transfer prices that companies within a group can fix when they trade in goods and services. For example, the OECD Model Tax Convention uses the "arm's length principle" (ALP), stating that the transaction must be under the same conditions as "those which would be made between independent enterprises."[77] Many countries require companies to keep documentation as evidence of their transfer pricing policies. For companies with a lot of internal trading, transfer pricing manuals can become fiendishly complicated, running to thousands of pages. Determining transfer prices – and assessing whether a company is in compliance with the ALP – can be very difficult in some circumstances, for example for intangible assets such as trademarks, and in situations in which there is very little trade in a service except within multinationals. In any event, assessing ALP compliance presents a considerable challenge for tax authorities.

Controlled foreign company (CFC) rules

Where developed countries tax the overseas income of their MNCs, they usually do so when it is remitted back to the home country. To keep hold of a tax saving through a transfer mispricing arrangement such as the one above, a company would avoid remitting the profits back home, most likely reinvesting them elsewhere in the group. A country's CFC rules prevent this by requiring residents to pay tax on their share of any unremitted income generated by a foreign company in which they have a controlling stake, if it is based in another country with a significantly lower tax rate. Not all countries have CFC regimes at all, and some regimes are stronger than others. CFC rules designed to protect the home countries of multinational companies are of little use to developing countries which usually have many subsidiaries and few parent companies.

Cooking the books

Transfer pricing disputes can last for years, and are costly to execute. In many cases they relate not to a breach in rules so much as a dispute over how the rules should be interpreted. But the obstacle to enforcement created by the sheer complexity of transfer pricing means that some multinationals also get away with clear violations, deliberately manipulating the prices they charge for goods and services to shift profits to low tax jurisdictions. This is called transfer mispricing (Box 4).

Global Financial Integrity (GFI), a non-governmental research institute based in Washington, DC, has estimated the volume of capital flight from developing countries as a result of such illegal transfer mispricing. For 2006, it put the figure at between US$471 billion and US$506 billion (£262 billion and £275 billion).[78] In Vietnam's Ho Chi Minh City, some 70% of multinational companies' subsidiaries are thought to have declared a loss in 2006, many as a result of transfer pricing arrangements designed to shift profits abroad.[79]

The cost of tax evasion

Tax evasion like this can have a major impact on government revenue. Christian Aid has estimated that developing countries collectively lose US$160 billion (£89 billion) in tax revenues as a result of transfer mispricing and other international tax evasion by multinational companies.[80] A commission established by the Norwegian government estimates that Norway loses as much as 30% of its corporate tax revenue as a result of transfer mispricing by multinational companies.[81]

Transfer mispricing is just one example of international tax evasion, which costs governments across the world hundreds of billions of pounds each year. The South African revenue estimates that it loses up to R64 billion (£4.7 billion) in revenue each year due to tax evasion in tax havens,[82] and the US Senate's Permanent Subcommittee on Investigations concluded that 'offshore tax abuses' cost the US Treasury US$100 billion (£66 billion) a year.[83] These figures include tax evasion by individuals. In 2005, the Tax Justice Network estimated that governments across the globe lose $255 billion (£140 billion) annually in tax revenues from high net worth individuals, based on the likely income earned on some $11.5 trillion (£6.3 trillion) of assets held offshore.[84]

"Action by the international community is required to ensure that the potential tax base of developing countries is not undermined through tax evasion."

African Tax Administrators' Forum, Pretoria, South Africa, 2008[85]

> **"We should endorse sharing information and bringing tax havens and non-cooperating jurisdictions under closer scrutiny."**

Manmohan Singh, Indian Prime Minister, 2009[86]

Making international transactions more transparent

International tax evasion is possible because governments cannot fully examine income earned abroad or transferred across borders. Multinational companies are not obliged to make such information available either publicly or to tax authorities in developing countries, which makes it much harder for tax authorities to uncover evidence of transfer mispricing.

"It's not easy to trace [transfer pricing abuses] because it's hard to get information from a [foreign] company that is a unit of one of our companies here," says Indonesia's Director General of Taxation, Darmin Nasution. He has proposed placing tax attachés in Indonesian embassies, but notes that, "we are unable to check [tax files] abroad. But we can collect information."[87]

At a global level, two interventions could give tax authorities the information that they need: country-by-country financial reporting and automatic information exchange.

Country-by-country financial reporting

Financial reporting requirements for multinational companies make it difficult to identify their corporate structures and the distribution of economic activity between them – a prerequisite for analysing the legality of their tax practices. Developed by the International Accounting Standards Board, a largely private sector body, the international financial reporting standards (IFRS) in use in most countries only require multinational groups of companies to report on a consolidated basis: they must present one set of accounts showing the overall financial activities and results for the group.[88] The data for individual companies and countries is therefore aggregated together, hiding all intragroup transactions.

A requirement for companies to break down their financial results for each country of operation would allow civil society, the media and tax authorities to uncover potential cases of tax avoidance and evasion. Multinational companies would be forced to defend their tax practices publicly, and would face investigation if there were signs of tax evasion. These factors would in themselves act as a deterrent to tax evasion, as well as providing the tools to combat it.

Information to be disclosed on a country-by-country basis should include a list of subsidiaries together with the turnover, profits, and taxes paid in each country, the number and cost of employees, the nature and value of any assets owned, and information to show the extent of intragroup transactions.[89] This information would make it possible for tax authorities to spot many instances of transfer mispricing, and for civil society and the media to gain a better picture of tax avoidance and tax incentives affecting their country.

The UK government announced in July 2009 that it was, "discussing with its international partners whether other initiatives, including country-by-country reporting of tax payments, could offer an effective and suitable means of advancing the tax transparency agenda".[90] In the same month, UK Prime Minister Gordon Brown and French President Nicolas Sarkozy called on the OECD to "look at country-by-country reporting and the benefits of this for tax transparency and reducing tax avoidance".[91]

It is important that this momentum is not lost while technical details are discussed, and in particular that:

- governments and international groupings (including the G20 and United Nations) should support a country-by-country financial reporting standard, and formally request that the International Accounting Standards Board to adopts it;
- the OECD should continue its feasibility study of country-by-country reporting, and report back to both the G20 and the UN during 2010;
- the International Accounting Standards Board should adopt a new standard that includes country by country reporting;
- civil society and the media should in future make use of the information disclosed under country-by-country reporting to hold governments and multinational companies to account.

Automatic information exchange

Tax authorities in developing countries need to be able to gather information from their counterparts in other countries, so that they can build up a picture of a company's profit-making activities and financial transfers across the globe.

Tax treaties contain provisions for information exchange, so why does the problem still exist? The answer is that the existing model does not work for developing countries.[92]

Most importantly, although tax treaties place obligations on tax authorities to respond to requests they receive from each other, this obligation is conditional. The requesting tax authority has no automatic right to the information it requests: it must demonstrate that the information it is requesting is 'foreseeably relevant' to its administrative or enforcement work, and provide a large amount of information that it may not have. This provision is specifically designed to prohibit 'fishing expeditions' by tax authorities. As Jersey Finance, which promotes the island of Jersey's financial industry, explains in a 2009 factsheet:

> "The Jersey authorities may still decline a request for information if they consider it does not meet the strict criteria laid down in the agreement… A high threshold therefore exists before the Jersey authorities will accede to a request under a TIEA [Tax Information Exchange Agreement]. For example in the past year, there have been just four requests from the US under the terms of the TIEA."[93]

The UK has double taxation treaties (discussed in the next chapter) with many tax havens, including its own Crown Protectorates, but even the information exchange provisions that they contain have been of limited use. A freedom of information request by the British magazine *Private Eye* showed that, in the last three financial years, Guernsey, Jersey and the Isle of Man between them spontaneously exchanged a total of 17 pieces of information with the UK on their own initiative, while the UK requested a further 141 (it is not clear how many of these requests were fulfilled).[94]

Table 2: Netherlands – Average Information Sharing on Request, 1992-2005[95]

Received			Provided		
Country	**Mean**	**%**	**Country**	**Mean**	**%**
Total	**862.8**	**100**	**Total**	**569.2**	**100**
Germany	180.9	21	Belgium	122.6	21.5
Belgium	165.8	19.2	Germany	108.9	19.1
United Kingdom	123.4	14.3	France	64.9	11.4
Argentina	1	0.1	Kazakhstan	2	0.4
Belize	1	0.1	Mexico	2	0.4
Brazil	1	0.1	Argentina	1.5	0.3
Guatemala	1	0.1	India	1.2	0.2
Indonesia	1	0.1	Brazil	1	0.2
Mexico	1	0.1	Pakistan	1	0.2
South Africa	1	0.1	South Africa	1	0.2
Sri Lanka	1	0.1			
Thailand	1	0.1			

Even where agreements exist and some richer countries have been able to take advantage of them, it is very rare that developing countries benefit. The Netherlands, for example, has an extensive network of tax treaties, including 22 with developing countries.[96] This is unsurprising, as the Netherlands is both a large financial centre and one with large population movements. It plays host to US$231 billion (£152 billion) in assets from developing countries, and over 1.7 million immigrants, of whom 600,000 were born in one of four low and middle income countries – Turkey, Suriname, Morocco and Indonesia.[97] Despite this, as Table 2 shows, tax information is rarely exchanged with developing countries.

This problem would be overcome by a system in which information was exchanged automatically. European Union tax authorities already exchange information showing individuals' savings income on an automatic basis, under the European Savings Taxation Directive, demonstrating the technical feasibility of an intervention like this. The most useful types of tax information to be exchanged might be different in the case of developing countries, encompassing, for example, information on the beneficial ownership of bank accounts, companies and trusts.

Mexico and the United States exchange some tax information, such as on dividend income, automatically. In February 2009, Mexico's Finance Secretary, Agustin Carstens, wrote to the US Treasury Secretary Timothy Geithner, requesting that the arrangement be extended to include savings income, which he said, "will certainly provide us with a powerful tool to detect, prevent and combat tax evasion, money laundering, terrorist financing, drug trafficking and organized crime".[98]

Mexico's revenue service is better equipped than many smaller developing countries, which would need time to develop the capability to participate in automatic exchange of information. Capacity building work with developing-country tax authorities already includes support to help them build information technology systems, and should incorporate systems to process the large volumes of information that would be received and would have to be provided through automatic information exchange.

Addressing the issue of what information is exchanged and how is only one part of the picture. For developing countries to benefit, a network of bilateral treaties is not enough. The bilateral nature of OECD model agreements makes them costly and time-consuming for developing countries to negotiate. But more importantly it means that a country's ability to secure an agreement on its terms – or indeed at all – is based on its economic power.

Gordon Brown and Nicolas Sarkozy recognised this in July 2009 when they committed to, "work through the G20 to ensure that proposals are developed by the time of the next G20 Summit to ensure that developing countries can benefit from the new cooperative tax environment, including through a new multilateral tax information exchange agreement".[99]

Not all multilateral treaties are the same, however. The ongoing discussions at the G20 and OECD should result in an agreement with the following characteristics:

- It must put in place a truly multilateral mechanism, not a bundle of bilateral treaties. Parties to the agreement must be bound to exchange information with all other participants.
- Its remit must be global, extending to all states with a legitimate interest in tax information, and all states from which they need tax information.
- If they request it, donors should provide support for developing countries to develop the technical capacity – including the requirements for confidential handling of information – needed so that they can adhere to this agreement.
- Any agreement should include a robust review mechanism to evaluate benefit to developing countries and include provision for change if necessary.

The agreement should lay the foundations of an eventual system with further characteristics:

- Premised on the automatic exchange of tax information, not only exchange of information on request.
- Enforced using multilateral counter-measures for non-compliance that are imposed by all states at once. It is important that countries with smaller economies do not miss out because their smaller economic power limits the impact of any bilateral counter-measures.
- Under the auspices of a representative global body with a political mandate from all countries.

"...it is likely that if there is better information sharing across financial sector regulators there would be less illegal cross-border flows of funds."

Jaimini Bhagwati, Indian Ambassador to the European Union, Belgium and Luxembourg, 2009[100]

Box 5: What role do tax havens play?

What is a tax haven?

The term 'tax haven' is understood in different ways by different people, and its use is often hotly contested. A report published by the OECD in 1998 suggested that tax havens are "countries that are able to finance their public services with no or nominal income taxes and that offer themselves as places to be used by non-residents to escape tax in their country of residence".[101]

The OECD furthermore suggested that tax havens can be characterised through a combination of four characteristics. These were:

a) no or only nominal taxes on the relevant income;

b) lack of effective exchange of information with other tax authorities;

c) lack of transparency in the operation of legislative, legal or administrative provisions;

d) no requirement that activity be substantial to qualify for tax residence.

Although we use the term "tax havens" in this report for simplicity, many commentators use the term "secrecy jurisdictions" or "financial privacy jurisdictions" to emphasise the importance of opacity (lack of information exchange and lack of transparency) in the way they are used.[102] Tax Justice Network uses the following definition:

> "Secrecy jurisdictions are places that intentionally create regulation for the primary benefit and use of those not resident in their geographical domain. That regulation is designed to undermine the legislation or regulation of another jurisdiction. To facilitate its use secrecy jurisdictions also create a deliberate, legally backed veil of secrecy that ensures that those from outside the jurisdiction making use of its regulation cannot be identified to be doing so."[103]

Although tax havens are usually small countries that act as offshore financial centres, it is worth noting that financial centres found in countries such as the UK, USA, Ireland and the Netherlands also have attributes that could lead to their designation as tax havens.

For example, taxation rules in the Netherlands exempt companies from corporation tax on profits earned by their foreign subsidiaries, and double taxation agreements reduce the taxes they have to pay on dividend, interest and royalty payments to and from the Netherlands. As a result some 20 000 'mailbox companies', with no substantial economic activity, exist in the Netherlands.[104]

Another example is the UK's 'non-domicile' taxation rule which is often described as a tax haven characteristic, because it is not available to UK citizens. It allows individuals who are resident in the UK but not domiciled there (usually people not born in the UK) to avoid paying UK taxes on their foreign earned income by keeping it abroad.

Who uses tax havens?

One measure of the role tax havens play in international finance is the amount of foreign assets saved there. Of the US$28.6 trillion (£15.6 trillion) of global assets held abroad at the end of 2008, some US$4.8 trillion (£2.6 trillion), or one sixth, were held in 20 tax havens – more than twice the amount in Asia, Africa, Latin America and Europe's emerging markets combined.[105]

Examining the number of companies registered in tax havens tells a similar story. In the Cayman Islands, for example, there are more companies than people. Jersey has ten times as many companies per person as neighbouring Britain. Mauritius, with a GDP per capita almost eight times smaller than the US, has more companies per person.[106] Most of these companies do not have any real activities in the tax haven where they are registered.

The impact of tax havens

The financial and regulatory environment offered by tax havens has an impact far beyond their borders. Examples of this include:

Tax avoidance and evasion Most financial transactions with tax havens are for legitimate purposes, but at least three aspects of what tax havens provide make tax avoidance and evasion more common. First, they offer low tax or nominal rates, and the right for companies to be resident there for tax purposes. Second, they make it extremely difficult for tax authorities in the place where income would have been liable for taxation to find out that it is there; often they even make it impossible to find out who the income belongs to. Third, their double taxation arrangements may deny the source and destination countries the right to tax income.

Financial instability The fiscal and regulatory environment provided by tax havens was a contributing factor to the current economic crisis. Tax distortions caused by the big tax advantages in tax havens "are likely to have encouraged excessive leveraging and other financial market problems evident in the crisis," said a recent IMF working paper.[107] UK Chancellor of the Exchequer Alistair

Darling noted that, "partly because of the very complexity of banking, the way in which sometimes just investment banks and sometimes others have sought to develop instruments in order to avoid [paying] taxes has in itself posed a systemic threat to the system".[108]

Tax havens also play host to a large part of the shadow banking system, because of the 'streamlined' regulation that allows financial institutions to circumvent the regulations imposed in other countries. Four Caribbean island states alone host over half of the world's hedge funds,[109] while Bear Sterns' problems first emerged in two of its hedge funds in the Cayman Islands, and the collapse of Northern Rock in 2007 revolved around a Jersey-based off-balance sheet vehicle called Granite. Nobel laureate Paul Krugman argues that the lack of regulation of the shadow economy laid the groundwork for the financial crisis, "re-creating the kind of financial vulnerability that made the Great Depression possible".[110]

Corruption The opacity provided by tax havens allows rich individuals in developing countries to evade taxes on legitimate earnings, but it also makes it near impossible to uncover the money that these individuals gain – and that leaves the country – through less legitimate means.

For example, General Sani Abacha governed Nigeria from 1993 to 1998 (when he died), during which time he is estimated to have looted between US$3 billion and US$5 billion. The proceeds were laundered through a complex web of banks and front companies in a range of locations, including Nigeria, the UK, Switzerland, Luxemburg, Liechtenstein, Jersey and the Bahamas. Following campaigns for its recovery, some of the money has now been repatriated from most of these locations.[111]

In its report *Undue Diligence*, the non-governmental organisation Global Witness describes how Denis Christel Sassou Nguesso, son of the president of Congo-Brazzaville and president of the state oil company, apparently used state oil money to fund a lavish lifestyle involving hundreds of thousands of pounds of credit card spending. Sassou Nguesso's credit card account was opened in Hong Kong, and paid off by two companies based in Anguilla, but documents revealing this only came to light as a result of creditor litigation in Hong Kong.[112]

Vulture funds 'Vulture funds' are companies that buy defaulted developing country debt at a discount and then try to recover the full amount, often through court proceedings. At the end of 2008, at least ten lawsuits against Highly Indebted Poor Countries had been initiated by funds based in tax havens, claiming in total over half a billion dollars.[113] For example, among the claims against the Republic of Congo-Brazzaville were three from funds based in Bermuda, the Cayman Islands and the British Virgin Islands.

These funds make money through reclaiming debt from poor countries' governments, yet many of those are based in tax havens for tax avoidance purposes. Tax haven opacity also means that the identity of vulture funds' beneficiaries can be concealed, protecting them from public criticism over what are widely regarded as immoral actions, and making it harder for developing countries to defend themselves in court.

"These times call for a tougher attitude from employers, workers and governments. We cannot go on living with tax havens."

Luiz Inacio Lula da Silva, Brazilian President, 2009[114]

3. Taxing across borders

When a company's supply chain – or an individual's income-generating activities – spans several countries, which government should benefit from the tax revenues they owe? Countries tackle this question differently, and many – including developing countries – have signed double taxation agreements to clarify the situation. Yet this global system of different treaties and tax rules can be exploited by businesses and individuals, by arranging their dealings and the way they distribute their income to avoid or reduce tax payments.

Many existing double taxation agreements restrict developing countries' ability to tax income and gains generated within their borders, giving the taxing rights to the country in which a foreign taxpayer is resident for tax purposes. Rules concerning tax residency that do not include a requirement for the presence of real economic activity mean that tax havens with a network of favourable double taxation treaties and low or non-existent tax rates can be used as conduits for tax-avoiding investments in developing countries.

A system of taxation that confers more taxing rights on the country in which income arises, and insists that tax residence be more closely linked to economic activity, would be of more benefit to developing countries.

The measures outlined in chapter 2 would help developing countries to reduce tax evasion and enforce their tax rules. But those rules themselves also need reform if governments are to raise enough money to fund essential public services.

When people and companies earn money in one country but are residents of another, the governments of the countries concerned need to divide up the rights to taxation on the income. Two principles come into conflict:

- The source principle: taxes are owed to the government of the country in which the income is generated.
- The residence principle: taxes are owed to the government of the country where the person or company earning them resides.

Different countries use different combinations of these principles to decide what income they will tax. For example, American companies are taxed according to the residence basis on all the income they earn anywhere in the world, but only when they remit it back to the US. They can credit foreign taxes paid on remitted income against their US tax bill, but the overall amount of tax they owe is determined by the US corporation tax rate. On the other hand, recent reforms moved the UK towards the source basis: British companies are now exempted from paying taxes on most dividend income from companies they own abroad (subject to controlled foreign company rules – see Box 4).

The source and residence principles come into conflict when both governments want to tax the income of a single entity: there is a risk that the taxpayer will be taxed twice on the income they have earned. To prevent this, many countries have negotiated double taxation agreements with each other to determine how the tax is divided up.

Complex companies

Decisions about how to structure a multinational group of companies will inevitably and legitimately consider the tax implications of different potential structures. However, they may also be deliberately designed to exploit differences between countries' tax rules and the terms of tax treaties. This can result in the creation of very complex company structures, such as those in Figure 2. "Businesses deliberately blur the line between their country of origin and the countries they operate within, in order to avoid paying tax," says Indonesia's Director General of Taxation, Darmin Nasution.[115]

As in Figure 2, these complex company structures frequently include subsidiaries in tax havens (for a discussion of tax havens, see Box 5 on page 28). For example, four major UK banks have on average around a fifth of their subsidiaries in tax havens.[116] In the USA, 12 of the 100 biggest publicly listed corporations have a majority of their subsidiaries in tax havens.[117]

In some cases, tax haven subsidiaries may be used for real economic activity. But in many cases, these companies have little or no physical presence and no real economic activity in these jurisdictions. It has been estimated that tax haven-based subsidiaries of US multinational corporations account for around 13% of their foreign plants and equipment and 9% of their foreign employees, yet constitute half of their foreign-earned profits.[118] One address in the Cayman Islands (Ugland House) has become infamous as the registered address of some 18,857 companies,[119] including subsidiaries of Coca Cola, Intel and many other well-known multinationals.[120]

In many cases, the role of tax haven subsidiaries is to exploit tax treaties to act as a lower tax route for remitting income, or to store that income in a low tax jurisdiction, rather than remitting it back to the home country at all. A 'tax holiday' offered to American companies in 2005 encouraged them to remit their unrepatriated profits at a reduced rate. A total of US$299 billion (£164 billion) was remitted, indicating that at least this amount had been kept overseas.[121]

This pattern can also be observed by looking at how investment into developing countries flows through tax havens. The United Nations Conference on Trade and Development (UNCTAD) reports that, in 2002 (the most recent year for which data is available), 46% of foreign direct investment (FDI) flows into Brazil came from tax havens. From a total of US$18.8 billion (£12.5 billion), this included US$1.5 billion (£1 billion) each from the Cayman Islands and British Virgin Islands, and US$1 billion (£67 million) from Luxembourg.[122] Common sense would deem it unlikely that the ultimate beneficiaries of this investment are all based in such small states.

Similarly, 43% of India's FDI between April 2000 and March 2009 came from Mauritius,[123] costing the Indian revenue some Rs. 40 billion (£530 million) in lost capital gains revenue (Box 6 discusses how this happens as a result of Mauritius' double taxation agreements).[124]

Investing in developing countries via tax havens does not in itself constitute shady dealings – however; indeed, it is considered normal practice. Another example involves Britain's Commonwealth Development Corporation (CDC), an investment company wholly owned by the government. CDC invests in developing countries via funds of which the majority – 40 out of 72 – are based in tax havens, including nine in Bermuda and 18 in Mauritius.[125]

A study of CDC's Norwegian equivalent, Norfund, found that 29 of the 35 funds in which it invested were located in tax havens.[126] Ten were focused on investments in just one country, but were based elsewhere, in a tax haven. Four in the Cayman Islands were aimed at investments solely in China, Vietnam or Thailand, on the opposite side of the world!

Both CDC and Norfund argue that basing these funds in tax havens shields their private sector co-investors from being obliged to pay taxes twice. This brings us back to our examination of the source and residency principles.

"Businesses deliberately blur the line between their country of origin and the countries they operate within, in order to avoid paying tax."

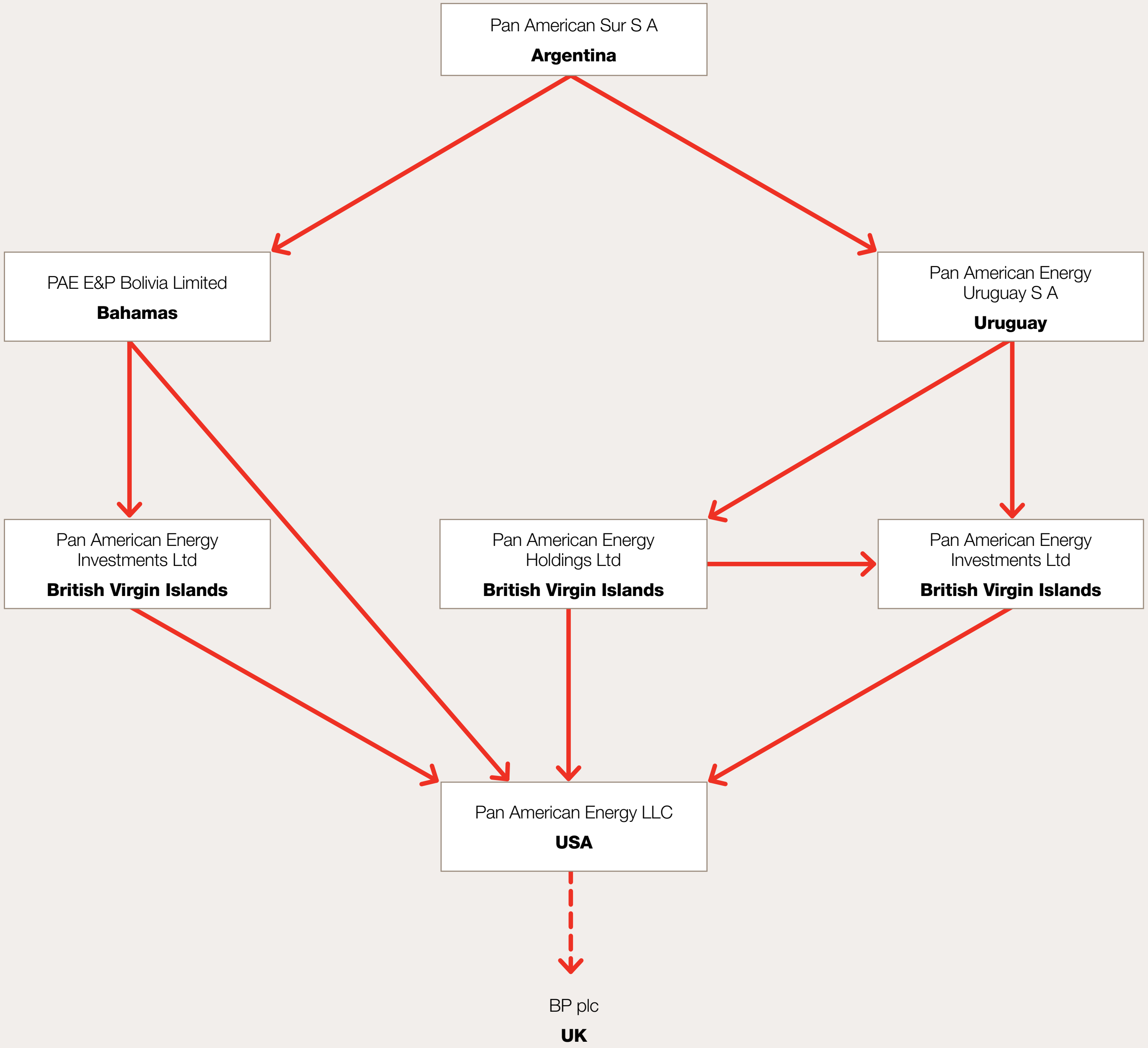
Darmin Nasution, Indonesia's Director General of Taxation, 2009[127]

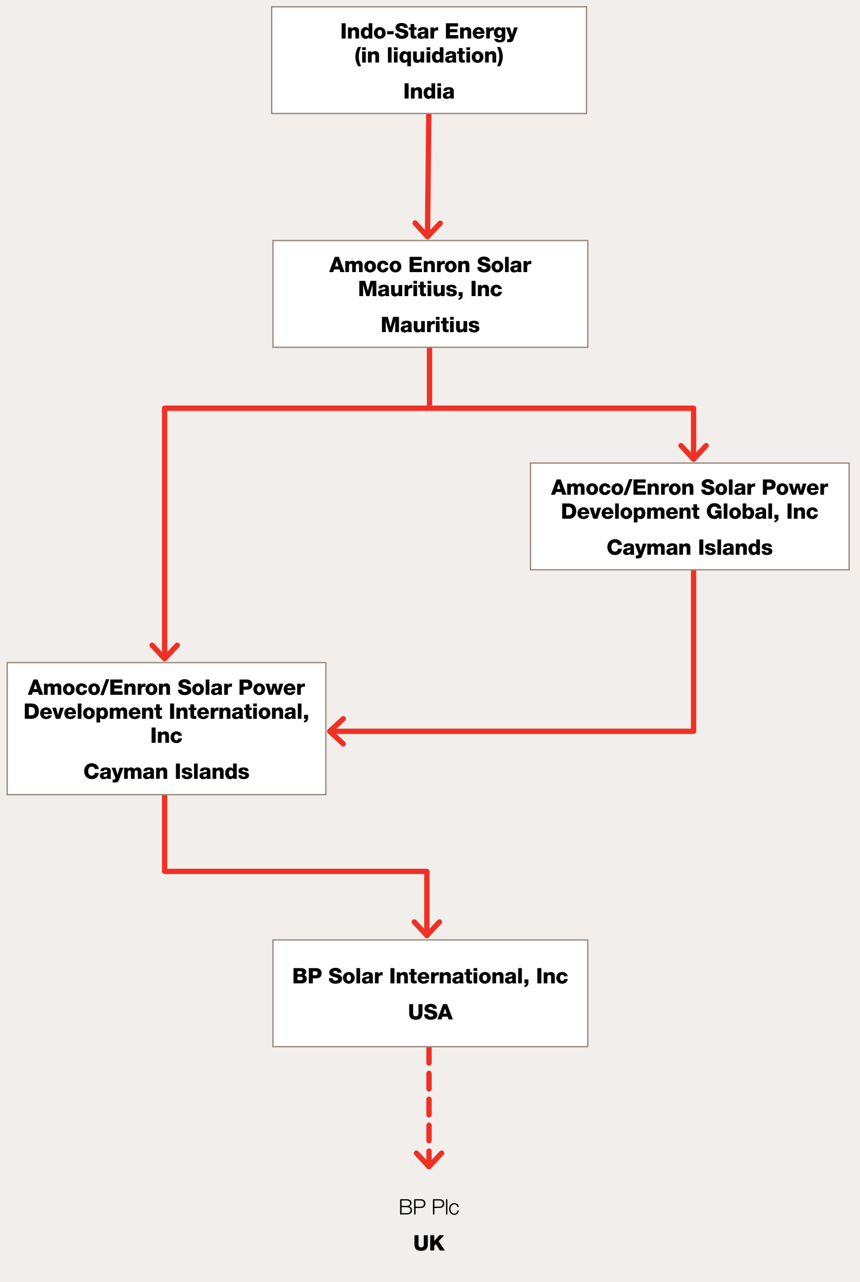
Figure 3: How investment income from developing countries flows through tax havens

ActionAid has studied some examples of multinational companies' ownership structures, to show the complex way in which companies route their investments in developing countries through tax havens. BP Group (to its credit) offers an unusually detailed description in its annual report, enabling us to plot the charts below. They trace two individual companies owned by the London-based multinational group: an investment in Argentina was routed through the British Virgin Islands and the Bahamas, while a single Indian investment was routed through Mauritius and the Cayman Islands. (These charts are based on real information, but there is no evidence that the structures shown in these specific examples are designed or used for the purpose of tax avoidance or evasion.)

means a separate subsidiary of the multinational group

shows the ownership structure. The arrows follow the route through which the subsidiary's profits are remitted towards the ultimate parent, BP plc, in London





Rs. 40 billion (£530 million): the annual cost to India of tax avoidance through investments routed through Mauritius[128]

Source versus residency

Most developing countries are net recipients of foreign direct investment: they host many foreign-owned companies that are subsidiaries of multinational companies, but they do not host the headquarters of many multinational companies. For this reason they benefit much more from the source principle than the residency principle. That is to say, a system in which taxing rights are granted to the country where income is earned suits them much better than one in which taxing rights are given to the country where the person receiving the income is resident.

In practice, the home countries of most multinational companies either exempt foreign-earned income from taxation altogether (this is an application of the source principle), or offer credits against taxes paid abroad (a compromise that is closer to the residence principle). If the picture were simple, therefore, developing countries would effectively have first refusal to tax profits generated within their borders. The picture is complicated, however, by the double taxation agreements (DTAs) between developing countries and tax havens.

DTAs serve an important purpose for developing countries: they give potential investors a degree of certainty around their tax liabilities, reducing or eliminating any potential for double taxation that would discourage investment. Many DTAs, especially those based on the OECD Model Tax Convention on Income and on Capital – the predominant template used internationally – restrict developing countries' rights to apply the source principle to capital gains, dividends and interest income.

Treaties often apply the residence principle to some of these types of income, set maximum amounts of tax that can be applied on income that is being remitted abroad, and set criteria that define when developing countries can use the source principle. For some tax havens, tax treaties play as significant a role as tax rates and secrecy in attracting business. Box 6 discusses the impact of DTAs with Mauritius on other developing countries.

A better division of taxing rights

The structure of multinational companies' investments in developing countries makes it harder for developing countries to hold on to the right to tax the income earned within their borders. Yet the pressure to retain an investor-friendly tax system means that double taxation agreements have become mechanisms through which developing countries compete for investment. The result is a race to the bottom in which they must give up their taxing rights in order to remain attractive to foreign investors.

Double taxation agreements that give developing countries the right to tax more income and gains at source – including by using a definition of tax residency that is closely tied to the location of economic activity – would allow them to keep more tax revenue. If taxes were deducted before they crossed borders, it would also reduce the incentive for companies to develop complex structures to exploit opportunities for tax arbitrage.

Governments should therefore ensure that any double taxation agreements into which they enter strike an optimal balance between raising revenue and attracting investment that benefits poor people. In particular:

- governments should fully consider the revenue implications of rules concerning the tax residence of legal entities, and of any restrictions placed on the application of the source basis, when negotiating double taxation agreements;
- developing countries should work together to promote and improve the United Nations model convention, which is more beneficial to developing countries in these matters than the OECD model, especially through the United Nations Committee of Experts on Tax Matters that developed the UN model.

Multinational companies' tax arrangements should be the subject of scrutiny by the public as well as by tax authorities. A country-by-country financial reporting requirement, discussed in chapter 2, would allow civil society, the media and tax authorities to study and challenge cases of tax avoidance by investors. Multinational companies would be forced to defend their tax policies publicly, and governments could be challenged to review tax treaties with a significant impact on revenues from corporate income and gains.

Box 6: Double taxation agreements and Mauritius[129]

Mauritius is a lower-middle income developing country off the east coast of Africa. It is also an important conduit for foreign investment into other developing countries.

Mauritius has double taxation agreements with a large number of countries, including ten African states. Because Mauritius is an important source of investment for African countries – albeit via subsidiary companies which may have little real economic activity – these countries have little option but to sign such agreements if they want to benefit from this foreign investment.

These agreements use the residency principle for taxation of capital gains, which means that African countries have no right to tax gains made within their borders by investors that are resident in Mauritius for tax purposes. Mauritius claims the right to tax these capital gains under the residence principle, but because it doesn't tax capital gains made by foreign-owned companies, these companies can escape capital gains tax altogether.

DTAs with Mauritius also put a maximum ceiling on the taxes that other African countries can apply to dividends earned within their borders by investors that are resident in Mauritius for tax purposes.

Yet many of these investors are not in fact Mauritius-based, but are based in other countries. Mauritius allows the formation of Global Business Companies (GBC1s), which are resident in Mauritius for tax purposes but deal in foreign currency and have no employees based in Mauritius. These companies pay an effective corporation tax rate of 3%, although the nominal rate is 15%.

What Mauritius gains from this arrangement is the employment, investment and tax revenue generated by its burgeoning financial services industry. But it hardly benefits from the investments themselves, having given away much of its potential tax revenue. The real benefits accrue to foreign investors who use Mauritius as a tax-minimising conduit for their investments.

“Aggressive tax avoidance is a serious cancer eating into the fiscal base of many countries.”

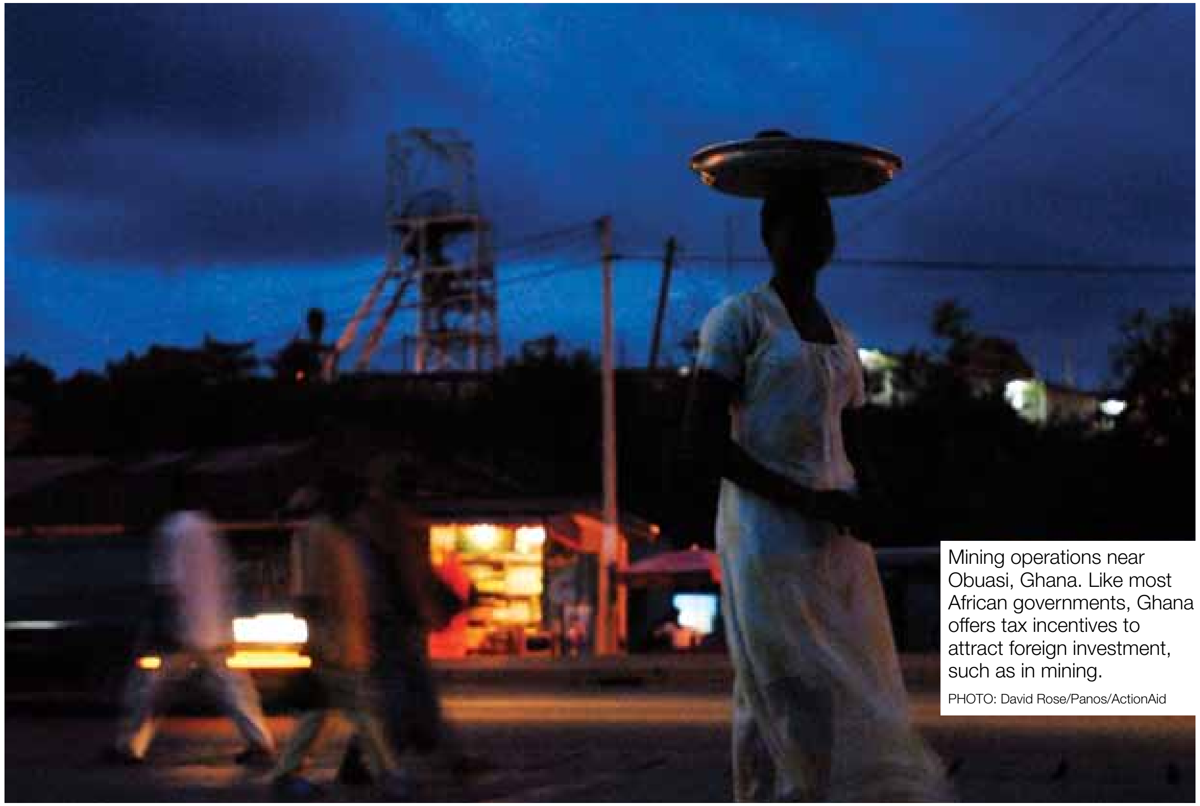
Pravin Gordham, South African Finance Minister, 2009[130]

4. The great tax giveaway

The use of tax incentives to compete for investment has been a cornerstone of development plans for many years. The doctrine of 'tax competition' casts countries in the role of competitors in a marketplace for investment – despite the numerous problems with this analogy. Incentives offered include lowering overall business tax rates and providing incentives specifically for foreign investors, which can be permanent or temporary ('tax holidays') for the first few years of the investment.

While there is some evidence to support the idea that tax plays a role in corporations' investment decisions, recent research supports a growing view that tax competition (in particular in the form of tax holidays) does not attract high-quality investment to developing countries – it does not encourage the skill and technology transfers, or create the jobs, that would help lift people out of poverty permanently. Instead, it can damage small domestic businesses, whose profits are far less likely to leave the country, putting them at a disadvantage in relation to foreign-owned ones. Moreover, tax incentives are frequently given on a discretionary basis, outside of the legislative framework, leading to allegations of corruption and patronage.

Meanwhile, poor people lose out, as the tax revenue foregone means more taxes on them, and less provision of public services. The revenue implications of tax incentives need to be considered, and national debates encouraged.



Mining operations near Obuasi, Ghana. Like most African governments, Ghana offers tax incentives to attract foreign investment, such as in mining.

PHOTO: David Rose/Panos/ActionAid

The notion that all countries – and especially developing countries – need to offer multinational corporations a discounted tax bill in order to attract investment has been a standard part of policy-making for many years. The result is that countries give away much of the tax revenue they could otherwise raise from multinational companies.

Perhaps the most high-profile example of this is the World Bank and PriceWaterhouseCooper's annual 'Doing Business' indicators, which since 2006 have included a ranking of countries according to an estimate of the "total tax rate" incurred by companies.[131] The report's message has been that, in addition to reducing the administrative burden of tax compliance, countries should reduce the amount that they tax businesses. Simeon Djankov, the senior World Bank economist who created the Doing Business series, described the philosophy in a posting on the Doing Business website:

> "There is a good rule in setting taxes: the poorer the country, the lower the tax burden. This is for two reasons. First, poorer countries waste more tax money through corruption. Second, lower tax burdens for businesses lead to more economic activity."[132]

The result has been an environment in which 'tax competition' (Box 7) between countries has become *de rigeur*.

Box 7: Tax competition: a misleading term

The term 'tax competition' is often used to describe the way in which countries distinguish themselves from others and compete for investment by offering lower tax rates or more tax incentives. It is of course the case that tax rates and incentives will play a part in companies' investment decisions.

When used in economics, however, 'tax competition' can be a misleading term: it implies that countries are 'selling' their tax systems, and companies are 'buying' into them, in a marketplace analogous to competition between companies. Most obviously, the analogy falls down because the ultimate sanction on a company that loses the market competition is that is goes out of business. This cannot be allowed to happen to a state.

Tax should not be seen as a transactional cost that is regulated by market mechanisms, but rather as a social obligation. Whether or not a government decides to lower tax rates or offer up tax incentives must be in accordance with a national development strategy and open to public debate.

> "Most likely, the impact [of tax incentives] is negative, with the beneficiaries likely to be the wealthiest individuals, often located in foreign countries."

IMF working paper, 2009[133]

The race to the bottom

Countries have responded to this environment with long-term and short-term tax incentives for multinational companies. The principal long-term incentive is a reduction in the corporate tax rate. A survey of corporation tax rates in more than 100 developed and developing countries by accountancy firm KPMG found that they fell from 31.4% in 1999 to 25.9% in 2008.[134] Between 2007 and 2008, four African countries – Burkina Faso, Cote d'Ivoire, Madagascar and Morocco – reduced their corporate income tax rates.[135] And India reduced its corporate tax rate from a high of 39.55% in 2001 to 33.99% in 2008, while South Africa's corporate tax rate fell from 37.88% in 2005 to 34.5% in 2008.[136] In Africa, low-income countries have reduced their corporate tax rates from 44% in 1980 to 33% in 2005.[137]

In the short term, countries also compete for foreign investment by offering lucrative tax incentives (known as tax holidays) targeted specifically at foreign businesses. Typically these consist of a reduction in or exemption from profit taxes, royalty fees and/or trade tariffs for the first few years of an investment. A recent IMF survey of sub-Saharan African countries shows a remarkable increase in these tax incentives: in 1980 less than half offered tax holidays. By 2005, more than two thirds did.[138] The case study on page 40 describes the tax incentives offered by Zambia.

Many more tax incentives are included in investment codes, also known as Investment Promotion Acts. In 2005, three quarters of the countries surveyed had investment codes which included tax incentives, compared with less than one third in 1980.[139] There has also been a proliferation of export processing zones (areas of a country with different corporate regulation) over the past 25 years; these zones often carry reduced corporate tax rates for investment located within them.[140] Research shows that low-income countries rely more heavily on tax incentives, particularly tax holidays, than do middle-income countries.[141] Despite their proliferation, the gains have been limited.

Do tax incentives work for developing countries?

Evidence on this is conflicting. There is some evidence to support the suggestion that the amount corporations are taxed affects their investment decisions. For example:

- Research for the World Bank indicated that a 10% increase in the effective corporate tax rate covering the first year of investments reduced foreign direct investment (FDI) by 2.3% of GDP (from an average of 3.4% of GDP) and total investment by 2.2% of GDP (from an average of 21.5%).[142]
- Research by US academics suggests that US multinationals shift their capital investment in response to tax rates: a 1% increase in the after-tax return on investment provided by the tax system of a country led to a 4% increase in the real capital stock of a company's subsidiaries based there.[143]

Other studies reach a different conclusion. For example, a 2001 IMF paper said that,

> "foreign investors, the primary target of most tax incentives, base their decision to enter a country on a whole host of factors (such as natural resources, political stability, transparent regulatory systems, infrastructure, a skilled workforce), of which tax incentives are frequently far from being the most important one".[144]

A United Nations report in 2000 made a similar point:

> "As a factor in attracting FDI, incentives are secondary to more fundamental determinants, such as market size, access to raw materials and availability of skilled labour. Investors generally tend to adopt a two-stage process when evaluating countries as investment locations. In the first stage, they screen countries based on their fundamental determinants. Only those countries that pass these criteria go on to the next stage of evaluation where tax rates, grants and other incentives may become important. Thus, it is generally recognized that investment incentives have only moderate importance in attracting FDI."[145]

The quality of investment encouraged by tax incentives can also be questioned. As well as providing employment, FDI that benefits poor people should lead to positive 'spillovers' through skill and knowledge transfers. Tax holidays that last for a fixed period of time may actually discourage such effects, as they attract firms that will be able to make high profits quickly, rather than those that require a long-term commitment to building a skilled workforce and a technology base within a country.[146] Research from the IMF (see Box 8) shows that, even when reduced corporate tax rates and long tax holidays do succeed in attracting FDI, they do not boost capital formation or growth in developing countries.[147]

Box 8: The IMF discusses the problems with tax holidays

The IMF and World Bank are often cited as the source of pressure on countries to open up to foreign corporations. ActionAid has been a stern critic of the IMF for its damaging policy prescriptions to indebted countries that seek its loans, but its commitment to liberalising developing country economies does have some nuances. In a 2001 publication *Tax Policy for Developing Countries*, the IMF says:[148]

"Of all the forms of tax incentives, tax holidays (exemptions from paying tax for a certain period of time) are the most popular among developing countries. Though simple to administer, they have numerous shortcomings. First, by exempting profits irrespective of their amount, tax holidays tend to benefit an investor who expects high profits and would have made the investment even if this incentive were not offered.

Second, tax holidays provide a strong incentive for tax avoidance, as taxed enterprises can enter into economic relationships with exempt ones to shift their profits through transfer pricing (for example, overpaying for goods from the other enterprise and receiving a kickback).

Third, the duration of the tax holiday is prone to abuse and extension by investors through creative re-designation of existing investment as new investment (for example, closing down and restarting the same project under a different name but with the same ownership).

Fourth, time-bound tax holidays tend to attract short-run projects, which are typically not as beneficial to the economy as longer term ones.

Fifth, the revenue cost of the tax holiday to the budget is seldom transparent, unless enterprises enjoying the holiday are required to file tax forms. In this case, the government must spend resources on tax administration that yields no revenue and the enterprise loses the advantage of not having to deal with tax authorities."

"It is generally recognized that investment incentives have only moderate importance in attracting FDI."

United Nations Conference on Trade and Development (UNCTAD), 2000[149]

Case study

Multi-facility economic zones (MFEZs) in Zambia

In 2006, the Zambian government presented its plans to parliament to set up Multi-Facility Economic Zones (MFEZ) in all districts throughout Zambia to attract foreign direct investment and stimulate industrial development.[150] Both national and foreign companies would be allowed to operate in these MFEZ and would benefit from the following tax breaks:

- **0% tax on dividends for five years;**
- **0% tax on profits for the first five years; from years six to eight, 50% of the profits will be taxed; and from years 9 to 10, 75% of the profits will be taxed;**
- **0% import duty on raw materials, capital goods and machinery;**
- **deferment of VAT on machinery and equipment used in the MFEZ.**

The promised benefits from this investment include:

- **improved infrastructure such as medical facilities and schools;**
- **higher foreign exchange earnings;**
- **higher tax revenue after the expiry of the tax holiday;**
- **increased foreign direct investment.**

In response, the Parliamentary Committee on Economic Affairs and Labour challenged the value of the tax holidays offered in the MFEZ as follows:[151]

i) The operationalisation of MFEZs across the country is not an easy task. It requires vast amounts of resources, land and infrastructure. Your Committee recommends that care is taken to ensure that the land acquired is not used by communities for farming or any other social, religious and economic activity.

ii) Industries operating in MFEZs have the ability to potentially affect the companies that are operating outside MFEZs. This is because they will be enjoying incentives which will reduce their cost of production. Your Committee, therefore, recommends that the operations of MFEZs should not be to the detriment of firms that are operating outside the MFEZs.

iii) The incentives to operate in an MFEZ as provided for in the ZDA Act[152] are very generous. In the past, companies which were given such incentives relocated to other countries when the tax holiday came to an end. Your Committee urges the Government to avoid a repeat of such unfortunate situations.

iv) The MFEZ is an important initiative that will improve the competitiveness of Zambia's industries. However, there are no other companies that have applied to operate in the MFEZs apart from those of Chinese origin. They, therefore, recommend that other companies, particularly citizen influenced and citizen empowered companies, be allowed to compete freely in the Chambishi MFEZ area.

With a corporate tax rate of just 1.7% and a total tax rate of 16.1%, Zambia scores well in the World Bank's index of countries with low corporate taxes.[153] But the rates are so low that it cannot afford to adequately finance key social and economic investments. Desperate for investment, the Zambian government is continually pushed to offer generous tax incentives to attract foreign companies.

Zambia has long been known for the exceedingly low tax rates it offers in its principal industrial sector – mining. Royalty rates for the mining sector are 0.6%, against the 3% stipulated in the tax code, along with a 25% corporate tax rate. Starting in April 2008, the government amended its tax law, forcing companies to pay a windfall tax on profits, a 3% royalty rate and a 30% corporate tax rate.[154] When the price of copper fell in 2009, however, the Minister of Finance withdrew these changes, reverting back to the previous low tax rates. It has been estimated that between 2004-6 the government could have earned an additional US$63 million (£35 million) in revenue if mining companies had paid the 3% royalties on gross sales.[155]

As a result of the generous tax incentives, mining revenue did not contribute much overall tax revenue despite previously high commodity prices.[156] But since prices have fallen, revenue receipts are even lower, forcing the government to borrow more to finance its 2009 budget. "In light of constrained revenues, [government spending will] be achieved through a realignment of resources, and an increase in borrowing," it said. "Domestic borrowing will therefore increase to 1.8 percent of GDP from 1.4 percent of GDP in 2008."[157] Overall the foregone revenue as a result of these generous tax incentives may far outweigh the benefits.

The collateral damage of tax incentives

As well as the loss of revenue, tax incentives can have a number of negative side-effects. Because they are frequently targeted at outside investment, they create an unequal playing field in sectors where both national and international companies compete, and can disadvantage and discourage domestic entrepreneurship and investment.[158] Tax compliance is affected by taxpayers' perception of others' tax compliance: the visible concessions offered to foreign businesses can encourage tax evasion and avoidance by domestic companies and individuals.

Research indicates that transfer mispricing is also more likely when countries offer corporate tax holidays.[159] There is less oversight from tax authorities when a company receives a tax holiday and so less incentive for companies to maintain records. This can lead to abuse and a further outflow of much needed revenue from developing countries through tax evasion.

Particularly where tax administrations are weak and tax evasion is prevalent, tax incentives may be linked to corruption rather than genuine economic interests, especially when they are often offered in a less than transparent way.[160] It is common practice in the extractive sector to include tax exemptions in large mining contracts, but these tax incentives are frequently negotiated outside the legislative framework and the contracts are not made available for public scrutiny. In Ghana, the law stipulates that a full parliament must ratify the contracts between government and mining companies, but in reality they are only presented to the parliamentary select committee on mines and minerals.[161] In many more countries, parliament has no oversight or opportunity to debate the tax incentives offered in mining contracts at all.

Having said all this, tax incentives, carefully used, can also be deployed in a positive way for poor people, for example as part of an industrial development strategy, or in order to create particular spillover benefits for poor people.

The cost of tax competition

Taxes on multinational companies' profits and activities are an important part of the tax mix for developing countries. Economists point out that the cost of paying taxes on a company's profits is ultimately distributed between the company's consumers, employees and shareholders. But by definition, the consumers and shareholders – and many employees – of a multinational company that has investments in a developing country are resident elsewhere. Taxing profits incurred and activities undertaken within its borders is how a developing country raises revenue in proportion to the benefit that a company has gained from operating there.

By reducing headline tax rates on corporations, or by offering incentives that reduce them for a period of time for foreign investors, governments in developing countries shift the tax burden onto domestic taxpayers whose means are likely to be less, and most of whose spending would stay within the national economy. The revenue foregone as a result of these tax incentives needs to be balanced with the positive benefits that come from foreign direct investment through new jobs and technological spillovers (see case study on page 42).

Recent debates in Zambia's parliament (see case study opposite) illustrate how problematic tax holidays can be. However, once countries start to offer tax incentives, it is difficult to move away from these policies, and firms pressure governments to either extend existing tax holidays or offer new ones so that they can compete with firms already benefiting from the tax holiday.[162]

US$63 million (£35 million): revenue foregone in Zambia due to reductions in royalty payments by mining companies alone in 2004-6[163]

Case study

Revenue foregone in India

Since 2006, the Indian government has presented an analysis of the revenue foregone because of tax incentives and subsidies alongside its national budget. The corporate tax rate in India is 33.99%, but on average most companies paid an effective tax rate of 22.24% in 2007-08. Larger companies accounted for 54.98% of profits before taxes, but their effective tax rate was only 21.85%. In contrast, smaller companies (whose profits before tax made up a meagre 3.16%) ended up paying an effective tax rate of 24.04%, the highest amongst all companies.[164] Large companies are those least affected by rising corporate tax rates and most likely to benefit from tax incentives designed to attract large scale investments.

A comparison of the foregone tax revenue in 2007-08 and 2008-09 as a per cent of aggregate tax collection shows a considerable increase. The proportion of total potential tax revenue foregone as a result of incentives on corporate taxes rose from 10.5% to 11.4%. The overall foregone revenue (which includes personal income tax, excise duty and customs duty as well as corporation tax) increased from 48% in 2007-08 to a massive 69% in 2008-09, partly as a result of India's fiscal stimulus measures.[165]

The World Health Organization estimates that there is a global shortage of 4.3 million healthcare workers – with more tax revenue, governments could pay for all of them.

PHOTO: Sanjit Das/ActionAid

Weighing up the costs

Some of the poorest countries are using the most harmful tax incentives to attract investments that do not offer much in return. Tax holidays not only result in a loss of revenue, but also create a more opaque tax system, leaving room for corruption and abuse. Desperate for foreign direct investment, many poor countries make unreasonable revenue concessions that undermine their overall tax base.

Taxing business fairly

It is the responsibility of national governments to design tax systems that will raise enough revenue to finance public investments and redistribute wealth equitably. Governments must recognise the role of corporate taxation in a progressive tax system and the consistent failure of tax incentives to attract foreign investment that can contribute to national development and raise revenue. Investment promotion policy should take into account the revenue implications as well as the quality and longevity of investment that any incentives are likely to encourage.

Learning these lessons should cause governments to refrain from granting tax incentives unless there is a demonstrable benefit to poor people. Governments should therefore:

- Aim to strike an optimal balance between raising revenue and attracting investment that benefits poor people when setting corporate tax rates and offering tax incentives.
- Refrain from putting fixed term tax holidays in place.

International organisations such as the IMF and World Bank should support countries in their efforts to halt the race to the bottom.

More transparency

All tax incentives given to foreign firms should be based on a legal code. Governments should:

- Consider the impacts on growth and equity when making such decisions, and undertake tax expenditure analyses as part of the budgetary process (showing the extent of tax incentives). Tax expenditure reports, such as India's (see case study, page 40), inform government and the general public of the revenue foregone from the mix of tax exemptions offered. It is an opportunity for government and civil society to weigh the revenue costs of existing policies against the benefits that can come with foreign investment. Governments should promote public debate on the findings, as part of national development strategies.
- Ensure that any tax exemptions awarded to companies are given on a consistent, transparent, accountable basis as part of a country's investment code, and not on a discretionary basis to individual companies.

A country-by-country financial reporting standard, discussed in chapter 2, would afford civil society greater information with which to assess the extent and consistency of tax incentives offered by a government.

Curtailing corporate abuse

Companies should not use economic or political power to extract tax incentives from developing country governments. At a minimum, they should comply with the OECD Guideline II (5): "Refrain from seeking or accepting exemptions not contemplated in the statutory or regulatory framework related to environmental, health, safety, labour, taxation, financial incentives, or other issues."[166]

Rs 689 billion (£8.8 billion): revenue foregone due to tax incentives for large businesses in India, 2008-9[167]

5. Tax authorities: a worthwhile investment

Developing-country governments do not make the most of the potential tax revenues available to them. Many tax inspectorates are under-resourced, under-trained, and lack political support.

Experience in a number of countries has shown that, with external financial and technical support, developing countries can develop their tax policy and administration sufficiently to be able to increase the tax revenues they raise severalfold.

More of these programmes are needed to afford developing-country governments a more diverse menu of taxes through which to raise revenue. This would allow them to broaden their tax bases so that more people and businesses – those with enough income to afford it – contribute to government revenue. Finally, it would make it much harder for businesses and rich individuals to evade the taxes they owe.

Building stronger tax administration

In many developing countries, poor tax compliance and weak tax administrations are a key reason for low tax revenues. In Bangladesh, tax compliance among what is already a narrow tax base is very low. Out of a population of around 150 million, 2.2 million registered taxpayers are liable to pay income tax, but only 600,000 actually do.[168]

One reason for low tax compliance is the perception that government is corrupt, that tax payments will not finance public services, but instead line the pockets of corrupt government officials. Such perceptions, when pervasive, shred the social contract between the state and its citizens.

However, another major reason is that tax administrations are poorly resourced and lacking in staff capacity. In Bangladesh, for example, for resourcing and political reasons, the National Board of Revenue has not been able to hire any new qualified tax officials for over 20 years. Though VAT and customs units are sanctioned to have 7,326 staff, at least half of these are vacant posts. This has led to a large deficit in the revenue authority, making it difficult for tax inspectors to detect and curb tax avoidance and evasion. Tax officials claim that a total of 14,164 posts would be needed to run an effective VAT and customs unit.[169]

African tax inspectors, too, recognise that they need to build the capacity of their own revenue services. Meeting in South Africa in 2008, they said:

> "Improving revenue performance will require a major improvement in tax administration through better service delivery, and taxpayer education, effective use of automated systems (especially in the clearing system and monitoring refund claims), better cooperation between tax administrations to counter tax evasion and aggressive tax planning, and strengthening audit and human resource management capability."[170]

Significant investment of resources, expertise and political will in a tax authority can substantially improve compliance, as the example of Rwanda (Box 9) shows.

Poor people lose out when tax administrations are ineffective

Inefficient and ineffective tax administration, a product both of legislation that is difficult to implement and of underinvestment in revenue authorities, reduces the tax revenues available to governments and forces them to rely on the easiest taxes to administer, which may not be the most progressive. When developing countries rely on import tariffs and sales taxes, without appropriate credits and exemptions for poor people, the impact can be regressive. It also results in greater vulnerability to economic shocks, such as a decline in imports.

Although most poor people are not liable to pay taxes such as income tax, it is still the rich who benefit from a weak tax administration. These are the people who can afford to put in place tax avoidance and evasion schemes that require time and resources to investigate. Weak and less independent tax authorities mean that rich individuals may also benefit from preferential treatment if they are able to influence tax officials or politicians.

Poor people are net beneficiaries of a progressive tax system: they pay less of their incomes in tax, and they have a greater need for the essential public services that are funded by taxes. If less tax revenue is collected, it means fewer teachers and nurses in public schools and hospitals.

Building tax authorities: in everyone's interest

International donors have already begun to provide funds and technical assistance for developing countries to strengthen their tax systems, improve surveillance and collection, and tackle illicit flows of capital. DFID, for example, says that between 2001 and 2006 it "undertook 181 tax-related projects or programmes across 44 countries, with a financial commitment of about £159 million".[171]

These programmes can deliver a major boost to government revenue. Ghana worked with the German government's development agency GTZ to improve its tax policy and administration between 2003 and 2005. As a result, it increased corporation tax revenues by 44% in real terms, and direct taxation by 22%.[172]

The return on this investment is evident, yet in 2005, only 1.7% of the US$7.1 billion (£3.91 billion) in bilateral aid committed for public sector administration went to improving tax administration.[173]

Developing countries should therefore invest time, money and political will in strengthening national tax inspectorates with the aim of substantially increasing the proportion of national budget that comes from domestic tax revenue, and the overall size of the budget, with the aim of meeting their international poverty-reduction commitments. The latter will require paying particular attention to girls' and women's rights.

Rich-country governments and international donors should increase funding for developing countries to strengthen their tax systems, surveillance and collection, and to tackle illicit flows of capital. This should include funding for technical assistance as governments require it, for them to purchase from a service provider of their choice.

Programmes to share knowledge and experiences already exist at global level, including the OECD's Global Relations programme, International Tax Dialogue, and the International Tax Compact initiated by the German government, and at a regional level, for example through the African Tax Administration Forum.[174] These initiatives should be encouraged and supported, and emphasis must be placed on supporting the governments of developing countries to build effective and appropriate tax systems that meet their own needs and priorities.

Box 9: The Rwanda Revenue Authority

Support for tax authorities in developing countries can help to lay the foundations for sustainable revenue collection. The Rwandan Revenue Authority (RRA) was set up as an independent body in 1997. Alongside funding from other donors and the government's own resources, the UK's Department for International Development has to date given the RRA £20.5 million in funding, as well as training for new staff. From a mere £60 million in tax revenue in 1998, the RRA increased the amount of taxes it could collect to over £240 million in 2006.[175]

By creating a revenue service independent of the finance ministry, improving the efficiency of tax collection was given a higher priority. Separating tax policy-making from the collection of taxes also reduced the potential for tax evasion, corruption and the special treatment of the political elite and its allies.

Rwanda has also raised the profile of tax compliance and administration. In 2001 the RRA started the 'Official Tax Payers Day'. Each year the government commemorates citizens who have made a significant contribution to the country's economic development. The day is meant to build citizens' sense of responsibility and pride in paying their taxes to help the country become less aid dependent. It is also a moment to assess the government's revenue and expenditures alongside the long-term national development plan, Vision 2020.[176] Combined, these efforts are not only raising more tax revenue, but also strengthening state-citizen relationships.

6. A rich man's club: why all countries need to be involved

Combating international tax competition, avoidance and evasion in a way that benefits developing countries requires a forum that can create and enforce global rules designed to benefit all. Yet at present no global body possesses the political mandate, legitimacy, and technical expertise necessary to do this.

Work is proceeding fastest through the G20 and OECD, but both bodies have a big representation problem: they are rich countries' clubs, even though they have invited developing countries to participate in discussions and forums. The United Nations' Committee of Tax Experts suffers from a lack of political mandate and resources.

Long-term solutions to the problems outlined in this report must include the development of a global, multilateral framework, whether an intergovernmental body of the United Nations or a new, independent organisation.

A system stacked in favour of the powerful

Several international frameworks exist through which developing countries are able to shape the rules on global tax cooperation. However, each one has its problems:

- The United Nations' Economic and Social Council (ECOSOC) has an expert committee on tax matters, which sits within its Financing for Development structure. UN summits in 2008 (Doha) and 2009 (New York) have called on ECOSOC to "examine the strengthening of institutional arrangements to promote international cooperation in tax matters", including this committee.[177] But the UN Committee only has a technical mandate, not a political one. Capacity problems limit both the committee's secretariat, and developing country participation. In negotiations before the Doha summit, the G77 group of developing countries called for the committee to be upgraded to an intergovernmental body with a political mandate, but this proposal did not make it into the final Doha communiqué.
- The G20 has taken a lead in the past year on pushing for stronger cooperation measures, and sanctions on states that do not comply. It has bolstered support for the OECD, which is the global body with the greatest technical expertise on tax cooperation. The OECD in turn has a forum for tax administration, which operates a peer review mechanism through which countries' cooperation on tax matters is assessed. Both the OECD and G20 have a representational deficit, however: several middle-income countries participate in the G20, but there is no regular low-income country participation. The OECD is by definition a rich countries' club, and while its Global Forum is expanding to include some developing country representation, it remains a part of the OECD structure, with membership dominated by rich countries and tax havens. The OECD Forum will never gain the necessary legitimacy to handle the political aspects of tax cooperation.

Global tax rules are loaded against developing countries, and the institutional frameworks through which they might be addressed leave little room for developing countries to participate meaningfully.

A new institutional framework

When considering the solution to an institutional deficit, a balance has to be struck between legitimacy and realpolitik, idealism and realism. Efforts are continuing at the OECD and G20 to develop a multilateral tax information exchange framework that will benefit developing countries, and this has the potential to deliver real gains for them. Regional groupings – in particular the African Tax

Administrators' Forum – are gathering strength and have not shied away from political declarations. These efforts must be supported.

But in the long term, global tax cooperation must be tackled by a representative political body with a political mandate from all countries. As a first step, all governments should support the United Nations Committee of Experts on Tax Matters by upgrading it to an intergovernmental body, and by promoting its Model Tax Convention and Code of Conduct on Cooperation in Combating International Tax Evasion.

The political scientist Harold Laswell said that politics is "who gets what, when, and how".[178] As this report has shown, decisions about tax – whether within or between countries – are about exactly that. Tax is a fundamentally political matter, and all governments need to take responsibility for changing a global system that benefits the rich, at the expense of the poor.

Several thousand women take part in a mass rally in coordination with ActionAid's HungerFREE campaign, Chitwan District, Nepal. If governments had more tax revenue, they could invest in more agricultural programmes to help people feed themselves.
PHOTO: Brian Sokol/ActionAid

7. Recommendations

A number of organisations have produced recommendations for governments, intergovernmental bodies and civil society to increase the amount of tax revenue available to developing countries. These include the Task Force on Financial Integrity and Economic Development, the Tax Justice Network, and the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System.[179] Partly drawing on these, here we present a brief summary of ActionAid's recommended policy responses to the issues discussed in this report.

ActionAid's Outlandish Revenue Service meets Stephen Timms, Financial Secretary to the Treasury, to discuss tax evasion by multinational corporations in developing countries.

PHOTO: Kristian Buus/ActionAid

A country-by-country financial reporting standard

- Governments and international groupings (including the G20 and United Nations) should support a country-by-country financial reporting standard, and formally request the International Accounting Standards Board to adopt it.
- The OECD should continue its feasibility study of country-by-country reporting, and report back to both the G20 and the UN during 2010.
- The International Accounting Standards Board should adopt a new standard that includes country-by-country reporting.
- Civil society and the media should in future make use of the information disclosed under country-by-country reporting to hold governments and multinational companies to account.

Better tax information exchange

- Ongoing discussions at the G20 and OECD should result in a fully global multilateral tax information exchange agreement. This agreement should lay the foundations for an eventual multilateral, global system of automatic tax information exchange, including multilateral countermeasures for non-compliance.
- If they request it, donors should provide support for developing countries to develop their technical capacity – including the requirements for confidential handling of information – needed so that they can adhere to this agreement.
- Any agreement should include a robust review mechanism to evaluate benefit to developing countries and include provision for change if necessary.

Stronger taxing rights for developing countries

- Governments should ensure that double taxation agreements into which they enter strike an optimal balance between raising revenue and attracting investment that benefits poor people. In particular, the revenue implications of rules concerning the tax residence of legal entities, and of any restrictions placed on the application of the source basis, should be fully considered.
- Developing countries should work together to promote and improve the United Nations model convention, a double taxation treaty that better takes developing countries' needs into account, especially through the United Nations Committee of Experts on Tax Matters that developed this model.

Taxing business fairly

- Governments should aim to strike an optimal balance between raising revenue and attracting investment that benefits poor people when setting corporate tax rates and offering tax incentives, and refrain from granting tax incentives unless there is a well established evidence base to demonstrate the benefit for poor people of similar incentives.
- Governments should consider the impacts on growth and equity when making such decisions, and undertake tax expenditure analyses as part of the budgetary process (showing the extent of tax incentives). They should promote public debate on the findings, as part of national development strategies.
- Governments should refrain from putting fixed-term tax holidays in place.
- Governments should refrain from granting tax exemptions on a discretionary basis to individual companies.
- International organisations such as the IMF and World Bank should support countries in their efforts to halt the race to the bottom.
- Companies should not use economic or political power to extract tax incentives from developing-country governments. At a minimum, they should comply with the OECD Guideline II (5): "Refrain from seeking or accepting exemptions not contemplated in the statutory or regulatory framework related to environmental, health, safety, labour, taxation, financial incentives, or other issues."

Investing in tax authorities

- Developing countries should invest time, money and political will in strengthening national tax inspectorates with the aim of substantially increasing the proportion of national budget that comes from domestic tax revenue, and the overall size of the budget, with the aim of meeting their international poverty-reduction commitments. The latter will require paying particular attention to girls' and women's rights.
- Rich-country governments and international donors should increase funding for developing countries to strengthen their tax systems, surveillance and collection, and tackle illicit flows of capital. This should include funding for technical assistance as governments require it, for them to purchase from a service provider of their choice.

International cooperation

- Tax cooperation should ultimately be tackled by a representative political body with a political mandate from all countries. As a first step, all governments should support the United Nations Committee of Experts on Tax Matters by upgrading it to an intergovernmental body, and by promoting its Model Tax Convention and Code of Conduct on Cooperation in Combating International Tax Evasion.

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