The crumbling tax base of developing countries

Money on the move

Developing countries lower their taxes to attract foreign investment. Rich individuals and multinationals use tax havens to evade taxes. Both of these processes are eroding the tax base of many governments. Yet development policy makers and researchers have so far ignored the issue of taxation.

By **Evert-jan Quak**

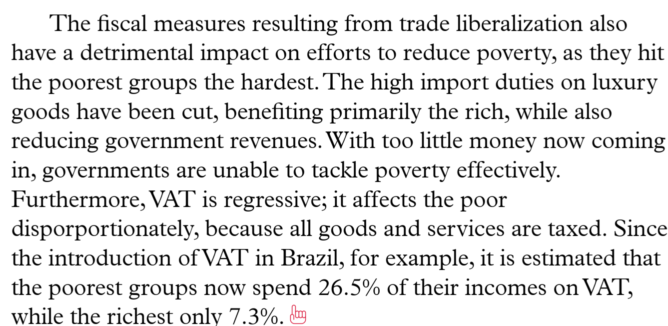
Development policy makers have long focused on good governance, but have paid little attention to the matter of how governments acquire the income they need to finance it. As a consequence, taxation has remained a technical issue, restricted to specialists who concentrate mainly on efficiency.

This situation is about to change, however. Researchers such as Charles McLure Jr., Alex Cobham, Lorraine Eden and John Christensen, and a number of development organizations, have begun calling for more consideration of taxation issues in development policies. Their studies show that developing countries find it very difficult to raise sufficient income from taxes. They conclude that more practical research and analysis are needed to rectify the lack of knowledge about this important area, and its implications.

What is the cause of the problem facing developing countries? Over the past two decades, the International Monetary Fund, the World Bank and the World Trade Organization have urged developing countries to open their borders in order to stimulate trade and economic development. This, in effect, meant that they had to drastically reduce their import and export tariffs. The multilateral institutions believed that these countries could compensate for the loss of these import and export tariffs by introducing value-added tax (VAT) and raising income taxes. But since it is easier for developing countries to collect taxes on import and exports than VAT and income taxes, the change has had a devastating impact on government revenues. Between the early 1980s and the late 1990s, average tax revenues fell by 7% as a proportion of gross domestic product (GDP).

The impacts of trade liberalization have been particularly severe for the poorest countries in sub-Saharan Africa and South Asia, which still depend largely on import and export tariffs for their tax revenues. While their revenues from VAT and income taxes have increased by 9%, this has not been enough to compensate for the loss of trade tax revenues of 20%. In effect, low-income countries were being asked to experiment, to be the first countries to base their entire tax systems on VAT, something that had never been done before. For countries that can rely on effective government institutions it has been relatively easy to implement VAT-based tax systems. Rich countries have therefore made the switch successfully, achieving a net increase in total tax revenues of 5% between the early 1980s and late 1990s.

Evert-jan Quak is a freelance journalist specializing in development and trade issues. He has a degree in international economics and economic geography from the University of Utrecht. To read more of his articles, visit www.globalissues.nl

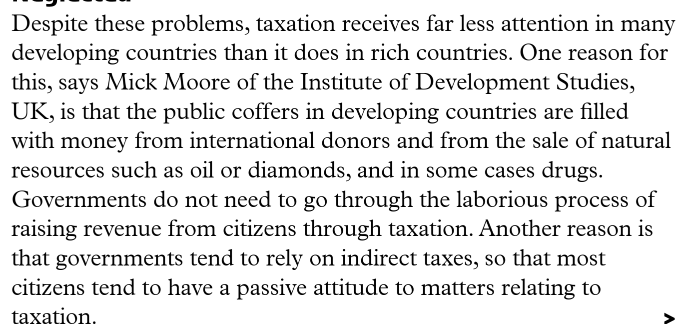


The fiscal measures resulting from trade liberalization also have a detrimental impact on efforts to reduce poverty, as they hit the poorest groups the hardest. The high import duties on luxury goods have been cut, benefiting primarily the rich, while also reducing government revenues. With too little money now coming in, governments are unable to tackle poverty effectively. Furthermore, VAT is regressive; it affects the poor disproportionately, because all goods and services are taxed. Since the introduction of VAT in Brazil, for example, it is estimated that the poorest groups now spend 26.5% of their incomes on VAT, while the richest only 7.3%.

What are taxes for?

- *Revenue*: tax revenues are used to finance public sector activities, including health care, schools, the judiciary and infrastructure.
- *Redistribution*: progressive taxation affects the poor less, while the rich pay more. If the revenue is then used to reduce poverty, taxation can help reduce the income gap in developing countries.
- *Re-pricing*: governments can use taxation to influence the behaviour of companies and individuals. For example, increasing the duty on cigarettes discourages smoking, and offering low tax rates attracts foreign investors.
- *Representation*: taxation promotes a critical population and increases their involvement in political decision making, making politicians more careful in how they use tax revenues.

Source: Cobham (2005).



Neglected

Despite these problems, taxation receives far less attention in many developing countries than it does in rich countries. One reason for this, says Mick Moore of the Institute of Development Studies, UK, is that the public coffers in developing countries are filled with money from international donors and from the sale of natural resources such as oil or diamonds, and in some cases drugs. Governments do not need to go through the laborious process of raising revenue from citizens through taxation. Another reason is that governments tend to rely on indirect taxes, so that most citizens tend to have a passive attitude to matters relating to taxation.

Inflation, too, plays a role. As inflation tends to be high in developing countries, monetary devaluation undermines any attempt to place taxation at the top of the political agenda. High inflation can completely neutralize the effects of the energy and money put into setting up a good tax system. As a conequence, individuals and companies in developing countries choose to negotiate directly with the government on the rate of tax they have to pay. This is one reason why tax policies in developing countries are often non-transparent and favour a select group of individuals and businesses powerful enough to lobby the government.

There are signs that things are already changing. Taxation is becoming an important political issue in developing countries, particularly those faced with the prospect of declining donor aid in the future. In addition, through the Washington Consensus, the IMF and World Bank have ensured that tax systems in many developing countries have become less complex and more transparent, making it more difficult for individuals to negotiate with governments directly on special tax rates. The monster of inflation, which caused such havoc in the 1980s, has now been brought under control and monetary devaluation has fallen to more reasonable levels, making it worthwhile for governments to set up effective tax systems.

The passive attitude to taxation in developing countries can therefore be expected to come to an end in the near future, but Mick Moore is unsure whether this should be seen as a good or a bad prospect. One benefit, he concludes, is that taxpayers will become more critical, meaning that governments will have a greater incentive to justify their use of tax revenues, and to use them more effectively for the future development of their societies.

Tax havens

While globalization can help to improve the accountability or representation (see box on page 9) of many developing country governments, it has also resulted in declining public revenues. But other processes also play a role in eroding the tax base of these countries. It is now easier than ever for rich individuals to deposit money in offshore tax havens, which offer very low or zero taxes to attract investments and capital from abroad. These tax havens usually offer their clients complete confidentiality, precluding the exchange of information with tax authorities in other countries.

At the same time, the internet has made it possible for corporations individuals and multinational to move money across borders, and to hide the transactions from national tax authorities. The number of tax havens has increased, according to IMF figures, from 25 in the 1970s to more than 60 in 2003.

The Cayman Islands are a good example. With one trillion dollars in assets, this tiny country is home to the fifth largest international banking sector in the world, after the US, the UK, Germany and Japan. It is estimated that US investors alone have deposits of US$290 billion in banks in the Cayman Islands, 80% of which is not declared to the US tax authorities. That means that the US is missing out on US$2.5 billion in tax revenues.

While the problem of tax evasion is not exclusive to developing countries, there is good reason to assume that they have greater difficulty in addressing it. This is because there is often no legislation in these countries to tackle the increasingly sophisticated forms of tax evasion. And even if legislation is in place, the poorest countries still do not have fully fledged tax systems that are able to tackle the problem. Auditing tax administrations is complex and has to be conducted by specialists trained to identify fraud. Lacking both funds and capacity, the tax authorities in developing countries are no match for the expensive teams of specialists employed by multinationals.

What multinationals do is actually very simple. Today, 60% of world trade takes place through transactions between branches of multinationals located in different countries. Because the internal market of international companies is so large, they can easily adjust the prices of transactions within the group. That means that they can manipulate invoices so that the total amount over which tax is to be paid in a country with high tax rates can be kept artificially low. The discrepancy between the actual and manipulated prices can be transferred to a second country where tax rates are lower, by using invoices on which the taxable amount is raised. In economic jargon, this creative activity is known as transfer pricing. For a multinational, says Charles MacLure Jr of Stanford University, 'the benefits of manipulating transfer prices depend on differences in tax rates in countries where real economic activity occurs. Once transfer pricing and tax havens are combined, the benefits of manipulating transfer prices increase dramatically and depend on differences in tax rates in such countries and in tax havens … where there may be little or no economic activity'.

Workbook / Hollandse Hoogte

Transfer pricing is permissible to a certain degree because it is sometimes difficult to establish a clear price for internal transactions. In recent years, the US and Europe have imposed increasingly strict requirements on multinationals in order to reduce tax avoidance. But because developing countries do not yet have in place, or are unable to implement such legislation, it is relatively easy for companies and rich individuals to move money around to evade taxes. Consequently, tax avoidance and the accompanying capital flight and corruption are having an unprecedented impact on developing economies (see box on page 12).

Tax competition

Countries do everything they can to make their countries more attractive to investors, which essentially means reducing taxes. This phenomenon, often referred to as the 'race to the bottom', has resulted in substantial reductions in the rates of corporation tax. In 1996 the average corporation tax rate in OECD countries was 37.5%. By 2003, it had fallen to 30.8%. The same trend is visible in developing countries such as Brazil, where corporation tax has fallen by 8% in recent years. Brazil supports the automobile industry, for example, with low taxation. An analysis of foreign investors in this sector has shown that, in two out of three cases, the subsidies offered to attract the companies were many times higher than the value of the investment itself. And these companies would probably have set up operations in Brazil even without tax benefits.

Foreign investors bring many benefits to a country, such as knowledge, employment and capital. By lowering taxes, governments hope to attract investments that will contribute to economic development in the long term. According to Sheila Killian of the University of Limerick in Ireland, however, most of the benefits are short lived. 'Countries which were successful at the first round of tax competition are now finding that tax rates alone will not hold the multinationals on which they have become so dependent. The economic growth associated with their earlier success has brought high operating and wage costs. Multinationals who have remained lightly rooted in the soil of these countries can easily move their manufacturing to cheaper, emerging economies, taking with them their coveted jobs and exports'.

Opponents of tax competition are also sceptical about the economic benefits of foreign investment attracted through fiscal incentives. They see it as setting economic theory on its head, with governments negating the economic principle of comparative advantage by keeping production costs artificially low for some companies through far-reaching tax benefits. Economic theory requires, conversely, that companies compete through the production factors that determine productivity instead of using fiscal tricks.

The World Investment Report 2006 shows, in addition, that to a large extent foreign direct investment involves takeovers of local companies. It is therefore not new investment, raising the question of the value of encouraging such investment with tax incentives. Such incentives are by no means the most important reason why companies choose to locate in a country. A good infrastructure, an educated workforce and a stable macro-economy are factors that usually weigh more heavily.

This means that developing countries – which are often unstable, the level of education low and the infrastructure weak – find it difficult to attract foreign investors, and so choose to compete by offering low wages and taxes. It is doubtful whether this strategy is beneficial in the long term; many companies have left Mexico and Vietnam, for example, to countries with even lower wages and tax rates. The advantages offered to foreign investors can also affect the growth of local companies, which are often more oriented towards domestic markets than those in developed countries. Tax incentives for foreign investors can disrupt these domestic markets, especially if local businesses have to pay a higher tax rate.

Another line of reasoning considers all forms of government intervention as undesirable. Opponents of lowering taxes to attract foreign investors see it as government intervention, whereas proponents argue that this is not the case, as taxation is by nature interventionist. They claim that it is international competition between countries that keeps taxes at acceptably low levels, which is advantageous for trade and the economy. In the words of Milton Friedman, the eminent neoliberal economist, 'Competition among national governments in the public services they provide and in the taxes they impose is every bit as productive as competition among individuals or enterprises in the goods and services they offer for sale and the prices at which they offer them'.

So why do countries compete in the race to the bottom when it affects their income so drastically? There are several possible explanations. First, for a central government or local authority, a multinational company locating an office in their country or district, for example, is a tangible sign of the success of foreign direct investment. It is easier to point to the employment that is created and the money that the investment generates than to the costs involved. Second, countries tend to adopt supposed 'best practices' without looking closely at their own specific needs. There are examples – such as Ireland – where lowering taxes has proved to be extremely effective in promoting economic development. But these countries combined this strategy with an effective mix of other measures designed to protect their embryonic industries, and increased their expenditures on education.

Although the issue of taxation is not high on the development agenda, it has come to the fore in the rich countries. The government of Norway, for example, has recently offered to fund a World Bank study of the scale of illicit financial flows, the findings of which will undoubtedly lead to demands for action on tax havens. The OECD is now pressing for the development of a multilateral policy against tax havens. Following the publication of the report, *Harmful Tax Competition*, in 1998, the OECD Global Forum was set up, in which 60 OECD and non-OECD countries are working to establish 'a global level playing field in the areas of transparency and effective exchange of information in tax matters'.

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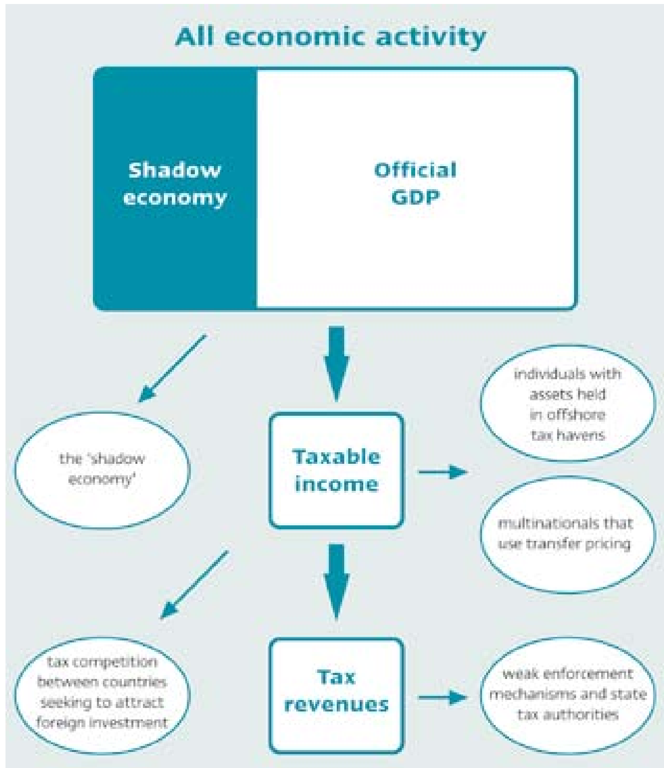

Carthographics, Heemskerk

A simple model of a taxed economy and key leakages
Source: Cobham (2007)

Transparency

For the OECD, improving transparency is the most important objective, not competition as such, as that is a politically sensitive issue. Every country wishes to retain its sovereignty in the area of taxation, yet the objectives of governments are sometimes contradictory. On the one hand, they want to address harmful competition to protect their own tax base, while on the other they wish to secure the interests of their own industries abroad.

Capital flight

Many researchers have attempted to determine how much developing countries lose due to capital flight and tax evasion. Baker and Nordin of the Center for International Policy, for example, calculate that at least US$500 billion flow out of developing countries each year – ten times more than they receive in aid. For Africa, it is estimated that 60% of trade transactions are not priced at the correct value, as a result of which 7% of the value of trade (worth US$10–11 billion in 1999) leaves the continent each year. Oxfam has calculated that US$50 billion disappears from developing countries each year as a result of tax competition and what rich individuals spirit away to tax havens (i.e excluding transfer pricing and tax evasion by multinationals). The London-based Tax Justice Network claims that the total amount lost due to capital flight could be as high as US$255 billion.

These amounts vary considerably because exact figures do not exist or are difficult to track down. While some researchers are reluctant to quote precise figures, others, including Baker, Cobham and Christensen consider it important to mention amounts like US$500 billion in order to highlight the scale of the problem. A World Bank study of illicit financial flows, to be funded by the Norwegian government, is expected to find that the true scale of capital flight is probably significantly greater.

All Western countries need to examine their own policies regarding their former colonies, argue Lorraine Eden and Robert Kudrle of Texas A&M University. 'About half of all tax havens have quasi-outsider status because they are linked to an OECD member country either as a former colony or dependency, possession, free association, or a double tax treaty; for example, Aruba and the Netherlands Antilles are linked to the Netherlands. Most Caribbean islands still have tax treaties with the UK. Some are islands off the coast of OECD member countries (e.g. the Channel Islands)'. They refer to the European mother countries 'renegade helpers', because their tax policies allow tax havens to weaken the overall effectiveness of the international tax regime.

Another solution is to impose higher sanctions on companies found guilty of tax fraud, tax evasion or illegal forms of transfer pricing. Companies carefully calculate the risks involved, however. A recent US Senate enquiry found that the management of accountancy firm KPMG gave its approval to a company that was underpricing its services in the US because any fines imposed would be low anyway. If, like individual taxpayers, companies were punished more severely for tax fraud, many of them would make different decisions.

But such steps would still not be sufficient for developing countries. They have almost no access to information because there are few tax treaties between developed and developing countries. As a result, there is hardly any cooperation between them, despite the great need for it. And even if there is a tax treaty, it would still take a great deal of money to improve the level of tax administration and expertise in developing countries sufficiently to enable them to make adequate checks on the outflows of capital into bank accounts in tax havens. Overall, developing countries cannot be blamed for this. The onus is therefore on the rich countries to take the first step to help developing countries by cracking down on the world's tax havens. ■

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