

DPRN PHASE II – REPORT NO. 15

Research Papers

Supporting developing countries’
ability to raise tax revenues



Colophon

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Background

Domestic tax revenues are the most sustainable source of financing for public expenditures in developing countries. Tax revenues are more stable and more predictable than foreign aid and allow for more policy space because of the conditionality attached to loans or grants. Enhancing direct tax revenues also has the potential to strengthen government accountability towards a country's citizens rather than external donors or national elites.

However, the ability of developing countries' governments to raise direct tax revenues is constrained by a number of external and internal factors, such as trade liberalisation, tax avoidance and evasion, a lack of capacity of revenue authorities and low tax compliance. Yet attention for this issue from development agencies and NGOs has been relatively limited, as has information exchange and active cooperation between staff from government departments for development cooperation and tax departments or ministries of finance. This is partly because attention for taxation and development is relatively new. Unfamiliarity with the theme and a lack of expertise or experience among donors and NGOs play a role as well. Although there has been substantial progress in research on taxation and development, this has not yet resulted in a similar progress in development policies.

To address the issue, SOMO and Tax Justice Netherlands organised a series of activities in 2009 in the framework of the Development Policy Review Network with the aim of enhancing the exchange of information and cooperation among relevant actors to support developing countries' ability to raise tax revenues, and of presenting concrete policy recommendations and tools for policy makers and NGOs on how to address the issue.

The activities comprised three main components, namely:

1. Building an enhanced *knowledge base* about research, policies, and initiatives on the issue by way of a consultation, literature review, and research papers.
2. Stimulating an informed *policy dialogue* on the subject and cooperation between different actors by organising a seminar.
3. *Following up* and embedding newly created linkages and information infrastructure in existing initiatives and networks.

The present publication contains three research papers, produced by SOMO, Tax Justice NL and CIDIN, the output relating to the first component. A list of resources and a report of the seminar have been published on the Tax Justice NL site <http://www.taxjustice.nl>, where also follow-up projects and initiatives will be published.

Paper 1 assesses in how far the ability of developing countries to effectively implement tax policies and increase tax revenues is compromised by international factors, such as aid conditionality, international opportunities for tax evasion and avoidance, or trade agreements. Paper 2 discusses domestic constraints, such as limited expertise of local NGOs for advocacy on and monitoring of tax policies, capacity constraints of revenue authorities, and problems regarding tax compliance. Paper 3 analyses the relationship between external aid and taxation and tax structures in developing countries as well as reviewing donor policies to support tax reform.

Paper 1: International Barriers to Raising Tax Revenues

Thijs Kerckhoffs, Centre for Research on Multinational Corporations (SOMO)

1. Introduction

Non-Governmental Organisations tend to focus on the question of how to mobilise more money for the South from the North, whether through an increase in official development assistance or through new financial instruments such as global taxes.¹ More attention needs to be paid to the opposite trend, the international industry that has grown up specifically to maximise ‘tax efficiency’ or, in other words, to deny sovereign governments their income. Developing countries can only overcome their dependency on donors when they are able to mobilise enough domestic revenues to safeguard universal access to reasonable essential public goods and services. Moreover, taxation increases democratic behaviour as governments have to become accountable towards their citizens rather than donor countries.² Those countries will not only need to improve their tax systems and structures, including the functioning of tax authorities, but should also receive revenues that belong to them.

In this paper we focus on the opposite trend as financial resources flow out of the South due to corporate tax incentives, capital flight, tax havens and trade liberalisation. *Which international barriers exist and have a negative influence on the ability of developing countries to generate tax revenues?* The paper aims to provide a comprehensive overview regarding those trends on the basis of academic papers, civil society reports, policy documents and relevant websites.

This paper is composed of chapters that contain a general description of a phenomenon and a brief outline of the main characteristics and consequences that go together with that phenomenon. Besides this, each chapter ends with a comprehensive overview of the most relevant initiatives by international institutions such as the OECD, the UN and the IMF.

The author wants to thank Geerten Michielse (Center for Taxation and Public Governance) and Maaïke Kokke (SOMO) for their contributions.

2. Tax competition and tax incentives

The Tax Justice Network has defined ‘tax competition’ as the rivalry between countries that compete for investment by lowering the tax rates on business, or by offering other tax

¹ J. Martens, The Precarious State of Public Finance: Tax evasion, capital flight and the misuse of public money in developing countries – and what can be done about it, GPF Europe, Jan 2008, <http://www.taxjustice.net/cms/upload/pdf/martens_precarious_finance__2007.pdf> (September 2009).

² M. Everest-Phillips, Business tax as state-building in developing countries: applying governance principles in private sector development, *International Journal of Regulation and Governance* 8(2): 123-154.

advantages in order to attract or keep companies located within them.³ In this paper we focus on regional tax competition between more or less similar countries that are eager to attract foreign direct investments (FDI) by mobile companies or services. Various tax incentives are being used to attract different forms of foreign investment, such as:

- real investments in plant and equipment;
- financial flows associated with mergers and acquisitions;
- increased investment in foreign affiliates;
- joint ventures.⁴

The process of globalisation, with its substantial trade liberalisation, improved transport infrastructures and greater capital mobility, has enabled companies to operate or shift business activities across national borders and towards countries that are economically attractive. The economic attractiveness of a country depends on factors such as political stability, adequate skills, access to markets, good infrastructure, language and cultural conditions etc., but also, and especially in case of comparable circumstances, on a country's tax regime. Moreover, as non-tax barriers decline, the significance of taxes as an important factor on investment decisions increases.⁵ Countries no longer have the luxury of designing their tax systems in isolation. As a result, it is important for governments to consider the tax regimes of other countries in the region from, for example, the following perspectives.

- Their residents may be potential investors or consumers of products produced in the country;
- They are competitors for foreign investment.⁶

Some experts argue that tax competition makes governments more efficient in how they raise and spend taxes. Those arguments are based on the theory of Charles Tiebout (1956). Based on the assumption that consumers' purchasing power can act as a 'vote' in a market economy, Tiebout suggested that the level of provision of 'public goods' by local communities can be optimised if consumer-voters have a choice from a number of communities in which to reside which offer different levels of public goods and hence tax rates. Market failures because of economic externalities would be solved by cooperation as necessary. The Tax Justice Network considers this theory to be 'highly simplified and unrealistic' as it assumes that residents are all of the same type, entirely free to move and can decide where to live purely on the basis of their tax-expenditure preferences. Moreover, multinational enterprises are so dominant in certain sectors of development economies that

³ Tax Justice Network Tax Justice Briefing, Tax Competition, September 2006,

<http://www.taxjustice.net/cms/upload/pdf/Tax_competition_-_SEP-2006.pdf> (August 2009) p. 1.

⁴ Easson, A. & E.M. Zolt, Tax incentives, World Bank Institute, 2002,

<<http://siteresources.worldbank.org/INTTPA/Resources/EassonZoltPaper.pdf>> (September 2009) p 7.

⁵ Easson, A. & E.M. Zolt, Tax incentives, World Bank Institute, 2002,

<<http://siteresources.worldbank.org/INTTPA/Resources/EassonZoltPaper.pdf>> (September 2009), p.3.

⁶ Easson, A. & E.M. Zolt, Tax incentives, World Bank Institute, 2002,

<<http://siteresources.worldbank.org/INTTPA/Resources/EassonZoltPaper.pdf>> (September 2009), p. 4.

governments have little room for manoeuvre regarding the way they tax those companies because the corporations then often threaten to move their business to another the country. As a result, the Tax Justice Network argues that tax competition mainly puts pressure on governments to reduce corporate taxes, and therefore to cut public services or shift the tax burden to less mobile factors such as employment income.⁷ Measures to limit tax competition are needed in order to prevent a ‘race to the bottom’.

2.1 Corporate tax

Multinational corporations use tax advantages as a condition for investment to encourage a lot of governments to routinely engage in tax competition by offering tax incentives.⁸ In Latin America, for example, the average tax rate on corporations fell from 41% in 1985 to 29% in 2003 and the top rate on personal income from 51% to 28%.⁹ On average, governments of OECD countries decreased corporate tax rates from 37,6% to 28,31% between 1996 and 2006.¹⁰

2.1.1 Incentives

Tax incentives can be applied to try and attract new investments in general, in the form of domestic or foreign direct investments, or can be targeted on attracting a specific investment. The Tax Justice Network and others have identified several incentives:

- Lower tax rates on profits and capital. Tax incentives related to profits mean that only profitable companies benefit and governments suffer no revenue losses from investments that turn out not to be profitable.¹¹
- Tax holidays imply a reduction or elimination of tax for a certain period of time, for the purpose of attracting FDI or stimulating growth in selected industries.¹² The rationale is that newly attracted investors may also stay when the tax holiday ends. This approach may be tempting to poorer countries which may not have the resources to offer up-front investment grants, and which may consider foregoing some revenue from exempting business profits from taxation to be a necessary trade-off to attract investment.¹³ In

⁷ Tax Justice Network Tax Justice Briefing, Tax Competition, September 2006, <http://www.taxjustice.net/cms/upload/pdf/Tax_competition_-_SEP-2006.pdf> (August 2009)

⁸ Kokke, M. & F. Weyzig, Taxation and financing for development, (October 2008) SOMO, <http://somo.nl/publications-nl/Publication_2955-nl/?searchterm=> (August 2009)

⁹ Bird, R., Tax challenges facing developing countries, (March 2008), Inaugural lecture of the annual public lecture series of the National Institute of Public Finance and Policy, New Delhi, India <http://www.nipfp.org.in/working_paper/wp_2008_Richard.pdf> (September 2009)

¹⁰ J. Martens, The Precarious State of Public Finance: Tax evasion, capital flight and the misuse of public money in developing countries – and what can be done about it, GPF Europe, Jan 2008, <http://www.taxjustice.net/cms/upload/pdf/martens_precarious_finance__2007.pdf> (September 2009).

¹¹ Easson, A. & E.M. Zolt, Tax incentives, World Bank Institute, 2002, <<http://siteresources.worldbank.org/INTTPA/Resources/EassonZoltPaper.pdf>> (September 2009) p. 24.

¹² Kokke, M. & F. Weyzig, Taxation and financing for development, (October 2008) SOMO, <http://somo.nl/publications-nl/Publication_2955-nl/?searchterm=> (August 2009).

¹³ Tax Justice Network Tax Justice Briefing, Tax Competition, September 2006, <http://www.taxjustice.net/cms/upload/pdf/Tax_competition_-_SEP-2006.pdf> (September 2009).

India, for example, the government gives some of that country's biggest and richest companies a tax-free ride under the programme of Special Economic Zones, which were designed to bring more foreign investment into the country.¹⁴ Critics argue that tax holidays only attract short-term investments rather than sustainable investments.

- Sectoral tax incentives are targeted at, for example, the manufacturing industry, to create jobs, new and innovative industries or specific sectors that are absent in a particular country. Peru, for example, has preferential tax rates for asparagus producers which supply most of the asparagus consumed in the UK.¹⁵
- The creation of (Export Production) Zones, which are commercial regions that have a lower tax burden or less regulatory requirements. Those 'zones' may stimulate the economy or create employment in undeveloped areas. On the other hand, if local authorities are competent as regards tax, counterproductive competition may be caused between regions in the same country. Moreover, the zones may trigger practices such as domestic transfer pricing to decrease the tax burden and increase the profits.
- Accelerated tax allowance for spending on capital assets implies that a tax relief is given to companies that invest in capital assets. To benefit from relaxed regulations and tax incentives, companies frequently move the legal ownership of the assets from the location in which they are actually used.¹⁶
- Reduced import taxes and import duties. Some countries create special zones that are exempt from import duties in order to promote investment and therefore development.
- Subsidies to promote certain activities may be difficult for governments to implement as they actually need to spend funds to attract investors. On the other hand, this approach allows a more precise estimation of costs.
- Personal income tax or social security reductions for executives or employees.
- The absence of withholding taxes, which is the tax on dividends paid to shareholders.
- Tax inducements for mobile labour required for an investment project.¹⁷

Some experts argue that narrowly targeted tax incentive programmes may be successful in attracting specific projects or specific types of investors.¹⁸ The potential benefits could include the transfer of capital, the transfer of know-how and technology, the promotion of employment, and assistance with improving the conditions in less-developed areas.¹⁹ Besides this, those benefits may generate spill-over effects to other sectors of the economy

¹⁴ Christian aid report, Death and taxes: the true toll of tax dodging, (May 2008),
<<http://www.christianaid.org.uk/images/deathandtaxes.pdf>> (September 2009) p. 3.

¹⁵ Christian aid report, Death and taxes: the true toll of tax dodging, (May 2008),
<<http://www.christianaid.org.uk/images/deathandtaxes.pdf>> (September 2009) p. 3.

¹⁶ Kokke, M. & F. Weyzig, Taxation and financing for development, (October 2008) SOMO,
<http://somo.nl/publications-nl/Publication_2955-nl/?searchterm=> (August 2009) p. 7.

¹⁷ Kokke, M. & F. Weyzig, Taxation and financing for development, (October 2008) SOMO,
<http://somo.nl/publications-nl/Publication_2955-nl/?searchterm=> (August 2009).

¹⁸ Easson, A. & E.M. Zolt, Tax incentives, World Bank Institute, 2002,
<<http://siteresources.worldbank.org/INTTPA/Resources/EassonZoltPaper.pdf>> (September 2009), p. 10.

¹⁹ Easson, A. & E.M. Zolt, Tax incentives, World Bank Institute, 2002,
<<http://siteresources.worldbank.org/INTTPA/Resources/EassonZoltPaper.pdf>> (September 2009), p. 10.

because of, for example, suppliers and distributors. However, there is no such thing as a free lunch, so tax incentives may not just bring in money but may also be costly. Easson and Zolt define four types of costs relating to tax incentives²⁰²¹:

- revenue costs which consist of:
 - the foregone revenue from projects that would have been undertaken even if the investor had not received any tax incentive, and
 - the lost revenues from investors and activities that improperly claim incentives or shift income from related taxable firms to those firms qualifying for favourable tax treatment;
- resource allocation costs which mean that there is too much investment in certain activities, or too little investment in other non-tax favoured areas. Among others, investors may change their decision in order to take advantage of certain incentives;
- enforcement and compliance costs are related to the complexity of the structure of tax incentives. The greater the complexity, the higher the enforcement and administration costs needed to monitor whether the investments fulfil the applicable and prescribed conditions;
- costs associated with corruption and lack of transparency if discretion is applied to determining which investors or projects receive favourable treatment.

It seems that targeted tax is likely to reduce the number of free riders but also leads to greater misallocations of resources and competitive distortions between domestic and foreign companies and sectors that enjoy the incentives and those that do not. As a consequence of the attempt to attract FDI, developing countries may stand in the way of the development of local and regional companies.

2.1.2 Some examples of tax incentives in developing countries

In Guatemala, company tax rates vary between 5% and 31% depending on the applicable tax regime.²² Honduras has 15 export ‘free- zones’, where foreign firms have been granted a permanent exemption from all taxes. Another example concerns the Philippines, where preferential tax regimes ranging from 3% to 7% apply to companies in certain sectors (banking, insurance, finance, transport).²³ A neighbouring country of the Philippines, Indonesia, also applies tax incentives. The tax incentives there are available to entities with capital investments in certain approved industry sectors, or those operating in certain geographic locations. Incentives include a 5% tax investment allowance, accelerated depreciation, the carry forward of losses for up to 10 years and a reduced withholding tax of

²⁰ Easson, A. & E.M. Zolt, Tax incentives, World Bank Institute, 2002,

<<http://siteresources.worldbank.org/INTTPA/Resources/EassonZoltPaper.pdf>> (September 2009), p. 11.

²¹ Zee, Howell H., Janet G. Stotsky, and Eduardo Ley, Tax Incentives for Business Investment: A Primer for Policy Makers in Developing Countries, (2002), World Development, 30(9), pp. 1497–1516.

²² The Federation of International Trade Associations website, countries, ‘Guatemala’, <<http://www.fita.org/countries/guatemala.html>> (August 2009).

²³ The Federation of International Trade Associations website, countries, ‘Philippines’ <<http://www.fita.org/countries/philippines.html>> (August 2009).

10% paid to non-residents. As from 1 January 2008, an income tax reduction of 5% may be available to companies listed on the Indonesian stock exchange if certain conditions are satisfied.²⁴ African countries, such as Ghana, also use a variety of tax incentives. Agricultural enterprises, agro and waste processing companies, real estate business, venture capital financing companies, companies in the free-zone enclave and manufacturing companies engaged in the processing of crops, fish or livestock produced in Ghana are exempt from corporate tax for periods ranging from 3 to 10 years. Moreover, rural banks and free-zone companies pay 8% tax after their exemption period, while agro-processing companies pay tax between 0% and 20% depending on their location.²⁵

2.1.3 Consequences

Tax incentives can lead to more foreign direct investments for a single country or region but are expensive and countries compete with each other to attract or keep those investments. The result of such competition is a 'race to the bottom' as regards tax rates. Developing countries compete by means of tax incentives and by lowering their corporate tax rate while having little capacity to monitor and control the use of tax incentives. Because of this lack of capacity in the South, the use of the incentives by corporations for which the incentives were originally not intended may be larger in volume, and consequently in impact, in developing countries. However, most importantly, developing countries are less able of defending their tax base than high-income countries which also compete on the basis of corporate tax rates. This is because they usually have far less corporations among which to spread the general tax burden. This leads to lower average corporate tax revenues for developing countries and results in a shift of the tax burden towards labour and consumption. This harms employment generation and increases inequality. Consequently, tax competition increases poverty and inequality in the long run and, contrary to the original aim, slows economic growth.²⁶ However tax competition in OECD countries also has a negative impact on public investment. A decline of 15% in corporate tax rate reduces public investment by 0.6% to 1.1% of GDP.²⁷

Some argue that lower taxes keep money in private hand where it is more likely to find its way into investment and job creation. Those experts also maintain that government expenditure in developing countries is biased toward consumption and likely to crowd out private investment and hence hamper growth.²⁸

²⁴ Deloitte website, International Tax, Indonesia highlights 2009, <http://www.deloitte.com/dtt/cda/doc/content/dtt_tax_highlight_2009_indonesia.pdf> (August 2009).

²⁵ Deloitte website, International Tax Ghana highlights 2009, <http://www.deloitte.com/dtt/cda/doc/content/dtt_tax_highlight_2009_ghana.pdf> (August 2009).

²⁶ Kokke, M. & F. Weyzig, Taxation and financing for development, (October 2008) SOMO, <http://somo.nl/publications-nl/Publication_2955-nl/?searchterm=> (August 2009).

²⁷ Gomes, P. & F. Pouget, Corporate Tax Competition and the decline of public investment, (2008) CESifo Working Paper No. 2384.

²⁸ Bahl, R.W. & R.M. Bird, Tax policy in developing countries: looking back and forward, (May 2008), Institute for International Business, Working Paper Series No. 13, p.8.

Other experts regard the use of national tax incentives as harmful competition between countries from which developing countries will suffer most. Tax incentives promote inefficiency, as the advantage gained by one country by lowering its taxes is often short-term and is quickly offset by similar moves in neighbouring countries, which leads to long-term revenue losses in all countries. The experts state that lower taxes restrict infrastructure investments at suboptimal levels and slow down industrial development.²⁹ As a result, the revenue loss ends in an investment loss rather than an attraction of FDI, because multinational companies regard the quality of infrastructure, a well-educated workforce and a local dynamic market to be a much greater priority than tax advantages when investing in countries. A survey, by consultancy firm McKinsey, confirms that, of the 30 executives at companies that have moved jobs to India, the financial incentives were the least important factor in the decision. Most of the executives argued that they would rather see the government spend its money on upgrading the local infrastructure.³⁰ Furthermore, when developing countries invest in human capital, education or local technology capacity instead of lowering their corporate tax rates, the government retains the benefits in terms of a better educated workforce or an improved infrastructure in the event that a subsidiary is eventually closed, or lost to a country with a lower tax rate.³¹

2.2 Relevant actors and initiatives in relation to harmful tax competition

2.2.1 The Organisation for Economic Co-operation and Development

- The OECD compiled a report on tax competition entitled, 'Harmful Tax Competition: An Emerging Global Issue' (1998). This report followed up on the Ministerial Communiqué of May 1996 in which the Organisation was called upon to 'develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases, and report back in 1998'.³² In its report, the OECD states its intention to develop a better understanding of harmful tax practices because harmful tax competition would diminish global welfare and undermine taxpayer confidence in the integrity of tax systems.³³ The OECD makes a distinction between acceptable and harmful preferential tax regimes in relation to financial and other service activities. Moreover, the report contains 19 recommendations and guidelines relating to domestic legislation and practices, tax treaties and intensification of international co-operation in response to harmful tax competition.

²⁹ Bahl, R.W, & R.M. Bird, Tax policy in developing countries: looking back and forward, (May 2008), Institute for International Business, Working Paper Series No. 13, p.8.

³⁰ Farrell, Diana, J. Remes, H. Schulz, The truth about foreign investment in emerging markets (2004), In: McKinsey quarterly 2004;1.

³¹ Mold, A. A proposal for unitary taxes on the profits of transactional corporations, (April 2004), CEPAL Review 82.

³² OECD, Harmful Tax Competition: an emerging global issue, (1998), <<http://www.oecd.org/dataoecd/33/0/1904176.pdf>>, (September 2009), p. 3.

³³ OECD, Harmful Tax Competition: an emerging global issue, (1998), <<http://www.oecd.org/dataoecd/33/0/1904176.pdf>>, (September 2009), p. 8.

- Following the 1998 report, a special forum was set with the title, 'Forum on harmful Tax Practices'. The forum's work focussed on harmful tax practices in member countries, tax havens and on involving non-OECD economies.³⁴

2.2.2 The World Trade Organization

- The WTO will continue to serve as a forum to resolve disputes between countries over unfair trade practices, such as those that grant prohibited export subsidies. Additionally, it is likely that it will continue to require countries to reduce or eliminate certain types of tax incentives as a condition for admission to the WTO.³⁵

2.2.3 The European Union

- The European Commission states that tax competition can be beneficial. Nonetheless, they have created an EU Code of Conduct for Business Taxation (1997), which provides criteria for identifying harmful tax measures. The Code is not a legally binding instrument and has a broader scope than the OECD guidelines because it is oriented towards business in general. However, EU Member States have committed to end previously existing harmful tax measures ('rollback') and refrain from introducing new ones ('standstill').³⁶
- A Code of Conduct Group, also called the Primarolo Group, has been established to monitor the implementation of the Code for Business Taxation. The Group meets four times a year and reports to the ECOFIN Council. In November 1999, the Group identified 66 potentially harmful tax measures in EU Member States and dependent territories. Many of these have since been abolished, altered, or judged not to be harmful.³⁷
- The Communication on Preventing and Combating Financial and Corporate Malpractices (2004) provides a strategy for coordinated action in financial services, company law, accounting, tax, supervision and enforcement areas, aimed at reducing financial malpractices. In the tax field, the Commission suggests more transparency and information exchange so that tax systems are better able to deal with complex corporate structures. The Commission also emphasises coherent EU policies concerning offshore financial centres, to encourage these jurisdictions to move towards transparency and effective exchange of information as well.

³⁴ European Commission website, DG Taxation, Company Tax, 'Harmful tax competition', <http://ec.europa.eu/taxation_customs/taxation/company_tax/harmful_tax_practices/index_en.htm#OECD> (September 2009).

³⁵ Easson, A. & E.M. Zolt, Tax incentives, World Bank Institute, 2002, <<http://siteresources.worldbank.org/INTTPA/Resources/EassonZoltPaper.pdf>> (September 2009), p. 5.

³⁶ European Commission website, DG Taxation, Company Tax, 'Harmful tax competition', <http://ec.europa.eu/taxation_customs/taxation/company_tax/harmful_tax_practices/index_en.htm#OECD> (September 2009).

³⁷ European Commission website, DG Taxation, Company Tax, 'Harmful tax competition', <http://ec.europa.eu/taxation_customs/taxation/company_tax/harmful_tax_practices/index_en.htm#OECD> (September 2009).

- The EU also applies a reduced duty or zero duty with respect to designated goods originating from a number of developing countries. These preferential duties are based on the 'General System of Preferences'.³⁸
- European state aid rules restrict or prohibit state assistance to the business which covers many types of tax incentives. However, numerous countries still have more attractive corporate tax regimes than others. Proposals regarding a Common Consolidated Corporate Tax Base (CCCTB) have not yet been presented by the European Commission.

3. Capital flight by tax planning

Capital flight involves the deliberate and illegal disguised expatriation of money by companies or individuals taxable within the country of origin. The estimates of the consequences of capital flight for developing countries vary but one is that developing countries lose ten times more money through illegal capital flight than they receive in public aid.³⁹ The outflow of private capital reduces the domestic savings and available tax revenues for the financing of investments and public expenditures. So capital flight has a negative effect on development.

Illicit flows of capital comprise three main types of transaction:

- flows arising from corruption or criminal activities, such as the drug trade;
- corporate illicit flows through tax avoidance and tax evasion;
- capital flows by private individuals that go abroad, for example in the form of savings.

Eurodad has focused on commercial, criminal and corrupt illicit capital flows from developing countries and estimates that commercial capital flow accounts for 64%, the criminal capital flows for 31% and the corrupt money for 5%.⁴⁰

Given that the focus of this paper is on the international tax barriers for developing countries to generate tax revenues, we will not elaborate on the existing non-tax reasons for capital flight, such as:

- a secure location for capital, for example, because of political instability;
- avoidance of local currency risks;
- avoidance of legal obligations, such as reporting requirements.

As a result, it is important to realise that, to a certain extent, capital flight would remain a problem even if there were no tax incentives implicit within it.

³⁸ Customs website, Special import procedures, 'Preferential rate', <http://www.douane.nl/zakelijk/invoer/en/invoer-09.html#P99_11013> (September 2009).

³⁹ Norwegian Commission on capital flight from developing countries, Tax havens and development. Summary of the preliminary report., (June 2009), <http://www.regjeringen.no/en/dep/ud/Documents/Reports-programmes-of-action-and-plans/Reports/2009/tax_havens.html?id=570947>, (September 2009), p. 4.

⁴⁰ Eurodad website, Capital flight, tax havens and financial regulation, <http://www.eurodad.org/uploadedFiles/Whats_New/Reports/factsheet_capitalflight08.pdf>, (September 2009).

The more illicit transactions are interwoven with genuine and legitimate transactions, the harder it becomes to detect them. Characteristics of legitimate transactions that can be interwoven with possible illicit capital flows are:

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

3.1 Corporate strategies

Tax avoidance and evasion on a large scale enables companies to become economic free-riders, enjoying the benefits of corporate citizenship without accepting the costs, while also causing harmful market distortions and transferring a larger share of the tax burden to individual taxpayers and consumers.⁴¹

3.1.1 Tax evasion and aggressive tax avoidance

Tax avoidance is a legal practice but often aggressive in the way that companies seek to pay less than their tax obligations. Legal capital flight is recorded on the books of the entity making the transfer, and earnings from interest, dividends, and realised capital gains normally return to the country of residence of the company where, for instance, goods are manufactured.⁴² The volume of the return will most likely depend on the capacity of the tax authority to monitor those capital flows. Aggressive tax avoidance occurs when companies exploit loopholes and flaws in tax laws and international arbitration opportunities. Even though this may be legally allowed, such behaviour is in conflict with the purpose of the legislator at the moment the tax provisions were introduced. Because a company does not aim to pay the right amount of tax at the right time and the right place, it abuses the spirit of the tax laws.⁴³ Tax-avoidance schemes, tax concessions and the negotiation of low royalty rates are important ways of avoiding some tax.

- Tax-avoidance schemes are considered in this paper to be tax planning by multinational corporations in order to minimise tax liabilities. International tax planning is performed by multinational companies that consist of a parent company and one or more subsidiaries in other countries. Double tax treaties prevent the income of these subsidiaries of one company being taxed in more than one country. The arrangements in these treaties are complex and this complexity gives companies the opportunity to plan their tax liabilities by making choices that affect the amount of tax that needs to be paid

⁴¹ Christensen, J. & R. Murphy,, *The Social Irresponsibility of Corporate Tax Avoidance: taking CSR to the bottom line*, (2004), In: *Development*, (2004), nr. 47, p. 37–44.

⁴² Baker, R., *Illicit Financial flows: a note of concept*, (December 2008), In: Kar, D. & D. Cartwright-Smith, *Illicit financial flows from developing countries: 2002–2006*, (2008), *Global Financial Integrity*.

⁴³ Kokke, M. & F. Weyzig, *Taxation and financing for development*, (October 2008) SOMO, <http://somo.nl/publications-nl/Publication_2955-nl/?searchterm=> (September 2009).

in a positive way.⁴⁴ In this case it is a legal practice but often harmful to the country of source as it misses out on tax revenues. Although there are few tax treaties between tax havens and third countries, including developing countries, those that do exist exacerbate the situation for developing countries as they contribute to ensuring that tax havens secure the rights to tax activities that are actually pursued in those countries.⁴⁵

- Tax concessions concern the tax incentives that are used by some companies, such as tax holidays. The incentives are usually acknowledged by national laws but have the consequence that multinational corporations pay less tax than they would have done if they had operated in that country without the existence of those tax incentives. As a result, the tax incentives are seen as a tax concession to companies and therefore a way for them to avoid a certain amount of tax.
- Negotiating low royalty rates. In this case a royalty is the remuneration to a country for minerals extracted. The royalty rates vary from 2% to 30%, with most being between 5% and 10%.⁴⁶

Tax evasion is an illegal practice. The earnings disappear from any record in the country of source and do not return to the country where, for instance, the products are manufactured.

- False invoicing, which is when unrelated companies import and export goods to each other at manipulated prices. Those companies inflate the price or undervalue goods with the aim of paying less tax. Importers and exporters use several techniques to minimise the risk of detection, such as the misreporting quality and grade and/or quantity of the products, to justify higher or lower prices. It is estimated that around 45% to 50% of trade transactions in Latin America are falsely priced by an average of more than 10%, while 60% of the transaction in Africa are mispriced by an average of more than 11%.⁴⁷
- Transfer mispricing is when different parts of a company sell goods or services to each other at manipulated prices. Those prices differ from the normal market prices for the goods or services. Companies manipulate their prices to lower tax liabilities in countries with high marginal tax rates, and increase profits in countries where the tax liability is correspondingly low. Some types of components or intermediate products may be readily available on the open market and, as a consequence, it is relatively easy to compare the price paid by a subsidiary with the open market price. However, other products may be specific to a particular company and have various patents structures, and will therefore be impossible to value in terms of a 'market price'. In the latter case, it is very difficult to assign costs accurately between affiliates. Moreover, developing countries often lack sufficient information from the parent company to be able to challenge those practices.⁴⁸

⁴⁴ Kokke, M. & F. Weyzig, Taxation and financing for development, (October 2008) SOMO, <http://somo.nl/publications-nl/Publication_2955-nl/?searchterm=> (September 2009).

⁴⁵ Norwegian Commission on capital flight from developing countries, Tax havens and development. Summary of the preliminary report., (June 2009), <http://www.regjeringen.no/en/dep/ud/Documents/Reports-programmes-of-action-and-plans/Reports/2009/tax_havens.html?id=570947>, (September 2009), p. 6.

⁴⁶ Baunsgaard, T., A primer on mineral taxation, (2001), International Monetary Fund Working Paper WG/01/139 p. 26.

⁴⁷ Christian aid report, Death and taxes: the true toll of tax dodging, (May 2008), <<http://www.christianaid.org.uk/images/deathandtaxes.pdf>> (September 2009) p. 8.

⁴⁸ Mold, A., A proposal for unitary taxes on the profits of transactional corporations, (April 2004), CEPAL Review 82.

According to a survey of 476 transnational corporations, nearly 80% acknowledge having transfer pricing at the heart of their fiscal strategy.⁴⁹

- Mispricing of financial transfers is when different parts of a company make financial transaction at manipulated prices. Financial transactions vary from loans and corresponding interests to real estate, goodwill, patent and copyrights and securities.⁵⁰
- Round-tripping takes place because foreign investors may receive tax incentives of a government that tries to attract FDI via the granting of such incentives. Once again, tax incentives are not the only way of parking money outside the country of origin. In the case of round-tripping, the protection of property rights, the expectations on exchange control and exchange rate and the competitiveness of financial centres also play a role.⁵¹ As a consequence, local businesses send their money offshore, either legally or illegally, and bring it back disguised as foreign investments, which then qualifies for preferential treatment. Xiao estimates that around 40% of the Chinese FDI concerns round-tripping.⁵² This would imply that FDI in the People's Republic of China are much lower than often assumed.

3.1.2 Some examples of tax avoidance and evasion by corporations

In 2005, the Wall Street Journal reported that Microsoft, for example, made use of a subsidiary in Ireland to save at least US\$ 500 million from its annual tax bill. In 2004, this small subsidiary controlled more than US\$ 16 billion in Microsoft assets and had gross profits of nearly US\$ 9 billion. Moreover, Microsoft routes the license sales through Ireland and this Irish subsidiary pays a total of just under \$17 million in taxes to about 20 other governments (Europe, the Middle East and Africa) that represent more than 300 million people.⁵³ At the expense of other counties, the Irish government has created a low tax environment for intellectual property and financial fruits. As a result, only this small Microsoft subsidiary generates US\$ 300 million in tax for the Irish government

Besides practices of aggressive tax avoidance, many multinational corporations make use of false invoicing of transfer pricing. For example, in June 2005, the U.S. imported 32,000 GM of scrap gold from Mexico and paid US\$825,000. What is interesting about this import is that the unit value of the scrap gold US\$25.78/GM (equivalent to US\$801.85/oz) is substantially higher than the price of pure gold at the time, about US\$14.16/GM (equivalent to US\$440.85/oz.) The U.S. importer clearly overpaid for the scrap gold, sending capital to

⁴⁹ Chavagneux C. and R. Palan, *Les paradis fiscaux*, (2007), p. 65.

⁵⁰ Kapoor, S., *Haemorrhaging Money*, a Christian Aid briefing on the problem of illicit capital flight, (2007), A Christian Aid briefing, <<http://www.financialtaskforce.org/beta/wp-content/uploads/2009/04/haemorrhaging-money-briefing-on-the-problem-of-illicit-capital-flight.pdf>> (September 2009) p. 14.

⁵¹ Xiao, G., *People's Republic of China's Round-Tripping FDI: scale, causes and implications*. (July 2004), <http://www.hiebs.hku.hk/working_paper_updates/pdf/wp1137.pdf>, (September 2009).

⁵² Xiao, G., *People's Republic of China's Round-Tripping FDI: scale, causes and implications*. (July 2004), <http://www.hiebs.hku.hk/working_paper_updates/pdf/wp1137.pdf>, (September 2009).

⁵³ Simpson, G. R. *Irish subsidiary let Microsoft slash taxes in U.S. and Europe*, Wall Street Journal, (7 November 2005), <http://faculty.law.wayne.edu/mcintyre/text/in_the_news/WSJ.com%20-%20Irish%20Subsidiary%20Lets%20Microsoft%20Slash%20Taxes%20in%20U.S.pdf> (September 2009).

Mexico and reducing taxable income in the US.⁵⁴ Besides this, there are low-priced commodity imports into the US from developing countries. In 2004, nickel was imported from Chile to the US at a price just over one-thousandth of the world price. The US company paid the Chilean company US\$219,883 for the nickel – the median world price would have been US\$125 million. This means that the Chilean treasury lost out on nearly US\$125 million of taxable income. Again in 2004, over 400,000 tonnes of platinum were imported into the US from the Dominican Republic, at a price that was only just over three-thousandths of the world price. Had the median price been paid, the Dominican treasury would have charged tax on more than US\$4.5 million of export income.⁵⁵ Other remarkable U.S. examples are; 1 kg. of paper tissues from China for US\$ 4,12.81, a unit of plastic buckets from Czech Republic for US\$ 972.98, air pumps from Malaysia for US\$ 5,000 a piece, as well as forklifts for Jamaica at the price of US\$ 384.14 or car seats exported to Belgium for US\$ 1.66 a piece.⁵⁶

3.1.3 Consequences

Several calculations have been made of the consequences of capital flight for developing countries. Although the outcomes of these calculations vary because of different methodologies and interpretations, the conclusion is the same. Capital flight is a harmful practice for developing countries as they miss out on tax revenues that cannot be invested in, for example, health and education.

Global Financial Integrity has conservatively estimated that illicit financial flows from developing countries amount to between US\$850 billion and US\$1 trillion a year. Their calculation does not include a) trade mispricing, b) criminal activities and smuggling, c) mispriced asset swaps.⁵⁷ Others, such as the former German Development Minister Wieczorek-Zeul, estimate a loss of US\$ 500 billion per year because of tax evasion.⁵⁸ Christian Aid calculated that tax evasion, via transfer mispricing and false invoicing, represents a loss of corporate taxes to the developing world currently running at US\$ 160 bn a year. That would be more than one-and-a-half times the combined aid budgets of the whole rich world in 2007, namely US\$ 103.7 bn.⁵⁹ In addition, a study by CEPAL (Economic Commission for Latin America), estimated that developing country governments lose at

⁵⁴ Pak, S. J. ,Capital flight and avoidance through abnormal pricing in international trade –the issue and the solution, (2007), In: Tax Justice Network, Closing the Floodgates Collecting tax to pay for development, (2007), <http://www.taxjustice.net/cms/upload/pdf/Closing_the_Floodgates_-_1-FEB-2007.pdf> (September 2009).

⁵⁵ Christian aid report, A rich seam: who benefits from the rising commodity prices, (January 2007), <http://www.christianaid.org.uk/Images/a_rich_seam.pdf> (September 2009), p. 10.

⁵⁶ Pak, S. J. & Zdanowicz, U.S. trade with the world, (2002) <http://www.oss.net/dynamaster/file_archive/040318/50b167ce2bb58f256cf8c2225aa4da82/OSS2003-01-09.pdf> (September 2009).

⁵⁷ Kar, D. & D. Cartwright-Smith, Illicit financial flows from developing countries: 2002–2006, 2008, Global Financial Integrity.

⁵⁸ Bretton Woods Project website, Combating tax flight: ending evasion and reducing avoidance Seminar at World Bank, minutes, (10 October 2008), <<http://www.brettonwoodsproject.org/>> (September 2009).

⁵⁹ Christian aid report, Death and taxes: the true toll of tax dodging, (May 2008), <<http://www.christianaid.org.uk/images/deathandtaxes.pdf>> (September 2009), p. 2.

least US\$35 billion revenue a year through tax avoidance practices.⁶⁰ Kavaljit Singh used data from the United Nations Conference on Trade and Development to show that some African developing countries have no positive net balance if the foreign direct investments are compared with the profits leaving the country between 1995 and 2003. For instance, the Democratic Republic of Congo made a loss of US\$ 1,150 million, Nigeria lost US\$ 1,603 million and Botswana had a negative balance of US\$ 4,678 million. Other countries, such as Angola (US\$ 3,592 million), Cameroon (US\$ 156 million) or Kenya (US\$ 50 million)⁶¹ have a positive balance but could have acquired more financial resources for development if their profits had not been sent out of the country. Even Angola, which had the most positive balance, had a profit remittance of US\$ 7,169.

3.2 Private individuals

Not only do corporations use tax evasion and avoidance strategies. Private individuals are sometimes also guilty of circumventing the intentions of tax laws. In that case private individuals try to benefit from low taxes. The practice of avoiding paying tax is at the expense of the country in which the individual is a registered resident.

3.2.1 Saving tax

Income from capital is one of the most mobile tax bases, and tax competition is rife. Some countries have a lower or a zero tax rate on income from savings, which makes them attractive to wealthy private individuals who then transfer their savings to that country. Such transfers cause countries to lose huge amounts of tax revenues and potential investments. The German government has estimated that its citizens have US\$378 billion to US\$631 billion in offshore bank accounts.⁶² As a result, the European Union adopted a directive in 2003 to streamline the exchange of information between countries to tackle this type of capital flight. See relevant initiatives by the European Union for more information.

3.2.2 Bank secrecy

Bank secrecy has two basic forms: de jure and de facto. De jure bank secrecy means that financial institutions are prohibited by national law from disclosing the identity of depositors/investors except in cases of money laundering or other criminal activity. De facto bank secrecy implies that these institutions are not required to provide their governments with information through automatic reporting about foreign depositors or investors.⁶³ Advocates claim that this protects the financial privacy of citizens from unauthorised access by other private persons or the State.⁶⁴ However, if countries are not willing to exchange

⁶⁰ Mold, A, A proposal for unitary taxes on the profits of transactional corporations, (April 2004) CEPAL Review 82.

⁶¹ Singh, K. Why investment matters, Madhyam books, (2006) p. 44.

⁶² Wright, T., Tax evaders keep step ahead of EU, New York Times, 25 May 2005, <<http://www.nytimes.com/2005/05/24/business/worldbusiness/24iht-tax.html>>, (September 2009).

⁶³ Spencer, D., The IMF and capital flight: redesigning the international financial architecture, (January 2006), <<http://www.brettonwoodsproject.org/art-507905>> (September 2009).

⁶⁴ The Federal Department of Finance of the Confederation Suisse, <<http://www.efd.admin.ch/dokumentation/zahlen/00579/00607/00621/index.html?lang=en>>, (September 2009).

information on the interest on savings of private individuals and/or on the corporate accounts registered in a country, the existence of bank secrecy in such a country makes it even more difficult for tax authorities to trace tax evasion. Furthermore, it makes it easier for private individuals and corporations to evade tax or to organise crime. In 2007, the World Bank and the United Nations estimated that corrupt leaders of poor countries skim off as much as US\$40 billion each year and stash their looted funds overseas.⁶⁵ Countries such as Panama and the Cayman Islands are famous for their strict bank secrecy. Switzerland is slowly relaxing its bank secrecy under international pressure.

3.3 Initiatives against capital flight and tax havens

3.3.1 *The Organisation for Economic Co-operation and Development*

- The OECD Transfer Pricing Guidelines emphasise the use of the arm's length principle. This principle means that a corporation must establish the same (market value) prices internally as it would agree with companies that are not part of this corporation.
- The OECD Model Tax Convention forms the basis for many double tax treaties. For most types of income, especially business profits and investment income, double taxation is avoided in such treaties by allocating tax rights between the resident and source countries and by requiring the former to eliminate double taxation where there are competing taxing rights.⁶⁶ Among others, Switzerland is now also willing to include article 26 of the OECD Model Convention concerning administrative assistance in its double taxation agreements. It is therefore committing itself to providing information for tax purposes to its treaty partners in individual cases on the basis of specific and justified requests, irrespective of whether the offence is a tax offence. This provision of information also extends to banking information.⁶⁷
- The OECD Model Agreement on Exchange of Information on Tax Matters was published on 18 April 2002. Since then, many OECD members, such as Belgium and the United States or the Netherlands, have reached bilateral agreements. For example, Belgian banks provide the United States with an insight into the financial accounts of American account holders. In return the American authorities do not tax dividends on Belgian investments in the United States. The Netherlands usually trades-off the exchange of information for a much lower tax on international goods which enter the Netherlands by plane or ship en route to other European countries.⁶⁸ Some experts and NGOs argue that the bilateral agreements are only negotiated between OECD countries and tax havens and do not cater

⁶⁵ The World Bank website, New and Broadcast, 'Bank, UN Join in Stepped- Up Drive to Help Countries Recover Looted Assets', (September 2007),
<<http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:21475359~pagePK:64257043~piPK:437376~theSitePK:4607,00.html>> (September 2009).

⁶⁶ Kokke, M. & F. Weyzig, Taxation and financing for development, (October 2008) SOMO,
<http://somo.nl/publications-nl/Publication_2955-nl/?searchterm=> (September 2009).

⁶⁷ The Federal Department of Finance of the Confederation Suisse,
<[http://www.efd.admin.ch/dokumentation/zahlen/00579/00607/00621/index.html?lang=en](http://www.efd.admin.ch/dokumentation/zahlen/00579/00607/00621/index.html?lang=en>)>,
(September 2009).

⁶⁸ Z24 website, Z24 Geld, Belastingen, 'Afrika als nieuw belastingparadijs?',
<http://www.z24.nl/z24geld/belastingen/artikel_16195.z24> (September 2009).

for developing countries. Agreements with those countries seems to mean there is no longer any incentive for the OECD to work on the issue. Furthermore, the automatic exchange of information is preferred to bilateral agreements and the existence of bank secrecy. The government of the country in which the investment is made automatically transmits the relevant information to the government of the country in which the investor resides. The overriding of bank secrecy in international tax matters, in situations in which income tax treaties apply, should become an international standard.⁶⁹

- The OECD report entitled 'Towards Global Tax Co-operation' (2000) identifies 47 'preferential tax regimes' among its member countries with a mandate to eliminate such regimes by 2003. By 2004, all but one (Luxembourg) of the preferential regimes identified within the OECD had been abolished, amended or found not to be harmful. In December 2006 Luxembourg enacted legislation to abolish the regime by the end of 2010.⁷⁰ Moreover, the OECD identified 35 tax haven regimes among non-members against which the OECD has raised the possibility of counter measures. In May 2009, the OECD's Committee on Fiscal Affairs removed the remaining three uncooperative tax havens (Andorra, Monaco and Liechtenstein) from the list because they made statements in March 2009 that they intend to ensure rapid implementation of the internationally agreed tax standard.⁷¹

3.3.2 The United Nations and the World Bank

- Governments agreed at the 2002 Financing for Development conference to work towards: 'an enabling domestic environment' for 'mobilising domestic resources, increasing productivity' and 'reducing capital flight'. Since this Monterrey Consensus of 2002, the massive capital flight from third countries into OECD financial centres and tax havens and the resulting tax evasion and loss of tax revenue in developing countries, has severely undercut the ability of developing countries to mobilise domestic resources. At the 2005 World Summit it was agreed that the UN should 'support efforts to reduce capital flight and measures to curb the illicit transfer of funds'. Among other things the UN resolved to pursue and reaffirm good governance, to support efforts to reduce capital flight and measures to curb illicit transfer of funds and to make the fight against corruption a priority at all levels.⁷² However, NGOs stress that too little is being done to implement these and other commitments. According to the Tax Justice Network, developing countries and countries which are not financial centres should emphasise this issue in their contacts with the UN and adopt a more dynamic and forceful position vis-à-vis the UN and its departments.

⁶⁹ Spencer, D., The IMF and capital flight: redesigning the international financial architecture, (January 2006), <<http://www.brettonwoodsproject.org/art-507905>> (September 2009).

⁷⁰ OECD, Overview of the OECD's work on countering international tax evasion, a background information brief, (31 July 2009).

⁷¹ OECD website, Countering offshore tax evasion, some questions and answers on the project, <<http://www.oecd.org/dataoecd/23/13/42469606.pdf>> (September 2009).

⁷² UN General Assembly, Resolution adopted by the general Assembly, 2005 World Summit Outcome, sixtieth session, (24 October 2005), <<http://www.un.org/News/Press/docs/2005/20051020051005.htm>>, (September 2009).

- The UN also has a Committee of Experts on International Cooperation in Tax Matters, the so-called UN Tax Committee, to develop the UN tax treaty model. The Committee currently consists of 25 tax administrators from 10 developed and 15 developing and transition countries. Apart from tax treaties, the Committee also examines tax evasion, tax avoidance, and capital flight, and promotes international tax cooperation and capacity building of tax administrations in developing countries.
- UN Code of Conduct on Cooperation in Combating International Tax Evasion and Avoidance is a voluntary code, which sets minimum standards for countries as regards cooperation on measures to combat capital flight and international tax evasion and abusive tax avoidance, as well as providing guidance to governments and private actors. Although the idea of the proposed code was widely supported, it was suggested that the focus should only be on tax evasion and not on tax avoidance.⁷³
- The UN Convention Against Corruption (UNCAC) entered into force in December 2005. It is the first legally binding global anticorruption agreement that provides a framework for asset recovery, including mechanisms to prevent money laundering and to recover assets diverted through corrupt practices.
- The United Nations Research Institute for Social Development stated that international collaboration by sharing information and permitting joint actions could dramatically increase the fiscal resources available to developing countries. Moreover, it would include a disincentive to capital flight, increase fiscal and macroeconomic stability and make greater resources available for poverty alleviation.⁷⁴
- In 2007, the World Bank and United Nations launched the Stolen Assets Recovery Initiative (StAR). This plan urges G8 and OECD countries to ratify the UN Convention Against Corruption and provide technical assistance in the recovery of stolen assets.
- NGOs consider this an important step in tackling the sensitive issue of capital flight from developing countries. However, they also stress the need for a shared responsibility by banks and financial centres that host stolen assets. Furthermore, the exclusive focus on corruption illicit flows is too limited. Because of this narrower focus, the commercial flows through tax evasion and avoidance schemes are beyond the scope of this initiative. The NGOs conclude by stating that the World Bank should promote regulatory measures to tackle capital flight.⁷⁵

3.3.3 The International Monetary Fund

- Although tax evasion and aggressive tax avoidance is still a major problem for developed and developing countries, the International Monetary Fund advises its member governments not to use capital controls.

⁷³ Kokke, M. & F. Weyzig, Taxation and financing for development, (October 2008) SOMO, <http://somo.nl/publications-nl/Publication_2955-nl/?searchterm=> (September 2009).

⁷⁴ FitzGerald, E.V.K., Regulating large international firms, (2001) United Nations Research Institute for Social Development, Technology, Business and Society Programme Paper Number 5, p. 6.

⁷⁵ Eurodad, CRBM, WEED & Bretton Wood Project, Addressing development's black hole: regulating capital flight, (May 2008), <http://www.taxjustice.net/cms/upload/pdf/Eurodad-WEED-CRBM-BWP_Capital_Flight.pdf> (September 2009) p. 21

3.3.4 The European Union

- The Savings Tax Directive was established by the European Union to tackle the problem of circumventing tax on interest income. The directive contains the principle that if a resident of one country within the scheme generates interest payments that are paid by a paying agent (usually a bank) in another country, details of that interest income are sent automatically to the resident's home state, each year. That Member State can then tax that resident's income appropriately. On 1 July 2005, all EU Member States started to apply the provisions of the Directive. Because some European countries have a history of bank secrecy, namely Belgium, Luxembourg and Austria, those countries introduced a system based on withholding tax for a transitional period. The system implies the reporting of information at the end of a transitional period, during which these countries levy withholding tax at a rate of 15% for the first three years, 20% for the following three years, and 35% thereafter. The countries transfer 75% of the revenue of this withholding tax to the investor's state of residence. These three Member States are entitled to receive information from the other Member States.⁷⁶ As the EU has entered into agreement with Switzerland, Liechtenstein, San Marino, Monaco, Andorra and the United States to exchange information upon request, as defined in the OECD Model Agreement on Exchange of Information on Tax Matters (2002), the transitional period should actually be coming to an end. Although Belgium has agreed to the exchange of information and is going to end its system of withholding tax, Austria and Luxemburg are going to continue to apply withholding tax and will only provide information on a case-by-case basis instead of engaging in the automatic exchange of information.

The same measures in the Directive have also been applied, from the same date, in 10 dependent or associated territories of EU Member States through the implementation of bilateral agreements signed by each of the 25 EU Member States with these jurisdictions. Furthermore, equivalent measures have been applied, from the same date, in five European third countries, including Switzerland. Ten relevant Member States' dependent or associated territories⁷⁷ undertook a commitment in the form of written agreements or arrangements between each of them and each of the 25 EU Member States to provide, as of 1 July 2005, for the same measures as those in the Directive, i.e. a system of information reporting or, during the transitional period of the Directive, the levying of a withholding tax on the same terms as Belgium, Luxembourg or Austria.⁷⁸

- After the Liechtenstein scandal of 2008, the Member States started focussing on the loopholes which exist in the current directive. The directive could be easily circumvented through the use of legal entities, such as funds or foundations. On 13 November 2008,

⁷⁶ European Commission website, DG Taxation, Personal Tax, 'Taxation of savings income', <http://ec.europa.eu/taxation_customs/taxation/personal_tax/savings_tax/rules_applicable/index_en.htm> (September 2009).

⁷⁷ Anguilla, Aruba, the British Virgin Islands, the Cayman Islands, Guernsey, the Isle of Man, Jersey, Montserrat, the Netherlands Antilles, the Turks and Caicos Islands.

⁷⁸ European Commission website, DG Taxation, Personal Tax, 'Taxation of savings income', <http://ec.europa.eu/taxation_customs/taxation/personal_tax/savings_tax/rules_applicable/index_en.htm> (September 2009).

the European Commission adopted an amending proposal to the Savings Taxation Directive, with a view to closing existing loopholes and preventing tax evasion more effectively.⁷⁹ The European Commission proposes broadening the scope to income from innovative financial vehicles and intermediate legal persons or structures inside and outside the EU. The latter applies if the beneficial owner resides in the EU. In its Communication on 'Good Governance in the Tax Area' the European Commission advocates more cooperation with third countries regarding the savings tax directive.

- The European Commission recently presented a Communication on 'Good governance in the tax area' to improve coordination and cooperation in fighting tax evasion. Among other things, the EC proposes that Member States will no longer invoke bank secrecy as a justification for not assisting the tax authorities of other Member States. The EC also proposes improving good governance in the relationships with third countries. Good governance in tax principles should be reflected in relevant EU-level agreements with third countries. Besides this, the Commission advocates the use of development cooperation incentives to encourage third countries to improve good governance in tax. In addition, funds need to be reallocated to developing countries that are satisfactorily implementing their commitments and, conversely, attention needs to be paid to the cancellation of funds earmarked for those countries that did not implement their commitments. Moreover, there needs to be a coordinated and coherent approach by EU Member States to promoting good governance principles vis-à-vis third countries, including coordinated action against jurisdictions that refuse to apply good governance principles e.g. regarding counter-measures towards non-cooperative jurisdictions in the tax area. Specific agreements on tax need to be established at EU level which contain provisions on transparency and the exchange of information for tax with certain jurisdictions.⁸⁰
- The EU Joint Transfer Pricing Forum was established in 2002. The forum works within the framework of the OECD Transfer Pricing Guidelines and is made up of one expert from the tax administrations of each Member State plus 15 experts from business. It is chaired by an independent chairman. Additionally, representatives from applicant countries (namely Croatia, Turkey and the Former Yugoslav Republic of Macedonia) and the WP6 OECD Secretariat attend as observers. The forum operates on the basis of consensus to produce pragmatic, non-legislative solutions to practical problems posed by transfer pricing practices in the EU. Their main work concerns the arbitration conventions, which is a specific dispute resolution mechanism for transfer pricing cases, and the addressing of other problematic transfer pricing issues.⁸¹

⁷⁹ European Commission website, DG Taxation, Personal Tax, 'Taxation of savings income', <http://ec.europa.eu/taxation_customs/taxation/personal_tax/savings_tax/rules_applicable/index_en.htm> (September 2009).

⁸⁰ Vander Stichele, M., T. Kerckhoffs, M. Ruiz Carnés, Denis, G., An oversight of selected financial reforms on the EU agenda, SOMO, (September 2009), < http://somo.nl/publications-nl/Publication_3221-nl> (September 2009).

⁸¹ European Commission website, DG Taxation, Company Tax, 'Transfer pricing forum' <http://ec.europa.eu/taxation_customs/taxation/company_tax/transfer_pricing/forum/index_en.htm> (September 2009).

3.3.5 The International Accounting Standards Board

- The country-by-country reporting standards for the extractive industries are currently being studied by the International Accounting Standards Board (IASB) and the cost benefits are being discussed. This should require the disclosure of sufficiently detailed financial information per country to determine whether companies are paying a fair share of taxes in the countries in which they operate. NGOs have pledged that country-by-country reporting should become mandatory for all multinational corporations as it would increase the transparency of global finance. The Tax Justice Network is critical that current reporting standards, which are widely accepted around the globe, mean that companies do not need to break down their accounts according to the countries in which they operate. Such companies could consolidate all the separate numbers for each country in which they operate, and publish these in a broader geographical segment. This would result in, for example, a single profit figure for 'Africa'.⁸² As a consequence, it would become more difficult for national tax authorities to trace flows of capital.
- Published accounts do not show intra-group trade (transfer pricing). This makes it more difficult to tackle the problems of transfer mispricing.

4. Tax havens

The practice of tax evasion is closely linked to the existence of tax havens as most of the 'tax escapes' take place through countries that are considered to be tax havens. Those havens are jurisdictions that allow foreign savings and the registration of companies for fiscal reasons. Some estimate that foreigners often account for 95% to 98% of the total number of registered companies in such jurisdictions. The tax havens usually have low or zero tax rates and have high levels of bank secrecy as well as secrecy as regards legal entities. Kudrle distinguishes three kinds of tax haven activities, which are usually combined, namely;⁸³

- the production of goods and services, especially financial services;
- the shifting of all kinds of flows and stocks;
- the hiding of all kinds of flows and stocks.

Most companies located in tax havens have little or no real commercial activity as legislation in tax havens specifies that those companies that wish to benefit from preferential regimes must not have local operations. The registered companies cannot normally own or lease real property, and their owners cannot reside locally or use the local currency in their business activities. If companies actually have operations in a tax haven they often have to pay more

⁸² Tax Justice Network website, activities, TJN research and advocacy, <http://www.taxjustice.net/cms/front_content.php?idcat=96> (September 2009).

⁸³ Kudrle, R. T., The OECD's Harmful Tax Competition Initiative and the Tax havens: from bombshell to damp squib, 2008, In: Global Economy Journal, volume 8, issue 1, p.2.

tax and fulfil, for example, accounting requirements.⁸⁴ Still as much as 50% of world trade is reported to pass through these tax havens.⁸⁵ In 1998 the OECD set out criteria for identifying tax havens:⁸⁶ These are:

- no or only nominal tax rates;
- a lack of transparency;
- a lack of effective exchange of information;
- the absence of substantial activities.

The OECD considered no or nominal tax to be in itself an insufficient basis to classify a country as a tax haven. Neither was the absence of substantial activities considered when determining whether a jurisdiction was cooperative. As a result, in order to avoid being listed as an uncooperative tax haven, jurisdictions which met the criteria were asked only to make commitments to implement the principles of transparency and exchange of information for tax purposes. Experts argue that this procedure is the result of the 9/11 attacks on the United States. The U.S. became very interested in tracking down terrorist financing, the disclosure of financial flows and, as a result, the low tax rates were of less importance. In March 2009, the OECD concluded that all jurisdictions surveyed by the Global Forum have now committed to the internationally agreed tax standard.⁸⁷ As a result, the OECD now regards 25 countries as having committed themselves in, for instance, the year 2000 or 2002, although the standard has not yet been substantially implemented. The blacklisting procedure implies that tax havens need to sign cumbersome bilateral information exchange treaties with at least 12 jurisdictions. Experts criticise this procedure because treaties between tax havens are also considered and because information is only exchanged on request, which itself requires at least a suspicion of tax avoidance by the requesting country. According to the OECD, even the Cayman Islands, which are often considered to be the largest tax haven in the world, have implemented the internationally agreed tax standard as they exchange information unilaterally with a selection of 12 countries. The Norwegian commission on capital flight from developing countries reported that the world has 30 to 70 tax havens, which would indicate that 15% to 30% of the world's states are classified as tax havens.⁸⁸

⁸⁴ Norwegian Commission on capital flight from developing countries, Tax havens and development. Summary of the preliminary report., (June 2009), <http://www.regjeringen.no/en/dep/ud/Documents/Reports-programmes-of-action-and-plans/Reports/2009/tax_havens.html?id=570947>, (September 2009), p. 4.

⁸⁵ Christian aid report, Death and taxes: the true toll of tax dodging, (May 2008), <<http://www.christianaid.org.uk/images/deathandtaxes.pdf>> (September 2009).

⁸⁶ OECD website, 'Tax Haven criteria'; <http://www.oecd.org/document/63/0,3343,en_2649_33745_30575447_1_1_1_1,00.html> (August 2009).

⁸⁷ OECD website, Countering offshore tax evasion, some questions and answers on the project, <<http://www.oecd.org/dataoecd/23/13/42469606.pdf>> (September 2009).

⁸⁸ Norwegian Commission on capital flight from developing countries, Tax havens and development. Summary of the preliminary report., (June 2009), <http://www.regjeringen.no/en/dep/ud/Documents/Reports-programmes-of-action-and-plans/Reports/2009/tax_havens.html?id=570947>, (September 2009), p. 5.

The Tax Justice Network indicated that the minimisation of tax liability is an important feature of tax havens and that this generally depends on:⁸⁹

- the use of paper or ‘shell’ companies, such as trusts and other legal entities;
- the routing and managing of financial flows.

An important difference between the approach of the OECD and the Tax Justice Network is the definition of a tax haven. The definition of the OECD is narrower as, for instance, it does not include financial centres. Moreover, the Tax Justice Network also considers some OECD countries, such as Ireland, Belgium, Switzerland and the Netherlands, to be a tax haven because of some corporate tax incentives.

4.1 Examples of tax havens

An example of corporations using tax havens is the simple fact that, for instance, 18,000 companies have the same address in the Cayman Islands. Moreover, the British Virgin Islands has a population of about 19,000 people, but is home to 830,000 registered companies.⁹⁰ Moreover, the Economist considers America to be a tax haven because foreigners do not pay tax on the interest income they earn and there is anonymity in some states. For example in Nevada companies, fraudsters and money launderers can form anonymous companies and open bank accounts. Furthermore, Nevada does not ask for the names of company shareholders, nor does it usually share the little information it has with the federal government.⁹¹

4.1.1 Consequences

Although stocks of FDI for the world as a whole increased around ten-fold during the period from 1980 to 2000, tax havens gained the most. For example, the Cayman Islands experienced a more than 100-fold increase, to US\$24.9 billion. With a population of only 36,000, this represents a massive US\$700,000 of foreign investment per inhabitant. Similarly, Bermuda’s investment stock rose by US\$10 billion in just one year, from 2000 to 2001, and now stands at a total of more than US\$66 billion. To put these figures in perspective, this is more than the US\$50 billion investment stock for the whole of Japan and, for a population of just 64,000, represents more than US\$1 million per inhabitant.⁹² For developing countries the losses are enormous. SOMO has estimated, for instance, that the tax haven features of the Netherlands alone facilitate a loss of more than € 100 million in tax revenue in developing countries.⁹³ In addition, Oxfam International calculated that

⁸⁹ The Tax Justice website, ‘Identifying Tax Havens’, (July 2007), <http://www.taxjustice.net/cms/upload/pdf/Identifying_Tax_Havens_Jul_07.pdf> (September 2009).

⁹⁰ Norwegian Commission on capital flight from developing countries, Tax havens and development. Summary of the preliminary report., (June 2009), <http://www.regjeringen.no/en/dep/ud/Documents/Reports-programmes-of-action-and-plans/Reports/2009/tax_havens.html?id=570947>, (September 2009).

⁹¹ The Economist, Haven hypocrisy, March 2009, Berlin.

⁹² Mold, A. A proposal for unitary taxes on the profits of transactional corporations, (April 2004), CEPAL Review 82.

⁹³ Weyzig, F. & M. van Dijk, Tax haven and development partner; incoherence in Dutch government policies?, SOMO, (June 2007).

developing countries miss out on up \$124 billion every year in lost income from offshore assets held in tax havens.⁹⁴ Professor Schjelderup, who chaired a Norwegian commission on capital flight from developing countries, stated that tax havens hamper growth in poor countries because they make it easier for the power elites to enrich themselves at the expense of society as a whole and undermine the establishment of effective tax systems in developing countries.⁹⁵ Tax havens are not only used by corporations. The losses of individual income evasions on a worldwide level are estimated as being US\$255 billion.⁹⁶

4.2 The European Investment Bank

In July 2009, a coalition of NGOs published a report entitled 'Flying in the face of development: how European Investment Bank loans enable tax havens' which stated that the EIB does not sufficiently guarantee that recipients of its loans do not avail themselves of tax havens or use other practices such as abusive pricing which may lead to tax evasion or avoidance. The EIB is considered not to be transparent and its capacity to assess and monitor its clients is regarded as too limited. Moreover, when the EIB does identify tax evasion practices, its sanctions are far weaker than those taken by the World Bank and other similar institutions. The NGOs stated that no public announcement is made regarding companies that are excluded from finance and there is no debarment from tendering for other EIB projects unless or until a financial criminal conviction has been achieved.⁹⁷

In August 2009, the EIB announced a revised policy on offshore financial centres. The EIB will refuse to operate wherever there is an offshore financial centre linked to a prohibited ('blacklisted') jurisdiction, unless a project is physically located in such a jurisdiction and does not show indications that the offshore financial centre structure is used for illegal activities or harmful tax practices. According to the EIB this exception is necessary to avoid penalising the general population of countries for which the EIB has a mandate from the European Council to support development. Moreover, the EIB will impose on any counterparty incorporated in a grey-listed jurisdiction an obligation to transfer its place of incorporation to a jurisdiction that is not an OFC, prior to signing the relevant contracts.⁹⁸

⁹⁴ Oxfam International, Tax haven crackdown could deliver \$120 billion a year to fight poverty, press release 13 March 2009,

<<http://www.oxfam.org/en/pressroom/pressrelease/2009-03-13/tax-haven-could-deliver-120bn-year-fight-poverty>> (September 2009).

⁹⁵ Norwegian Ministry of Foreign Affairs, Call on Norway to step up fight against tax havens, press release 18 June 2009, <http://www.regjeringen.no/en/dep/ud/press/News/2009/pm_taxhavens.html?id=567661> (September 2009).

⁹⁶ Kudrle, R. T., The OECD's Harmful Tax Competition Initiative and the Tax havens: from bombshell to damp squib, (2008), In: Global Economy Journal, volume 8, issue 1, p. 3.

⁹⁷ Ruiz, M., Flying in the face of development: how European Investment Bank loans enable tax havens, Eurodad and The Counter balance coalition, (July 2009),

<http://www.eurodad.org/uploadedFiles/Whats_New/Reports/EIBfinal.pdf> (September 2009).

⁹⁸ European Investment Bank website, 'EIB publishes interim revised policy on offshore financial centres', <<http://www.eib.org/about/news/eib-publishes-interim-revised-policy-on-offshore-financial-centres.htm>> (September 2009).

NGOs consider the revision a step in the right direction but insufficient to tackle tax evasion as it primarily relies on the blacklisting procedure by the OECD. The proposed measures of the EIB would only represent progress if the OECD would adopt a more serious attitude in its grey-list and black-list procedures.⁹⁹

5. Trade liberalisation

The beneficiaries of the liberalisation of trade and the increased movement of capital are debated by many NGOs. This paper focuses on the tax aspects of trade liberalisation for developing countries. The significance of tax as an important factor on investment decisions has increased due to trade liberalisation and increased movement of capital.¹⁰⁰ Besides this, trade liberalisation has its impacts on tax revenues because of the significant cuts in trade taxes that feature prominently on the agenda of the liberalisation process, which has been promoted by the World Bank and the IMF over the last two decades. One of the most important purposes of establishing the General Agreement on Tariffs and Trade was to achieve a substantial reduction in tariffs and non-tariffs barriers to trade.¹⁰¹ The IMF states that the association between trade liberalisation and more rapid economic growth will further bolster revenues for a given level of tariffs over the longer term. Moreover, genuine trade liberalisation must eventually result in reduced trade tax revenues and will lead to fiscal difficulties if appropriate steps have not been taken to strengthen the domestic tax system.¹⁰²

Developing countries in particular have a high dependence on trade taxes for revenue and are therefore challenged by trade liberalisation. In particular, the poorest developing countries have found it difficult to deal with the revenue consequences of trade liberalisation, which highlights the need for greater attention to be paid to the sequencing of trade reform and the strengthening of the domestic tax system.¹⁰³ The IMF advocates a lowering of the trade tariffs together with a strengthening of domestic tax, such as consumption taxes (Value-Added Tax and excises). Some experts claim that a strategy of increasing domestic consumption taxes (slightly less than) one-for-one with tariff cuts is an attractive approach for a small economy since it leaves consumers better off because consumer prices fall along with the increased competition from foreign products while the

⁹⁹ Eurodad website, 'European Investment Bank updates tax evasion policies in response to NGO pressure', (27 August 2009) <<http://www.eurodad.org/whatsnew/articles.aspx?id=3810>> (September 2009).

¹⁰⁰ The World Bank website, <<http://siteresources.worldbank.org/INTTPA/Resources/EassonZoltPaper.pdf>> (September 2009).

¹⁰¹ Santos-Paulino, A.U., The effects of trade liberalization on imports in selected developing countries, (May 2001), p. 6.

¹⁰² The World Bank website, The revenue implications of trade liberalization. Issues facing small economies, IMF research, <<http://siteresources.worldbank.org/PROJECTS/Resources/40940-1118776867573/revenuimplications.pdf>> (October 2009).

¹⁰³ Clements, B, S. Gupta, G. Inchauste, Fiscal Policy for Economic Development: An Overview, (2004) <<http://www.imf.org/external/pubs/nft/2004/hcd/ch01.pdf>> (September 2009).

production efficiency gain from the tariff reform will be preserved. Furthermore, the government's revenue will increase since consumption is a wider tax base than imports.¹⁰⁴ Other experts argue the opposite, namely that import products will be in unfair competition with domestic producers because of, for example, advanced technology and the economies of scale of western producers. In that case consumer prices will not decline and workers who have been displaced as a result of the transition to more efficient business, may not be as easily re-employed as is often theoretically assumed. Moreover, if unemployment becomes too widespread this may undermine social stability which itself is necessary for renewed economic growth. Therefore, trade liberalisation may shift workers from being employed in inefficient industries to being altogether unemployed. This would obviously create a loss for these workers and the (developing) economy as a whole.¹⁰⁵ Consequently, trade liberalisation via the lowering of import duties, which should lead to higher economic growth, may have the opposite effect. Moreover, the government's revenues may decline because of fallen tax revenues. What is more, if a developing country relies on the export of a specific item, it may suffer from world-wide trade liberalisation in the event that the price of that item declines more than the price of the goods it needs to import. In such situations the so-called 'terms-of-trade' is negative.¹⁰⁶

5.1 Import and export tariffs

Import duties are imposed on goods when they are moved across a political boundary. A low import tariff is often assumed to promote international trade and the movement of goods while higher tariffs offer better protection for domestic and local producers from international competitors. Import duties can be calculated on the customs value, which is the price paid for the export of the goods. In that case, you pay a percentage of the customs value as import duties. The level of that percentage depends on the kind of product you are importing. If the import duties are calculated in this manner, they are called 'ad valorem duties'. In a number of situations, there are specific duties. In that case, the level of the import duties is calculated on the basis of, for example:

- the quantity (expressed in kilograms, litres, etc.);
- the content (such as the alcoholic strength by volume or the fat content);
- the number of square metres.

Combinations of ad valorem duties and specific duties are also possible.¹⁰⁷

Besides import tariffs, some countries apply export tariffs, a tax on goods that are exported from a country. The aim is to create economic barriers to trade. Tariffs raise the overall

¹⁰⁴ T. Baungsgaard and M. Keen, Tax Revenue and (or?) Trade Liberalization, (June 2005), IMF Working Paper WP/05/112, p. 3.

¹⁰⁵ Weisbrot, M. & D. Baker, The relative impact on trade liberalization on developing countries, (2002), <http://www.policyinnovations.org/ideas/policy_library/data/01283/_res/id=sa_File1/> (September 2009).

¹⁰⁶ Weisbrot, M. & D. Baker, The relative impact on trade liberalization on developing countries, (2002), <http://www.policyinnovations.org/ideas/policy_library/data/01283/_res/id=sa_File1/> (September 2009).

¹⁰⁷ Douane website, Business, 'Import duties', <<http://www.douane.nl/zakelijk/invoer/en/invoer-04.html>> (October 2009).

prices of goods, limiting their production and sale. An export tariff specifically increases the cost of selling domestic goods overseas. Export tariffs can be used to prevent goods from escaping the country, for example commodities. However, export tariffs tend to be quite unpopular because they are perceived as being damaging to domestic business.¹⁰⁸ Furthermore, developing countries could end up with a net loss as a result of trade liberalisation because they sometimes benefit from subsidised exports. For example, if a country is a major consumer of subsidised wheat exports from the United States, and the United States then removes these subsidies, the importing country would be in a situation where it now has to pay more for the wheat it purchases. However, developing countries would benefit more from lump sum payments than subsidies attached to specific exports¹⁰⁹ because subsidised exports slow down the development of domestic agriculture and industry in developing countries. Some argue that eliminating all forms of agriculture export subsidies would make a major contribution to agricultural trade reform, and significantly improve trade opportunities and economic growth for developing countries. Furthermore, export subsidies provide an incentive to over-produce and to dispose of surplus production on the world market. This drives down world prices and limits opportunities for efficient producers and makes it more difficult for producers in developing countries in particular to compete in export and local markets.¹¹⁰

5.1.1 Consequences

Import tariffs are considered to be amongst the easiest taxes to administer. As a result, they have contributed significantly to revenue income for many developing countries, sometimes to the tune of 30 – 50 percent of total government revenue.¹¹¹ High-income countries only derive a small share of tax revenue. Those countries are more able than developing countries to recover the lost revenues, which are a result of the tariffs cuts, from other sources like consumption taxes. Middle-income countries have fared less well, recovering between 45 to 65% of the tax revenues they lost and low-income countries have only been able to recover about 30%. Moreover, there is no systemic evidence that low-income countries with a VAT have recovered more than those without.¹¹²

A study by Santos–Paulino on the basis of figures of the UNDP/UNCTAD, World Bank and WTO Policy Trade Reviews shows no single outcome on the import growth after trade liberalisation.¹¹³ In a selected group of 22 developing countries there were 20 countries

¹⁰⁸ Wisegeek website, 'What is an export tariff', <<http://www.wisegeek.com/what-is-an-export-tariff.htm>> (October 2009).

¹⁰⁹ T. Baunsgaard and M. Keen, *Tax Revenue and (or?) Trade Liberalization*, (June 2005), IMF Working Paper WP/05/112, p.22.

¹¹⁰ The Cairns Group website, fact sheet, 'Export subsidies: detrimental to developing country export', <http://www.cairnsgroup.org/factsheets/export_subsidies.pdf> (October 2009).

¹¹¹ R. Murphy et al., *Closing the Floodgates, Collecting tax to pay for development*, (February 2007), the Tax Justice Network, <www.taxjustice.net/.../Closing_the_Floodgates_-_1-FEB-2007.pdf> (October 2009).

¹¹² T. Baunsgaard and M. Keen, *Tax Revenue and (or?) Trade Liberalization*, (Jun 2005), IMF Working Paper WP/05/112, p.22.

¹¹³ Santos–Paulino, A.U., *The effects of trade liberalization on imports in selected developing countries*, (May 2001), *countries*, table 1, p. 24.

(except Indonesia and Zambia) that have decreased their import duties through the liberalisation of trade. Many of those countries, as well as Indonesia and Zambia, have seen their imports grow between 1976 (before liberalisation) and 1998 (after liberalisation). The import growth was especially in evidence in many Central and Latin American countries. On the other hand, imports have reduced in many African countries, such as Cameroon and Malawi, despite these countries decreasing their import duties slightly.

Export subsidies by rich countries often lead to export dumping in developing countries, which makes it almost impossible for domestic producers to offer competitive prices. For example, EU farmers produce more milk than can be consumed internally. The milk quotas are simply set too high. Now, the EU subsidises its milk across its borders to support its farmers. The EU has spent a little over \$4 billion annually to encourage exports of its agricultural and dairy products¹¹⁴ and these price supports are often coupled with import tariffs in rich countries. However, even if rich countries were to remove all barriers for the merchandising of exports of developing countries this would only result in very little additional income for the exporting countries. The World Bank has estimated that, if such changes were to be fully implemented by 2015, they would only add 0.6% to the GDP of low-income and middle-income countries. This means that a country in sub-Saharan Africa that would have a per capita income of \$500 per year in 2015 under present trade arrangements, would instead have a per capita income of \$503.¹¹⁵

5.2 Initiatives related to trade liberalisation

5.2.1 *The Organisation for Economic Co-operation and Development*

The OECD considers that the progressive liberalisation of cross-border trade and investment has been the single most powerful driving force behind economic growth and living standards. As a result, they seek to safeguard and promote an open, multilateral trading system and to encourage adjustments to that system to take into account the changing nature of international trade, including the interface between trade, investment and taxation.¹¹⁶

5.2.2 *The World Trade Organization*

The WTO argues that tariffs give a price advantage to locally-produced goods over similar goods which are imported, and they raise revenues for governments. The Uruguay Round resulted in countries' commitments to cut tariffs and to 'bind' their customs duty rates to levels which are difficult to raise. The WTO is continuing its efforts in that direction in

¹¹⁴ Wikipedia website, 'Export subsidy', <http://en.wikipedia.org/wiki/Export_subsidy> (October 2009).

¹¹⁵ Weisbrot, M. & D. Baker, *The relative impact on trade liberalization on developing countries*, (2002), <http://www.policyinnovations.org/ideas/policy_library/data/01283/_res/id=sa_File1/> (September 2009).

¹¹⁶ OECD, *Harmful Tax Competition: an emerging global issue*, (1998), <<http://www.oecd.org/dataoecd/33/0/1904176.pdf>>, (September 2009), p. 9.

agriculture and non-agricultural market access via the current negotiations under the Doha the WTO Agenda.¹¹⁷

5.2.3 The International Monetary Fund and World Bank

According to many NGOs the IMF primarily encourages capital account liberalisation and financial sector liberalisation in developing countries. Capital account liberalisation involves the removal of controls on both domestic residents' international financial transactions and on investments in the home country by foreigners. Financial liberalisation involves the elimination of government intervention in financial markets, essentially allowing the market to determine who gets credit and at what price. In addition, the World Bank and the International Monetary Fund (IMF) have advised developing countries to recover losses in trade tariff revenues by introducing consumption taxes.¹¹⁸ The IMF even continues to advise its member governments not to use capital controls. The 2007 'Global Financial Stability Report' edition states that capital control should only be used as a last resort and that they may have uncertain effectiveness and unintended side effects.¹¹⁹ And the 'World Economic Outlook' of 2009, notes that 'initiatives that support trade and financial partners - including fiscal stimulus and official support for international financing flows - will help support global demand, with shared benefits'.¹²⁰ The report pays some attention to the decrease in capital flows to emerging and developing countries but not to the capital flows that go from those economies to developed countries. Besides this, the report fails to focus sufficient attention on tax avoidance and tax evasion.

5.2.4 The European Union

Since 2002, the European Union has been negotiating regional Economic Partnership Agreements (EPA) with African, Caribbean and Pacific (ACP) countries to replace the 2000 Cotonou agreement. Since its commencement, the EPA negotiations have been extremely difficult from the point of view of process and substance. As a result, the original time schedule to finalise the negotiations in 2007 had to be abandoned. Instead, the European Commission decided to divide the negotiations into two stages: the conclusion of so-called interim EPAs, including goods that should be concluded at the end of 2007, followed by supplementary negotiations that entail full agreements. Currently, only the Caribbean region has signed a full EPA, while many individual countries have signed interim EPAs and some negotiations are still pending.¹²¹ Various studies have demonstrated the negative impact of

¹¹⁷ World Trade Organization website, tariffs, <http://www.wto.org/english/tratop_e/tariffs_e/tariffs_e.htm> (October 2009).

¹¹⁸ Kokke, M. & F. Weyzig, Taxation and financing for development, (October 2008) SOMO, <http://somo.nl/publications-nl/Publication_2955-nl/?searchterm=> (September 2009).

¹¹⁹ Eurodad, CRBM, WEED & Bretton Wood Project, Addressing development's black hole: regulating capital flight, (May 2008), <http://www.taxjustice.net/cms/upload/pdf/Eurodad-WEED-CRBM-BWP_Capital_Flight.pdf> (September 2009).

¹²⁰ International Monetary Fund, World Economic Outlook 2009, (April 2009), p. xvii.

¹²¹ European Commission website, DG Trade, <http://trade.ec.europa.eu/doclib/docs/2009/september/tradoc_144912.pdf> (October 2009).

EPAs on custom and government revenues.¹²² Obviously, the customs duty on European products has diminished but critics argue that the increase in the volume of imports is not compensating this effect and that customs duties are generally declining as a result.¹²³

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¹²² Friedrich Ebert Stiftung website, Cotonou <<http://www.fes.de/cotonou/DocumentsEN/Official%20ACP-EU%20Documents/EUdocuments/FurtherEUDocuments/TheInterimEconomicPartnershipAgreementsBetweenTheEUAndAfricanStates.pdf>> (October 2009) en Regional Trade Facilitation Programme website, <http://rtfp.africonnect.com/media/revenue_impacts_of_the_epas_between_eu__esa.pdf> (October 2009).

¹²³ CEPII website, <<http://www.cepii.fr/anglaisgraph/publications/lettre/pdf/2008/let276ang.pdf>> (October 2009).

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Appendix 1 – Recommendations Discussion Group 1

The first discussion group of the DRPN seminar focused on ‘International Barriers to Raising Tax Revenues’ for which Thijs Kerckhoffs, a researcher at SOMO, prepared this discussion paper. The exchange of views between various policymakers, advocates, academics and consultants was structured around three statements that were introduced by the author of the paper and discussed by all workshop participants.

Tax competition

Tax competition, which is the rivalry between countries that compete for investment by lowering the tax rates applicable to business, or by offering other tax advantages, in order to attract or keep companies located within their borders, is an issue frequently discussed by NGOs, governments and business. Some argue that tax competition on corporate taxes is beneficial to efficient spending by the government while others fear a ‘race to the bottom’ which could lead to cut public services or shift the tax burden to less mobile factors such as employment income. The discussed statement was: *Tax competition between developing countries hampers their development in the long term.*

Most workshop participants agreed that tax competition and the use of tax incentives is a complex concept. For instance one expert referred to the differences between statutory and effective tax rates which impact differently on who bears the cost from the shifted tax burden, multinational corporations, employees or consumers. Moreover, the consequences of the use of tax incentives differ between single countries, regions and the world. It was argued that targeted tax incentives could be useful for a single country to attract foreign direct investments and so to develop its economy. If this were to be the case, it was argued that tailor-made tax incentives should be combined with at least an adequate tax administration to monitor and collect tax.

On the other hand, tax competition could also lead to decreased tax revenues for all countries in a region because of the so-called ‘race to the bottom’. If economic development is identified in one country or region as a result of tax breaks, this result has to be measured against losses of other countries or regions as a result of that tax break. Participants therefore noted that intergovernmental organisations, such as the World Bank and the IMF, should no longer promote a blueprint on tax competition as this could be harmful for certain countries in the long term. The World Bank, for example, issued advice for tax free zones in Mauritania, a country known to be used as a tax haven. This advice also contradicts advice by other international bodies such as the IMF, to mobilise more revenues.

Furthermore, it was suggested that a global code of conduct on harmful tax competition was assumed to be the most feasible measure because of the sovereignty, and political will, of national governments on tax issues. Countermeasures, in the event that such a code were to be violated, were considered valuable but also impossible due to the absence of an international enforcement body, such as an international tax authority. There was a suggestion that transparency and available data were a precondition for any discussion on

solutions. Participants were not convinced that the UN had a role to play in enforcement of international regulations in the event of non-compliance.

Although no consensus was reached, the following statements were made by participants:

- Only tailor-made and targeted tax incentives would be useful for the development of a single country if an adequate tax administration is present.
- An inter-governmental organisation should not promote a blue print on tax competition.
- A global code of conduct on harmful tax competition should be established.
- Transparency is needed regarding financial flows before concrete solutions can be formulated.
- More research is needed to assess the impact of tax-free zones on developments.
- More research is needed into which parties are effected by a shift in tax burden when lowering the corporate tax rate.

Capital flight

The second discussion focused on corporate capital flight, which involves the deliberate and illegally disguised expatriation of money by companies taxable within the country of origin. The author introduced the discussion by briefly mentioning the difference between tax avoidance, tax evasion and the use of tax havens and by stating that developing countries lose more by capital flight than they receive in public aid. The second discussion statement concerned: *Substantial international anti-abuse criteria should be integrated into all international tax treaties.*

Furthermore, international prosecution should help prevent illicit corporate capital flows. The discussion about anti-abuse criteria made it clear that is difficult to define what is considered to be abusive. As a result, some other suggestions were made during the discussion, such as country-by-country reporting and more transparency in general regarding the tax planning by multinational corporations. Others were more reluctant about those proposals as they would lead to more administrative costs and would not solve anything if governments were unable to deal with the information. As a result, the standardisation of tax information and improved capacity at government level to verify such information were suggested. Practices of false invoicing and (financial) transfer mispricing were also argued to be targeted by such standardisation of information. Moreover, it was argued that more research should be done on, for instance, the methodology used by inter-governmental organisations and that tackling those practices should be a government priority. Where possible, governments should also agree on exchange of information treaties. The assumption that governments would stop agreeing tax treaties when fulfilling the minimum levels of the OECD to be no longer considered as an uncooperative jurisdiction was seen as incorrect by some participants since countries that exchange information with one country have the obligation to agree such treaties with other countries as well. Nonetheless, a lot of developing countries do not sign agreements or exchange information, often because they simply do not have the capacity to collect the information adequately and therefore the data. A participant who had worked for the Vietnamese tax authority gave a first-hand insight into the difficulties the authority had with complying with data requests

for tax purposes due to inadequate databases. Multilateral and automatic exchanges of information agreements were proposed since they would include provisions on enhancing capacities of tax administrations and would save developing countries time and effort spent on bilateral negotiations.

As regards tax avoidance, participants' opinions differed regarding the interpretation of what is abusive. A distinction between the letter of the law and the spirit of the law was made and this caused some experts to consider everything that is legal as not problematic. On the other hand others also focused on the enforcement of the spirit of the law. Experts argued that such compliance is partly a cultural question and that such tax compliance should be promoted in, for instance, the Corporate Social Responsibility (CSR) of a corporation. Participants suggested that a cultural change needed to take place within the tax community as technical details defining the daily work and problems for tax lawyers and officials often resulted in the social responsibility and social impact of taxes being overlooked. One suggestion was to include CSR units in university and training courses for tax lawyers as one solution to effecting a cultural change in the profession.

With regard to researching capital flight, one participant pointed out that, 10 years ago, financial flows were much easier to monitor through a relevant UN database which has since been abolished, whilst company information has become much more opaque. Difficulties regarding the confidentiality of company and trade information were not resolved during the discussion. It was suggested that it would be helpful to formulate research methodologies and create databases with the OECD or UN.

It can be concluded that several suggestions were made to the Ministry of Foreign Affairs, namely:

- Country-by-country reporting to improve capacity of countries to monitor corporations.
- The standardisation of tax information to improve verification of such information.
- The promotion of widespread exchanges of information treaties between governments.
- The promotion of multilateral and automatic exchange of information treaties.
- The promotion of tax issues as part of company's CSR policy.
- Research into the methodology used by inter-governmental organisations to tackle tax evasion.

Trade liberalisation

Only very limited time was available for the last discussion about the impact of trade liberalisation, which is influenced heavily by the significant cuts in trade taxes. Inter-governmental organisations, such as the IMF, promote a lowering of the trade tariffs as well as a strengthening of domestic tax. However, developing countries have a high dependence on trade taxes for revenue and experience difficulties recovering the losses that come from cuts in trade taxes. The third discussion statement was: *Tariff cuts are only beneficial to rich exporting countries.*

Due to the limited time, very few suggestions were made. However, it was argued that the challenge for developing countries is indeed related to compensating lost revenues. Some

argued that the problem was not in itself the fact that customs and trade tariffs were being abolished, but the lack of capacity of developing countries to compensate for this loss by raising other domestic tax revenues. Morocco was quoted as a success story, as a country that was able to compensate these losses by raising domestic revenue. Compensation, such as 'aid for trade', would only be a first step. Besides this, tailor-made policies for specific countries were again considered to be more appropriate than general recommendations. These could range from broadening the tax base through VAT and sales tax, which again presumes a good tax administration, or regional trade stimulation. One research question that was raised related to African customs unions that must be losing duties due to liberalisation and to how they could compensate these losses.

It was noted that there are ideological issues involved in trade liberalisation which were not discussed in the workshop. It was suggested that trade liberalisation be taken as a given.

In summary, it was suggested that:

- a system be developed for the collection of other tax revenues besides trade taxes.
- there should be an increase tax in administrations' capacity to compensate for lost revenues through liberalisation.
- tailor-made policies should be drawn up rather than blueprints.
- research be performed on the African customs unions and their methods for recovering lost trade taxes.

Paper 2: Raising Taxes in Developing Countries – Domestic Constraints

Andrina Sol, Tax Justice Netherlands

1. Introduction

Revenue collection is believed to be of major importance to a state. Revenues allow states to finance the provision of public goods and services. They allow states to generate public savings that can serve as a resource for investment and promote economic growth. Revenue can also be used to redistribute income and wealth in order to increase equality and provides the means to stabilise the economy, which is a pre-condition for further growth and development.

Developing countries often have unstable economies and generally face difficulties finding the resources for their budget expenditure. The question is what is it that makes it so hard to raise sufficient revenues to meet the needs of their population in terms of, for instance, safety and security, health care or education?

Effective revenue collection requires a good tax system, as well as political will. Appropriate laws need to be in place which provide clear executive power. An effective and efficient tax administration is also required. Establishing and maintaining a good tax system involves making all kinds of choices. Numerous decisions have to be made as to what kind of taxes will be levied. Decision makers have to balance vertical and horizontal equity and, at the same time, cannot turn a blind eye to the costs involved in the collection of each type of revenue. The place of the tax collecting body within the government structure may be another issue that needs consideration. Does it fit in best within the Ministry of Finance, or should it be (semi-)autonomous instead? Then there is the question of how to deal with the often widespread corruption?

Tax collection is also dependent on the consent of the taxpayer. Governments may need to make serious efforts to educate their citizens about the need to levy taxes and the importance of tax compliance. Taxes are a way of involving citizens in governance, as they will demand services for the taxes they pay and this will enhance accountability and citizen participation.

In this paper we explore all these topics and try to establish the constraints that developing countries face in raising tax revenue. The focus is set within the national context of developing countries. International aspects are discussed in a separate papers in this DPRN Series. It is hard to draw conclusions that are valid for all developing countries and that is something one may not even want to try. However, from the case studies provided in the available literature, we are able to abstract some fairly common situations. Various countries have started to deal with the challenges in various ways and, as such, may provide guidance as to the best way forward.

Chapter one discusses the aspects of tax policy. Chapters two, three and four cover the implementation of tax policy. Donor support is the subject of chapter five and chapter six discusses the role of civil society.

The draft of this paper was discussed at the DPRN seminar on 2 December 2009 and participants formulated recommendations for policymakers – in particular policymakers in donor countries involved in development cooperation. These recommendations can be found in chapter seven.

The author is grateful to Kees van Ballegooijen (Advocate General Hoge Raad der Nederlanden), Geerten Michielse (Center for Taxation and Public Governance) and Bjørn Volkerink (Center for Taxation and Public Governance), as well as to the seminar participants for their valuable contributions to this paper.

2. Tax policy

Economic globalisation and the reduction of revenue from trade tax is causing developing countries in particular to rethink their tax policy. They realise they need to find the most effective and efficient ways to raise sufficient (tax) revenue to meet the needs for their public expenditure and to contribute to a more equitable income distribution.

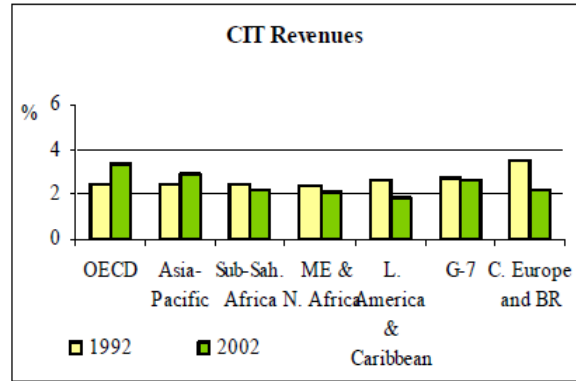
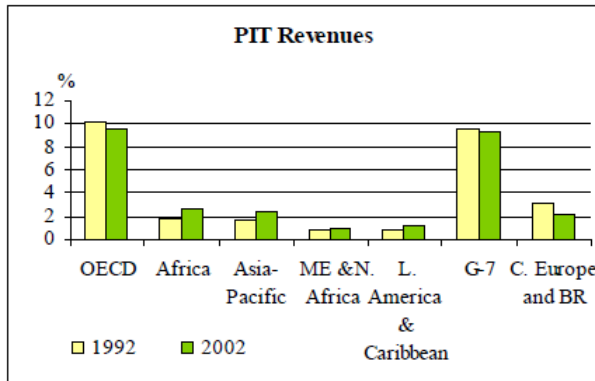
Although, in general, countries derive most their revenue from tax sources, other resources are also available to governments. In countries that are rich with natural resources owned by the government, revenue can be derived from transactions to extractive industries and form an important source of income to the country. Other sources that add to the non-tax revenue income may be grants from international organisations or foreign governments, or user fees for government services. This paper focuses solely on tax sources.

2.1 Composition of taxes

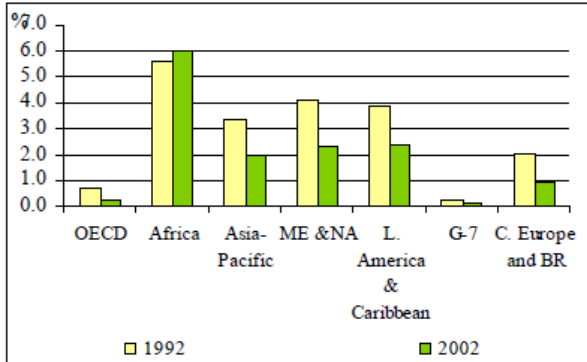
Major differences can be observed in the tax revenues that developing countries generate in comparison to developed countries. Tax revenues make up between one-tenth and one-fifth of the GDP of developing countries, while most OECD countries achieve a tax-to-GDP ratio of about one third. The main tax sources are also very different. Norregaard and Khan (2007) produced some figures of recent trends in tax policy (see below). Traditionally, developing countries, and African countries in particular, have relied mainly on revenue from trade taxes. Although the figures for indirect taxes on goods and services are rising, they have not played an important role, especially when compared to developed countries.

As already mentioned, global economic developments designed to abolish trade taxes all together are forcing developing countries to reconsider their tax policy in order to find different sources to make up for the reduced possibilities to impose tax on trade.

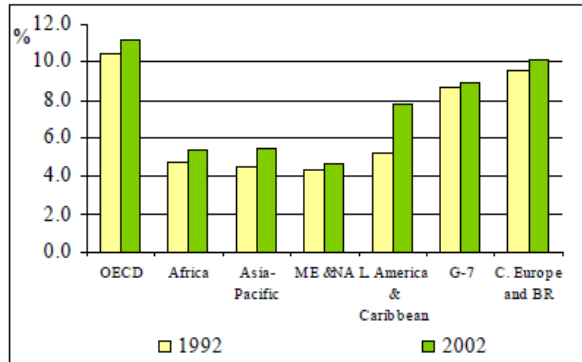
PIT and CIT Revenue as a Percentage of GDP, 1992–2002



Trends in Trade Tax Revenues (as a percentage of GDP)



Trends in Indirect Taxes on Domestic Goods and Services (as a percentage of GDP)



Source: Norregaard and Khan (2007)

2.2 Principles

Deciding on the right combination of taxes is complicated and involves complex economic and political considerations. There are, however, some general principles governments should bear in mind when deciding on tax sources. These principles inevitably lead to conflicts of interests which governments then have to decide on.

Tax should be based on horizontal and vertical equity, meaning that the tax burden should be the same for taxpayers in the same economic situation, and dealt with in a progressive manner so that the rich spend a larger proportion of their income on tax than the poor, or at least an equal proportion. The tax base and liability should be clear and not arbitrary and taxes should be based on the benefit principle: those who benefit (most) should pay (most). The latter may conflict with the vertical equity principle if the poor benefit more from a particular service.

Tax should also be economically neutral, that is it should not distort the relative prices and lead to a change in producer and customer behaviour, unless this is intended. This applies to the use of tax incentives, which should generally be avoided.

When making decisions on tax sources, states should consider the tax yield. The tax yield should to a large extent be certain and predictable, as widely varying yield creates budgeting problems. For example, taxing agricultural produce may lead to a decline in the event of bad harvest conditions. The yield should ideally be elastic (buoyancy), meaning that fixed amounts should be avoided. Taxes should be introduced that are in line with inflation, population growth and economic growth.

In conjunction with the abovementioned principle, states should always consider the costs of collection as a proportion of the yield, and their ability to implement a tax policy. This involves both political willingness and administrative capacity to implement. The first can be enhanced by using taxes that are less visible and rates that increase automatically. The capacity to implement includes the skills to assess and collect fairly and efficiently. This could be achieved by using taxes that are simple to administer.

The principles for evaluating tax sources:

1. Equity, both horizontal and vertical.
2. Economic neutrality.
3. Predictability and flexibility of tax yield.
4. Low collection costs.
5. Ability to implement in terms of political willingness and administrative capacity.

2.3 Corporate tax and tax competition

In order to enhance economic growth, developing countries try hard to attract foreign direct investment (FDI). The presence of international corporations is thought to have a positive effect on the balance of the country. To make investments in their countries more attractive many developing countries introduced tax holidays, free trade zones, and tax breaks and lowered their statutory rates, thereby acting in line with the trade liberalisation agenda. The World Bank promoted the policy of lowering tax rates.

It must be said, however, that questions have been raised about the effectiveness of such tax incentives. Figures given by the IMF over the years 1990–2002 indicate that the corporate tax revenue-to-GDP ratios declined up until the late 1990s. The main reason for this decline was the fall of statutory rates, which has been a worldwide phenomenon. The increase in revenue that the IMF figures show after the year 2000, is not likely to be the result of the foreign investment aimed for. It is far more likely to be the result the aftermath of the Asian financial crisis as well as general economic growth in Asia and Africa. Revenues from natural resources such as oil during the ‘price boom’ may have influenced the increase, too.

Keen and Mansour (2009) conducted a study of revenue mobilisation in Sub-Saharan Africa (SSA) and looked specifically at corporate taxation and tax competition. They found that, in 2005, 69% of the countries in SSA provided tax holidays, which means an increase of 24% in comparison to 1980. For the lower-income countries this increase was even 44%. Other incentives, such as reduced CIT rates and the establishment of free zones, have also increased significantly. Keen and Mansour list a number of dangers relating to tax holidays. They highlight the danger of abuse. Tax holidays may undermine tax revenue by providing

entrepreneurs with an incentive to use transfer pricing and financial arrangements to shift taxable income to where it is not taxed. Examples are taxpaying companies that can deduct paid interest and borrowing from tax holiday companies that are not taxable on received interest. These kinds of arrangements are difficult to deal with and even smart legal provisions may not solve the problem of abuse. Keen and Mansour therefore suggest that it would be better if weaker tax administrations were to focus their capacities on strengthening the basic tax system.

It is also worth noting that tax influences decisions regarding the location of investment only to a limited extent. In other words, it is not a major consideration. Other factors, such as good governance and infrastructure, and the quality of the labour force play a more important role (McKinsey; 2003, De Mooij and Ederveen; 2003, Dharmapala and Hines; 2007). If countries nevertheless decide to implement tax incentives, they should target the tax costs of making an investment, for example by investment allowances, investment tax credits and accelerated depreciation.

Rather than establishing tax incentives to attract investments, Tanzi and Zee (2000) believe there are opportunities for making improvements on corporate tax. They emphasise two prevalent problematic areas. First they mention the multiple corporate income rates based on sectoral differentiation and suggest that rates should be unified. Secondly, and more importantly for the aim of effectiveness of revenue collection, they highlight the design of the current depreciation system which, in many cases, is complex. Tanzi and Zee state that the depreciation system could be simplified by introducing far fewer categories of assets with only one rate attached to each category. Weighting whether certain sectors should be protected through multiple rates goes beyond the scope of this article, but the suggestions made by Tanzi and Zee to improve the depreciation system, may have a positive impact on the tax revenue collection. A simplified depreciation system will ease the implementation, and place a lower burden on the tax collector, hence leading to more cost-effective administration.

Breaking the curse – raising taxes from the mining industry

Research in seven African countries shows that African governments have not been able to optimise the mining tax revenue and anticipate windfalls during the price boom from 2003 to 2008. The reasons have to do with there being too many subsidies and concessions granted to mining companies operating in Africa and a high incidence of tax avoidance as a result of, for example, secret mining contracts and 'creative' accounting mechanisms. Mining companies have a strong negotiation position and claim that they need to be compensated for the unique risks they face through special tax exemptions and concessions.

The current mineral commodity prices, and the reduction of international finance available for new mining investment, could set back tax reforms that were actually in the process of being implemented. In January 2009 the Minister of Finance in Zambia announced that he was going to reverse a tax amendment that had been passed less than a year ago and was going to introduce a new windfall tax.

Despite the complications of the fall in mineral commodity prices and credit crunch the report argues that both systemic and political solutions are needed to increase mining tax revenue and transparency.

Finally the report provides policy recommendations to African governments:

1. Collaborate with the United Nations Economic Commission for Africa (UNECA) to develop and publish an easy-to-use guide on mining taxation. The guide should cite best practices and detail the purpose, costs in foregone revenue and benefit of each type of tax instrument and tax concession.
2. Review company and financial laws so that all extractive industry companies are legally required to use the Extractive Industry Transparency Initiative (EITI) template in their annual financial reports.
3. Stop the practice of granting tax exemptions to mining companies in mining contracts. All mining tax rates and terms should be legislated in substantive law and merely confirmed in mining development agreements.

The report makes the following recommendations to African parliaments:

1. Pass laws that require mining development agreements to be ratified by parliaments, as is the case in Ghana and Sierra Leone, and made public.
2. Push for a new international accounting standard that would force companies to report on their profits, expenditures, and taxes, fees and community grants paid in each financial year on a country-by-country basis.

2.4 Consumption taxes

Consumption taxes are taxes that are based on the consumption of goods en services. Value-added taxes (VAT), excise taxes, trade taxes, and general sale taxes are the best known types of consumption taxes. In particular, trade taxes, meaning taxing goods when they cross the border, are common in developing countries because they are relatively easy to administer.

2.5 Value Added Tax

VAT is seen as a particularly effective tax in the sense that revenue is secured throughout the chain of production. It also avoids distortion in production choices and enhances transparency. In some countries VAT has led to new ways of administering taxes, such as the introduction of self-assessment (Norregaard and Khan 2007). Opponents of VAT argue that the gains can be offset by substantial administrative and compliance costs and possibly adverse distributional consequences (heavy burden on the poor).

Most developing countries have introduced VAT. Tanzi and Zee (2000) note, however, that there is still room for improvement since the application of VAT has often been incomplete. They note that important sectors have been left out of the VAT net. Emran and Stiglitz (2005)

show that the attractions of VAT can be undermined by a shift of activity from the formal into the informal sector. Keen (2007) elaborates on the possibilities to find solutions. He mentions the VAT on imports, also noted by Emran and Stiglitz (2005), which leads *de facto* to taxation of the informal sector when they purchase goods for further production. Keen adds that the VAT could serve essentially the same purpose, if applied to all goods that informal operators purchase from formal operators.

As mentioned above, one comment that is frequently made as regards VAT is that it may cause a heavy burden on the poor. The poor spend a larger portion of their income than those who may have been able to save some money, and do not consume it. As a result, consumption taxes are levied on a larger share of the income of low-income households than of the income of those who are better off.

Some countries have tried to solve this equity issue by exempting certain goods. A decision of this kind should be based on an examination of consumption patterns of low-income and high-income households to see how the poor can benefit most.

Another measure to enhance equity was the introduction of two or more rates. Figures for March 1999 show that, for instance, Indonesia, Morocco, Tunisia and Nicaragua used four different tax rates, while Colombia used six (Tanzi and Zee 2000). The tendency in Africa has been to use single rates. Tanzi and Zee warn that, although they see the political attractiveness of multiple rates, these rates complicate the administration of VAT and may lead to higher administrative costs. Developing countries should consider these costs in their tax policy decisions.

As Volkerink (2009) argues, *'simplifying VAT regimes ultimately leads to more revenue, if not directly, then indirectly as it frees administrative resources for more productive activities'*.

3. The capability and capacity of tax authorities to raise revenue

Studies indicate that developing countries miss out on a large part of tax potential. In some cases this can even amount to between 60 and 70 percent (Rose-Ackerman 2006). This has led to the belief that developing countries should improve their capability to raise revenue. Various initiatives for tax reform have been initiated by developing countries, often with donor support. Many Anglophone countries in Africa have shifted the responsibility for tax collection from the Ministries of Finance to (semi) Autonomous Revenue Authorities (ARAs). We examine the ARAs in more detail later on. First we need to look at the point of departure for improving the capability of countries to raise taxes.

3.1 How should capability be measured?

The capability to raise revenue is hard to measure, as tax administration is country-specific. As Bird (2003) states, *'the 'best' tax administration is not simply that which collects the most revenues'*. There are no generally agreed measures to conduct comparative assessments. Von Soest (2006) suggests analytically differentiating between process and output as two interrelated elements of capability. The process reflects how taxes are collected, while the

output refers to the ability to fulfil the task of revenue collection. In other words it refers to how much is collected. Von Soest suggests measuring the latter by examining three indicators for revenue performance:

- Tax-to-GDP ratio
- The collection of direct taxes
- The tax gap

The tax-to-GDP ratio is the most commonly used indicator because it provides a readily available indication of fiscal pressure of a country and an instrument to compare data over time and in relation to other countries' results. Nevertheless, tax collection is not just about the administration's capability. It also depends on external environmental factors that are out of reach of the tax administration. Additional indicators are therefore needed. Von Soest (2006) regards the collection of direct taxes as an additional indicator. For administrative and political reasons direct taxes, like those on income, profits and property, are more difficult to implement than indirect taxes like consumption taxes or custom duties. Von Soest therefore regards the collection of indirect tax as a valid indicator. Finally, Von Soest uses the difference between tax potential and actually collected tax, the tax gap, as an indicator. This indicator relates to the ability of tax administrations to address the informal sector of the economy, a major challenge for most tax administrations in developing countries. However, as Von Soest argues, the output is crucially determined by the process of tax collection.

To assess the process he uses three process dimensions:

- Information collection and processing
- Merit orientation
 - Recruitment of staff
 - Promotion/career stability
 - Remuneration
- Administrative accountability
 - Corruption within organisation
 - Taxpayer rights
 - Taxpayer education and service

Based on this model Von Soest analyses the Zambia Revenue Authority's capability as follows:

Zambia Revenue Authority's capability

The Zambia Revenue Authority was founded 1994 to overcome the deficiencies of Zambia's old, state-integrated tax administration, as the tax-to-GDP ratio had dropped from 30% to 15,3% since Zambia's independence.

Information collecting and processing

The ZRA has pursued an active, or even aggressive approach of collecting information on taxpayer income and closely supervises large companies. Uncoordinated audits by different

tax divisions auditing the same companies, has led to business complaints. The information collected is processed through modern information technology. As a result, the revenue authority appears to have made significant progress in establishing taxpayers' liabilities.

Merit Orientation

The ZRA has its own recruitment policy independently from the rest of the Zambian civil service. Initially, expatriates held the four most senior management positions, as foreign leadership was thought to be less responsive to local social networks and to political interference. Every former civil servant from the former Department of Taxes and Customs and Excise had to reapply and the most qualified and motivated tax officers were selected. The ZRA introduced a minimum qualification policy. Officers are employed on a five-year contract, not for life as is the case with most civil service contracts, but as an incentive to create a business driven work ethic among staff.

Administrative accountability

The ZRA has introduced measures to prevent and fight corruption. Despite the fact that business representatives did not mention corruption as a main concern, there still continued to be reports of corruption. Local media regularly report incidents of misconduct and the ZRA featured in the Transparency International Chapter on Zambia as one of the public institutions with significant levels of corruption.

In the context of the day-to-day interaction between the ZRA and taxpayers the aggressive enforcement strategies have led to complaints about the significant focus on the formal sector of the economy, while the frequent tax audits were perceived as harassment. Yet, focussing on large businesses is rational, since it is harder to raise revenue from the dispersed informal sector, and it may be the result of the incentive structure of revenue authorities, where success is measured by output.

Information to taxpayers is provided through the ZRA's homepage and leaflets and through regular participation in public radio programmes. The ZRA also has an Advice Centre, which serves as a one-stop shop for interaction between taxpayers and the revenue authority.

Revenue performance

The tax-to-GDP ratio went up from 15.3% to 18.7% in the first year's operation. Since then the ratio has largely remained stagnant. The impact on direct tax incidence has remained 'modest' and the demanding task of expanding direct taxation has been left unresolved. The ZRA has also failed to reach out to all parts of the economy and society. Revenue collection has been largely confined to formalised economic activity. The formal sector employs about 500,000 people in a country with more than eleven million inhabitants. The burden of income tax is therefore on a relatively small number of people. Zambia's tax gap remains large.

Source: Von Soest (2006)

3.2 Improved capability by introducing autonomous tax authorities?

Tax collection in developing countries is generally conducted by line departments within the Ministry of Finance. However, as in the case of Zambia, a lot of developing countries in Latin America and Africa have established semi-autonomous revenue authorities (ARAs)¹²⁴ outside the ministry during the last two decades. Although circumstances differ from country to country, some common reasons that led to the reform can be found. A displeasing level of revenue collection and unsatisfactory efficiency, complaints regarding tax evasion and corruption within the public sector and high taxpayer compliance costs in all cases formed the underlying political and economic conditions, whilst reforms within the existing finance ministries were perceived to have generated notable and/or sustainable effects (Mann 2004).

Expectations were high as regards the ARAs. ARAs were to lead to higher tax ratios and real revenue growth. The arguments put forward for establishing an ARA include de-politicisation of tax administration, greater efficiency, reduced corruption, improved taxpayer services and reduced taxpayer compliance costs (Mann 2004; Rose-Ackerman 2006; Fjeldstad and Moore 2008).

Research shows that ARAs have not fully lived up to these expectations, especially in regard to the expected increase in revenue, nor in terms of reduced corruption. As we have seen in the Zambian case, after an initial increase, tax ratios generally remained stagnant and corruption continued to exist. Nevertheless, ARAs are not considered to be a failure. They can provide a platform for generating tax administration efficiencies (Mann 2004), they have facilitated a range of reforms in the ways in which taxes are assessed and collected (Fjeldstad and Moore 2009) and improved relationships between tax authorities and large corporate taxpayers (Fjeldstad and Moore 2008).

Mann (2004) rightly highlights the considerations prior to the decision to create an ARA, which are often forgotten. First he mentions the need for a cost-benefit analysis covering costs, revenue and technical aspects of disengaging tax administration operations from the MoF, and the need to gauge political commitment to such a major change. Countries should consider whether the improvements they aim at can indeed better be realised through an ARA, than within the existing structures. Secondly Mann underlines the need for a performance contract between the ARA and those entities the ARA would be accountable to. His report provides a number of examples. Funding and/or the renewal of high-level management contracts could become dependent on benchmarks in the contract.

If countries opt for an ARA there are some principle issues to deal with. Mann lists them and adds some of the best practices. A summary:

Principle issues and best practices ARAs

The Legal Base

¹²⁴ Also referred to as SARAs, or Revenue Authorities (RAs).

An Act based on parliamentary authority. This will enhance the ARA's longer-term stability and perceived legitimacy.

The Legal Form

Complete autonomy with separate legal character, perpetual succession, and the ability to own assets, to sue and to be sued. Under stable and competent management, this will help to ward off political interference and will provide some of the most important elements that underlie performance enhancement.

The Governance Structure

A Board of Directors with: 1) non-ex-officio private sector representatives selected by an independent committee, with all members serving for a fixed (and perhaps once renewable) tenure; 2) ex-officio members, being the Minister of Finance, the Central Bank's Governor, and heads of several other select public sector entities. Given that Board members usually have other full-time responsibilities, a Technical Assistance Unit reporting directly to the Board should be formed to advise members on matters regarding tax administration and policy. The ARA head is selected by the Board of Directors and approved by parliament for a period of five years (also once renewable). Removal should be by 'qualified' majority vote of the Board only for specific and proven causes.

Personnel Management Systems

Complete autonomy and the use of competitive entrance examinations (including psychometric tests) under the management of the Human Resources Department. Salary scales for professional staff should match those offered in the private sector, especially in such key areas as information technology, legal affairs, and top management positions. Career path and retirement systems should be incorporated in the ARA Act and subsequently implemented.

Financing Mechanisms

A given percentage of gross tax collections that will permit the ARA to develop and carry out better medium-term to long-term budgeting and planning.

Accountability Mechanisms

Institutionalised reporting to the Board of Directors, the MoF, the Parliament, the Auditor (Comptroller) General's Office, and (if it exists) the national anti-corruption body, and the establishment of internal anti-corruption and external fiscal fraud units.

The ARA-MoF Relationship

The MoF must establish tax policy, but with ARA input. The separation of responsibilities is important, but is hard to define and/or maintain. Nevertheless, countries should attempt to define this relationship in the ARA Act strictly, but adhere to the reporting mechanisms that are also part of the Act.

Relationship with other public sector entities

Formulate and institutionalise agreements for the exchange of information between the ARA and entities like the Ministry of Justice (to deal with taxpayer fraud prosecution), the Central Bank, the Customs Department (if not part of the ARA), and other tax collection entities (e.g., social security, regional and local governments).

What to include: Internal Taxes and Customs?

There does not seem to be a clear best practice, although the two are rather different administrative worlds, with different daily processes and procedures. The differences between them may lead to the conclusion that merging them physically may be counterproductive. Cooperation between them may be a better option and indeed serve the goal of increasing effectiveness.

Source: Mann (2004)

3.3 Capacity of tax administration

3.3.1 Capacity in terms of knowledge

Taxes are complex to administer. Yixin (2008) provides a clear example based on the enforcement of China's Transfer Pricing Rules and experience of their enforcement. Without going into the technicalities of transfer pricing we agree that the question of how to regulate transfer pricing manipulation effectively by transnational affiliated enterprises is one of the most common and most difficult problems faced by tax authorities. Yixin notes that Chinese local tax authorities are generally short of qualified transfer pricing experts who can accurately apply the complicated technologies and methodologies to deal with transfer pricing issues. Despite having various methods in place to regulate transfer pricing practices, local tax authorities rarely apply them. In most cases they prefer to use the approach of assessing taxable income. Green (2008) confirms Yixin's findings. In his experience the single most important factor for improving enforcement for a less developed country is to obtain adequate resources and personnel.

However, transfer pricing is not the only example. We have seen above the practice of tax on natural resources in the mining industry and the existence of (secret) contracts between governments and mining companies, usually including favourable provisions in terms of tax exemptions and concessions for those companies. In 2005 the Norwegian Government launched the Oil for Development initiative, which involves cooperation with ten less developed countries. Although, at the time, the project had not been fully evaluated, Sollund (2008) sketched some preliminary impressions. One of those impressions was that Ministries of Finance often do not play a prominent role when contracts are negotiated and fiscal terms of great importance are determined. He finds that capacity needs to be strengthened both at the MoF and revenue authorities, so that they can effectuate their important roles in developing tax policies, designing tax regulation, collecting resource rents and ensuring good management of revenues.

3.3.2 Capacity in terms of numbers

As already mentioned, administering taxes requires sufficient capacity in terms of knowledge, but also in terms of numbers. Although little literature is available, it may be assumed that the number of staff of tax authorities in developed countries relative to the number of inhabitants is far larger than in developing countries. Nigeria's Federal Inland Revenue Service, for example, has 5,600 staff members, with an estimated 141 million inhabitants. This may well contribute to the lower revenue-to-GDP ratio. Efforts by donors and UN bodies, such as the UN Tax Committee, as well as the OECD to provide guidance and technical assistance in complex tax matters, may not have the desired effects if insufficient staff are available to actually implement all this acquired knowledge. Given that a country's citizens have more of a voice if they pay taxes, the poor capacity of the tax administrations may be a hidden sign of political unwillingness by governments to change seriously.

Taking the costs-benefit aspects into account, countries should therefore consider enlarging their capacity in terms of the number of staff. Enlarging the tax administration by hiring more tax officers implies that there are indeed enough qualified people available in the country. A lack thereof results in the need to provide relevant education and training.

Research into this matter may be needed, and should therefore be included in the scope of activities of governments, donors and civil society in their policies to support revenue authorities in enhancing their capacity.

4. Organisation of tax administrations

4.1 Large taxpayer unit (LTU)

As Gallagher (2005) notes, there is some difference of opinion about whether tax administrations should separate the largest taxpayers from the rest of the taxpayer public. There is a risk that tax administrators merely focus on the large taxpayers, and make fewer efforts to address the non-large taxpayers. Nevertheless the establishment of LTUs in general is perceived as a good practice, especially with regard to audit and enforcement.

In July 2009 the OECD submitted a guidance note on the experiences and practices of eight OECD countries regarding compliance management of large businesses. It gives an insight into the issues that large taxpayers units deal with and the directions they choose:

- Risk management
- Compliance issues
- Improving relationship with taxpayers
- Real-time management approaches in the dialogue with taxpayers
- Tax linked to corporate governance
- Building capability and skills
- Performance measures
- Uses of technology
- Development of a mission statement

Guatemala, Nicaragua, El Salvador, Tanzania, Egypt, Morocco and Kenya are among the countries that established LTUs. Wareru (2008) explains the reasoning behind the decision to

establish an LTU in 2005. Segmentation within the Domestic Taxes Department was suitable because the large taxpayers accounted for 60% of the revenue collected by the department over 2004. Despite its short existence the unit was responsible for 72% of the taxes raised by the Department, and 45.6% of the total revenue raised by the Tax Authority in 2006.

4.2 Corruption

Corruption is a phenomenon many developing countries are faced with. It harms good governance and democracy. The area of taxation is particularly sensitive to corruption. Officials may be tempted to collude with taxpayers, who can then enrich themselves, and by taxpayers who, through bribes, may want to evade taxes. The complexity of tax regulations also create opportunities for corruption in the ways that tax officials can exercise discretionary powers.

The consequences of rampant corruption in the tax system are very serious. It reduces state revenues and therefore diminishes the capacities of the state to fulfil its obligations. Another effect is that it reduces the distributive function of tax collection and hence contributes to increasing income inequality.

Several indicators can be used to determine the probability of corruption in a state's tax administration.

- Indicators related to the institutional context.
- Tax evasion. Although, in itself, it is not necessarily linked to corrupt activities, it can still create the opportunity for illicit deals when it is detected.
- An unexplained discrepancy in the ratio between the estimated amount of cash in circulation and the actual tax revenue.
- The lack of effective access to information for taxpayers and the absence of credible review mechanisms.
- Staff-related indicators.
- Evidence of public officials living beyond their means.
- The absence of measures designed to maintain the integrity of staff.
- Low ethical standards among professions linked to the tax system.
- Perception by the members of the public.

Governments have a set of measures which they can use to prevent corruption, most of which have already been dealt with in the paragraph on the capacity of tax authorities.

As already mentioned, tax regulation is often very complex and includes exemptions for many – often poorly defined – cases, which make the system hard to understand and provide officials with discretionary powers. Tax systems should therefore have simple and clear rules, with only a few clearly defined exemptions. It may help to standardise tax procedures. If made available to the public, a standardised procedure will make taxation more transparent and allow for better control.

The recruitment and promotion of staff need to be based on merit. Remuneration needs to be sufficient and regular tailored training needs to be provided to all staff. Additionally,

responsibilities should be clearly defined and functions separated. Staff rotation schemes could be put in place to prevent clientelism.

In order to improve integrity, tax administration should be subject to regular controls, both internally and externally, based on performance standards. Codes of conduct need to be in place to effectuate effective controls, together with effective sanctions like internal disciplinary measures and the procedures to involve law enforcement agencies in the event of more serious cases of fraud and corruption. Customer surveys are useful tools to diagnose integrity problems and monitor the ongoing effects of reforms. A credible, independent and accessible appeals mechanism should be available to the taxpayers.

As already mentioned, some countries have opted for establishing a tax authority independent of the civil service. As we have seen, this often resulted in a significant increase in tax revenue in the initial year but the gains were not sustained at a steady level. Even if staff were carefully selected, there were no sustained integrity management policies in place. The experience with ARAs shows that governments should always continue their efforts to sustain integrity systems.

Understanding corruption in Uganda – Patronage

The Ugandan Revenue Authority (URA) was established in 1991. The set up outside the civil service freed the tax administration from constraints of the civil service system, especially by paying salaries above the civil service scales. It also eased the recruitment, promotion and dismissal of staff. These steps were expected to provide incentives for greater job motivation and less corruption.

The approach resulted in some success in the initial phase. However, corruption appeared to be an attractive proposition and senior managers seem to be heavily involved in corruption. The incident in 2003 in which five senior officers attached to the Large Taxpayers Department (LTPD) were accused of defrauding the URA of US\$ 338 million, is said to reveal only the ‘tip of the iceberg’.

Fjeldstad (2006) recognises patronage as one of the factors to help understanding corruption in the URA. Certain tribal networks are strong in the URA and influence promotions and transfers within the organisation. Many tax officers and managers remain under the strong influence of traditional patterns of social relations and recognise the benefits of large extended families and strong kinship ties. This implies that such social relations operate at cross purposes to formal bureaucratic structures and positions. For instance, according to some informants, one of the Commissioners of the URA is fully controlled by a lower ranking official in the department, because this person ranks above the Commissioner in the kinship system. The traditional system rules over the formal ‘modern’ one. Therefore fiscal corruption may, to some extent, be understood in the context of a political economy in which access to social resources depends on patron–client links which exist independently of the URA yet influence its performance.

Generally, kinship and other social relationships of reciprocity are used to mobilise affective ties for instrumental political and economic purposes. Such relationships combine moral obligation and emotional attachment. Many people rely on the social connections of their

extended families to secure admission to schools and to get help in paying school fees, to gain employment, obtain business contracts, or benefit from government services.

However, although kinship and social networks are pervasive at all levels of the URA, their most obvious impact is at the top. Serious cases of corruption, involving high-level, politically well-connected officers are rarely investigated. For instance, the Inquiry of Corruption in the URA (the Ssebutinde Commission) did not investigate systemic corruption and the role of family relations and nepotism in sustaining corruption networks.

To some degree the URA has contributed to strengthening existing social networks. For instance, when someone gets a job in the tax administration he or she is expected to help his or her kin and family. URA staff are seen by their family members and social networks as important potential patrons who have access to money, resources, and opportunities that they are morally obliged to share. Increased salaries may lead to increased social obligations, which again may 'force' tax officers to take bribes to compensate for the higher expenses.

Source: Fjeldstad, 2006, Corruption in tax administration. Lessons from institutional reforms in Uganda

5. Voluntary compliance

5.1 Taxpayer relations

In order to optimise tax revenue, taxpayers have to be mobilised. In a way they need to consent to paying taxes. There are two reasons for involving citizens in taxation. On the one hand, citizens need to be educated on the need to pay taxes and, on the other, taxation can be a catalyst for improved responsiveness and lead to a demand for accountability from governments.

The creation of a one-stop-shops for customers, with a customer-oriented focus rather than a tax focus, is perceived to enhance voluntary compliance and reduce compliance costs and administrative overlaps. These offices often serve the general public in terms of tax education. Taxpayer education may involve massive and sustained media campaigns to portray taxation as an instrument of national development. It may also offer tailored education to address the unique tax issues to certain sectors – as has been the case in Kenya. In addition, units are being created to deal with complaints and disputes. Accessibility and clear procedures, together with a timely and effective response to complaints, will help enhance the relationship with the taxpayer and voluntary compliance.

Ghana case

In 1995 the government of Ghana had to deal with widespread tax protests. These forced the government to make political changes. In 1999 the government re-introduced VAT, a move that was received with little resistance. The government ensured there was plenty of publicity and introduced the VAT at a rate that was much lower than before. However, the

intention was to increase the rates in subsequent years. In order to avoid major public protests the government linked the new revenue explicitly to new public spending programmes.

Although earmarking may lead to broader public acceptance of the tax policy, it is not the preferred way of working. It imposes limitations on budget flexibility. Critics claim that earmarking is a gimmick to gain public support, but does not necessarily lead to improved public services. The earmarked income may be deducted from the amount that was to be spent from the government's budget and will therefore not lead to any increase in spending. Other critics claim that the expansion of budgets through earmarking widens the scope for corruption and wastage.

In conclusion, the new earmarked funds will only be useful and justified if they are non fungible and used productively. The latter requires governments and civil society to have the capacity for monitoring and oversight. In order to retain support for earmarked taxes, governments have to live up to them.

Source: Wilson Prichard (2009)

5.2 Legal enforcement

The less friendly idea of voluntary compliance is that taxpayers will comply with tax laws because of their desire to avoid tax fraud punishments. Gallagher (2006) qualifies the application of the tax felony authorities as a benchmark for tax systems. For voluntary compliance to be effective, tax authorities must enforce the tax fraud felony legislation and impose criminal sanctions. However, they should operate in a balanced manner. Too many applications of this law are an indication that something is wrong, probably that the tax fraud laws are being used for reasons other than to encourage compliance, for example for the prosecution of political enemies. On the other hand, too little application of the tax fraud law, especially in the light of open fraud, means that the tax authorities have little power and that the law has no clout (Gallagher 2006).

In many countries in the developing world, tax fraud has only recently been made a criminal offence and its application is still very weak, limited. In some cases these sanctions have never been applied despite having been laid down in law.

Gallagher (2006) highlights a number of illustrative Central American cases. In El Salvador, which enacted its tax fraud felony legislation just over 10 years ago, only a handful of cases have been brought before the courts. Usually, however, the threat of imposing the weight of the tax fraud law is enough to force corrections to forms and declarations, and renewed compliance from fraudulent taxpayers. On the other hand, since its enactment in the mid-1990s in Guatemala, the tax fraud law was not applied once until 2005. The government of Egypt recently submitted a revamped sanctions law for enactment by its parliament. The law includes large and escalating financial penalties for tax fraud, but its structure indicates that the application of jail time for tax fraud, although contemplated, is unlikely.

Obviously, apart from sanctions to deal with tax fraud, tax laws should also provide for ways for taxpayers to dispute decisions by the tax authorities.

In some countries judges lack knowledge of tax law. In the Dutch Antilles, for example, there are no judges who are specialised in tax law. Four times a year a team of Dutch judges travels to the Antilles to handle the tax disputes. In Surinam a tax committee has been established for the same purpose. The literature does not provide any insight into the capacity of tax law judges in developing countries but does, inevitably, state that adequate law enforcement can only be realised if some form of arbitration is available.

6. Donor support

Technical assistance for developing countries on tax policy and implementation has become a spearhead of many key donor governments. The Norwegian Development Cooperation Policy, USAID and the UK Department for International Development (DfID) are, and have been, involved in such projects in developing countries. In its 2009 White Paper, the DfID states that it will 'help countries to establish a sound tax system' and 'make it easier for developing countries to benefit from the new co-operative tax environment'.

In its policy agenda for 2010 the Dutch government also states that:

'An important element is to increase tax collection by developing countries. In the current recession, the urgency to have taxation high on the agenda, is also felt by e.g. OECD/DAC. The Netherlands is therefore going to make a stronger commitment to improving systems for collecting national and local taxes. It is also going to focus on the possible effects on income ratios, corruption and accountability processes, including the relationship with the impact of illicit financial flows and tax regimes in donor countries to developing countries. Cooperation is going to be sought with the academic world and the Ministry of Finance to ensure that optimal use is made of the expertise and specialist knowledge available.' [-translation from Dutch by the author]

An important remark was made by Waweru (2008), Commissioner General of the Kenyan Revenue Authority in the light of organisational issues relevant to tax agencies, compliance and taxpayer relations strategies, but with a wider relevance. He stressed the importance for a developing country of being able to make your own decisions and of not being led by what donors may envisage. He also stressed that, to be successful, reforms should be driven by domestic concerns, not by donor conditionality. Conditions in countries differ, and donor support should follow a tailored approach.

Waweru's remark highlights the fact that, in their involvement, donor countries and any foreign experts should be as conversant as possible with the economical, political and social situation of a country. The success or failure of tax reform largely depends on commitment. When asked for assistance donor, countries should try to become involved in the policy discussion at an early stage. They might suggest involving a broad audience in the discussion and initiating a stakeholder consultation which could, for example, include the business community (large, medium and small enterprises) and the chamber of commerce. This would enhance commitment building within the country. Such involvement would also provide the donor country with the opportunity to acquire an understanding of the country-specific circumstances and to provide tailored input to the discussion. Technical support

would therefore be extended to the roots, rather than focusing primarily on tax administration. Appropriate country-driven technical assistance should be available for the entire chain: from developing tax policy, to implementation and legal enforcement.

Finally, donor countries should aim to achieve policy coherency. Improving the ability of developing countries to raise revenue generates huge potential for improving public services and reducing poverty. Nevertheless, donor countries should assess their internal tax policies, and the effects of these on developing countries. Donor governments should also ensure that these policies do not interfere with development policies.

7. The role of civil society

Untapped tax potential has been proposed as the means to finance the Millennium Goals. It is essential to close the gap between revenue income and revenue expenditure in order to provide the necessary public services like education, healthcare, water and sanitation and the like, which are the core concerns of many civil society groups. It is also essential for the implementation of strategies for poverty reduction.

However, debates about tax policy are mostly dominated by businesses and wealthy individuals who often do not share the same concerns as civil society groups. It is therefore important that civil society groups become involved in tax policy. As Friedman (2006) puts it, *'Civil society groups can help broaden the debate and bring a new focus on fairness and the needs of the disadvantaged to the discussion of tax policy.'*

A lot of people may be put off becoming involved in the tax debate, for it is perceived to be technical and very complex. Yet it is vital that civil society is able and has the capacity to voice its perspective on tax policies, and therefore influence the policy decisions being made.

In his Guide to Tax Works for NGOs (which is worth reading if you are considering becoming involved in the matter), Friedman (2006) lists a number of approaches that civil society organisations have taken to revenue work. He also suggests a process to get things started.

Since only few NGOs have thus far been involved in tax matters as a part of their programmes, further expertise has to be obtained. Friedman suggests starting with a revenue guide that provides background information on the revenue system in a country for non-experts, which guide would contain the following information:

- A description of all major revenue sources, both tax and non-tax revenue.
- Data on revenue collection
- Earmarked revenues
- A description of the budget process in relation to revenues
- Historical context
- A description of the tax administration
- Definitions of terminology

Little work can actually be done if no revenue information is available since that information is needed to increase transparency and participation in tax matters. Civil society groups may well find allies in their advocacy for transparency and information, for example in the media, as well as in the shape of business groups whose intention is to combat corruption.

Furthermore, basic training in the backgrounds to revenue issues, should be provided to broaden interest and build knowledge. This training should be oriented towards the organisations' staff but it could be extended to legislators and the media. At a more advanced stage, training could be tailored to specific tax policies that organisations want to advocate, or could provide specific analytical techniques.

Coalitions by organisations involved in tax policy may strengthen the knowledge base and advocacy. Initiatives in the North have led to the launch of the Tax Justice Network and the Tax Justice for Africa network was launched in 2007.

An example of projects that are intended to support civil society in enhancing their capacity in tax matters is the Towards Tax Justice Project, supported by the European Commission. The project envisages setting up new Tax Justice Networks in Asia and Latin–America with the aim being to raise awareness about the main tax themes, including tax havens, tax avoidance, tax evasion and capital flight in these regions. In addition, the networks will be responsible for the coordination of network and capacity building activities (training workshops and conferences), lobby activities, research, dialogue with policymakers, companies and other stakeholders, and contributions to international events. The programme also ensures continued co–funding of the Tax Justice Network for Africa and expanding its capacity.

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Appendix 1 – Recommendations Discussion Group 2

The condition for development aid by the Dutch Ministry of Foreign Affairs is that it should be *demand driven*, and never supply driven. However, it is not always clear what the underlying problems are that hamper development, especially with regard to tax matters, which tend to be complex. Assistance could therefore be provided to formulate the demand.

- Technical support on tax matters should be demand driven. Assistance may be provided to formulate the demand.

Realising tax potential in developing countries is often seen as a mean to reduce poverty. Such assumed correlation between increased taxes and reduced poverty is only likely to happen if improved tax policy and administration lead to visibility and accountability. It is therefore important to see the *tax policy in relation to the expenditure* side of a country's budget. Taxation may lead to economic growth if government expenditure is more effective. Income disposal and specific expenditures to generate income possibilities for the poor population are needed to make improved taxes work against poverty.

- Technical assistance to improve tax revenue in developing countries will only have an effect if dealt with in relation to a country's expenditure.

Even if tax laws and regulation are in place, many countries lack skilled judges in tax law. In the absence of independent judges appeals procedures are often dealt with within the tax administration. Some countries have opted for a board of appeal consisting of tax officers, tax advisors and other members of the private sector. The participants in the discussion disagreed on the question of to what extent the composition of such a board could cause a conflict of interest. However, they agreed that some form of *arbitration* should be available.

- Tax policy should allow for an appeals procedure and some form of arbitration should be available, and technical support should be provided to enhance the capacity of the institutions involved.

Countries often work with tax targets for the tax administration. This may lead to a focus on a small proportion of the *tax base*. Large companies may be a relatively easy target, as they operate in the formal economy. However, tax policies should also focus on medium and small enterprises.

On the other hand, large companies often have plenty of capacity to optimise their tax planning and the capacity of tax administrations should be built to match this *expertise*. Assistance in capacity building should take the problem of the so called '*brain drain*' into consideration. Similarly to many government bodies, tax administrations often lose their skilled staff to the private sector, which often offers better remuneration.

In order to match the expertise more effectively, developing countries should have a greater insight into where large companies hide their wealth. Only a few developing countries have been able to negotiate Tax Information Exchange Agreements (TIEAs). Developed countries, and tax havens in particular, should therefore be encouraged to *negotiate TIEAs* with

developing countries. Furthermore, *country-by-country reporting* should be made compulsory (at international level).

- Tax policy should include a balanced tax base, whose implementation should not just focus on the easy targets but include the medium and small enterprises.
- Tax administrations should be enabled to match their expertise with the expertise of large companies, while capacity building programmes should include measures to avoid the ‘brain drain’.
- Developed countries and tax havens in particular should negotiate TIEAs with developing countries and country-by-country reporting should be compulsory.

Although taxes are a means to enhance accountability and civil participation, tax policy is also a tool for governments to keep control. Attempts to help countries improve their tax revenue largely depend on the *political will*. For donor countries and development organisations this means they need to understand the context in which they operate. They should become involved in the political dialogue in developing countries. Another way to influence the political would be to strengthen *civil society*, and enable civil society to participate more effectively in tax policy.

Donor countries and development organisations should become involved in the political dialogue in order to gain political will for tax reform and enable civil society to engage in tax policy.

Paper 3: Development Assistance and Tax Revenues

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1. Introduction

Developing countries are usually characterized by limited contributions of domestic taxation to public finance, and consequently a relatively large share of gross national expenditures is funded through external loans or grants. Similarly, tax revenues as a percentage of GDP are typically much lower in developing countries compared to rich countries.¹²⁵ Tax regimes and fiscal regulations vary widely within and between developed and developing countries, with the latter facing reduced options for direct (income, corporate and property) taxes (Musgrave, 1990; Kelly, 2000). Consequently, indirect taxes still represent the major share of fiscal income in most developing countries.

While it is generally believed that developing countries should raise their internal sources of finance through more rigorous tax-raising, little attention is given to the role of foreign aid in promoting better tax regimes or higher tax discipline. Most available studies refer to individual countries or sub-regions and cover limited time periods (Feeny, 2007; Fjeldstad and Rakner, 2003). The scarce comprehensive studies that address the aid and taxation relationship that rely on larger samples (Gambaro *et al.*, 2007, Gupta *et al.*, 2003) generate inconclusive, contradictory and sometimes debatable conclusions on the effect of development aid on taxation in developing countries. This may be partly due to reliance on different estimation methods (i.e. structural equation modelling, panel designs, 2SLS), but it also reflects difficulties in applying adequate contextual control variables that explain part of the observed heterogeneity.

Reviewing the scarcely available evidence, the relationship between international aid and domestic taxation is found to be either positive (Gambaro *et al.*, 2007; Khan & Hoshino, 1992) or negative (Gupta *et al.*, 2003), or even insignificant (McGillivray, 1994). Positive effects of aid on taxation are expected when complementarities can be reached, which suggests that increased public expenditures will enhance economic growth and therefore reinforce the tax base according to traditional Keynesian principles. The underlying hypotheses for the inverse effect imply that development aid might reduce the incentives for national tax-raising, commonly referred to as the 'crowding-out' effect (Heijdra *et al.*, 1998; Andreoni, 1993).

A comparison of these studies indicates that disaggregation is of primary importance and creates differences both for aid (e.g. from bilateral or multilateral sources, between grants and loans) and for taxation (direct/indirect). Moreover, a general shortcoming in the

¹²⁵ Tanzi and Zee (2000) report that the tax revenue-GDP ratio for developing countries was 18.2 compared to 37.9% for OECD countries during the 1995-97 period.

literature is the lack of empirical tests of variables that are likely to mediate the relationship between aid and taxation. Factors like the structure of the domestic economy (e.g. agriculture or industry-based), the degree of openness (tax revenues from exports and imports), the population structure (urbanization) and the political regime (good governance, rule of law) are commonly believed to influence tax-raising opportunities.

This article tries to overcome some of the observed deficiencies and difficulties, developing an entire new and comprehensive data set on development aid disbursements and tax-raising in 77 developing countries. We introduced substantial differentiation in types of aid and categories of taxation, and furthermore incorporated structural variables for the character of the domestic economy and the degree of development as appropriate controls. Furthermore, the time span of our analysis covers 17 years, a substantially longer period than earlier studies. This also enables us to identify possible break-points related to periods when international attention was first focused on trade liberalization and Structural Adjustment (late 1980s/early 1990s) and subsequently shifted to Debt Restructuring and Budgetary Support (late 1990s).

The remainder of this article is structured as follows. Section 2 provides a concise overview of the current literature on tax and aid linkages, identifying some of the underlying causal mechanisms that foster development. In Section 3 we present an outline of the new database composed for this research, and we discuss the analytical procedures to guarantee unbiased results. Section 4 reports on the different estimations made and discusses our main findings. Finally, Section 5 concludes with some major implications for research and policy.

2. International aid, domestic taxation and development

The development literature describes the effect of international aid on domestic taxation usually within the framework of fungibility (Swaroop & Deverajan, 1998). This implies that aid disbursements cannot be fully traced to their final allocation, and therefore more attention should be given to the global effects of aid on stimulating economic growth and public governance. Recognition of the difficulties of directing aid to specific purposes (aid conditionality) paved the way for a set of new international cooperation policies. The most important shift during the late 1990s was the adoption by major donor countries of so-called coordinated sector-wide programmes and the shift from project support to global budget support.

The relationship between international aid and domestic taxation has been subject to a great deal of controversy. According to some authors, aid could be used to increase institutional capabilities and strengthen the fiscal administration and might therefore result in an *increase* in tax revenues. Others argue, however, that aid might easily be used to substitute tax revenues or might be captured by influential groups, therefore contributing to less productive public expenditures. In the latter situation we might expect *stable* or even *declining* tax revenues as a result of aid disbursements.

The few empirical studies on tax-aid linkages rely on (a) different hypotheses regarding the underlying factors influencing tax-raising capacities in developing countries, and (b)

different empirical methods used for specifying and estimating the tax-aid relationship. We discuss both these aspects.

2.1 Analytical approaches

Early studies on the effects of aid on domestic taxation are mostly limited to specific countries or sub-regions, and lead to mixed and inconclusive results.¹²⁶ The first comprehensive analysis of the tax-aid relationship presented by Gupta *et al.* (2003) covered 107 countries over the period 1970–2000. The study investigates whether the impact of aid on the revenue effort depends on the composition of aid (grants vis-à-vis loans). The results indicate that while concessional loans are associated with higher domestic revenue mobilization, the opposite is true of grants. On average, the dampening effect of grants on the revenue effort is modest. However, for those countries plagued by high levels of corruption, results suggest that the decline in revenues completely offsets the increase in grants.

Gambaro *et al.* (2007) study the relationship between development aid inflows and tax revenues for a sample of 65 countries over the period from 1990 to 2004. Their results do not support the hypothesis that aid substitutes domestic tax revenue. On the contrary, the study finds evidence that there is a positive association between aid inflows and tax revenue, which is primarily driven by the positive relationship between grants and taxation. No evidence is found for the hypothesis that the marginal impact of aid on tax revenue is different in countries with low corruption compared to more severely corrupted countries. At a more disaggregated level a heterogeneous association of aid with different components of tax revenue is identified. The possible two-way relationship between tax revenue and institutions is also acknowledged.

Further research has focused mainly on the analysis of specific factors that mediate the aid-tax relationship. While Gambaro *et al.* (2007) show that the poverty level of a country significantly influences the degree of taxation, Cobham (2005) explains that countries classified according to degrees of poverty and inequality differ significantly in their tax structure. Over the last thirty years, rich countries have generally maintained or extended their overall tax rate (as a share of gross domestic product) by increasing both direct (e.g. income tax) and indirect taxes. Poorer regions have also sought to increase tax revenues, starting from a much lower base. There has been little positive contribution from direct tax, and the pressure for trade liberalization has meant that this important source of indirect taxation has generally decreased. This has led to a general trend of increasing reliance on tax based on sales of

¹²⁶ For example, Pack and Pack (1990) find that foreign aid had a positive effect on domestic revenues in Indonesia, while Franco-Rodriguez and Morrissey (1998) find a negative relationship in Pakistan. McGillivray and Ahmed (1999) find that aid depressed tax revenues in the Philippines during the period of 1960–92. The results from the Cashel-Cordo and Craig (1990) study suggest that aid has had a positive impact on revenue mobilization among African countries and a negative impact on non-African countries. Heller (1975) found that aid had a negative effect on revenue for 11 African countries.

goods and services. Low income countries, notably in sub-Saharan Africa and South Asia, face overwhelming difficulties in regard to both the level and the stability of tax revenues.

Other relevant mediating variables refer to the influence of the internal economic and demographic structure on tax-raising capacity. Gambaro *et al.* (2007) argue that a large agriculture sector is detrimental for tax revenues since it is difficult to tax farmers directly and a large share of agricultural activity is normally directed towards subsistence. Similarly, Cobham (2005) argues that countries with large amounts of mineral resources generally depend less on domestic taxation. In more general terms, the degree of openness of the economy (i.e. exports and imports as GDP share) is used to assess the impact of trade on tax regimes. It is sometimes expected that more open economies are better able to raise taxes and that aid programmes which help to intensify foreign trade can be beneficial for tax-raising. However, Agbeyegbe *et al.* (2004) present evidence that trade liberalization is not strongly linked to aggregate tax revenues, but does contribute to higher income tax revenue.

Finally, several studies rely on political and institutional variables to explain the linkages between aid and taxation. Adam and O'Connell (1999) use the Polity IV indicators that classify countries on a continuum from fully autocratic to fully democratic governance. They argue that the quality of government has a decisive impact on the way that tax policies are defined and implemented and how tax revenues are used. The expectation is that in countries with more democratic governance any increase in aid is more likely to be associated with a corresponding increase in tax revenues. Other studies use the Kaufman dimensions of governance to assess the role of institutional quality on the effectiveness of aid (Moore, 2007; Fjeldstad and Rakner, 2003). Given the relatively short time span of the availability of these indicators, it is difficult to use them in panel data analyses. It is generally expected that countries with better levels of governance are able to generate more foreign aid, which consequently could increase their domestic tax base. Otherwise, good governance is supposed to be associated with better domestic tax-raising capacities. Therefore, the causality of the relationship between governance and taxation is still subject to a wide debate.¹²⁷

2.2 Methodological approaches

The analysis of aid-tax relationships can be specified in a number of different ways and outcomes are highly sensitive for the methodological approaches used to estimate mutual interactions. In general, outcomes depend on (a) the time period used, (b) the degree of (dis)aggregation of aid and tax data, and (c) the type of control variables applied.

The different outcomes regarding the aid-tax relationship in the studies conducted by Gambaro *et al.* (2007) compared to the results by Gupta *et al.* (2003) can largely be

¹²⁷ However, Gambaro *et al.* (2007) record considerable heterogeneity in the relationship between taxation and institutional development. While income and sales taxes are positively associated, export taxes have a negative relationship with governance. This suggests that countries with higher average revenue from trade taxes are systematically weaker in several aspects of administrative effectiveness.

explained by the time span investigated. The former study finds a positive association between aid inflows and tax revenues for the period 1990–2004, which was characterized by more focused development aid toward strengthening institutional and administrative capacity of the development countries. Therefore, development aid became oriented more towards strengthening institutional capacity and this fundamentally changed the tax revenue response. The latter study examines the revenue response to inflows of foreign aid during the 1970–2000 period and supports the hypothesis that aid substitutes domestic tax revenues. This is certainly the case for the early periods of development cooperation when grants were more important than concessional loans. We therefore included lagged variables in our estimates for aid to account for some delayed effects on the domestic economy. This proved to be an important innovation, since it permits the identification of the medium-term effects of aid on domestic taxation regimes.

Earlier studies rely on rather different procedures for the disaggregation of aid and taxes. Gupta *et al.* (2003) distinguish between grants and loans, and find that concessional loans are associated with higher domestic revenue mobilization, while grants are shown to have a dampening effect.

Khan and Hoshino (1992) further differentiate between bilateral and multilateral aid. On the other hand, Gambaro *et al.* (2007) differentiate between income and capital taxes, sales tax and taxes on trade, and ascertain that aid grants – but not loans – have a positive effect on sales and trade taxes while there is a negative association with income taxes. It should be noted that the net effect from income taxation in developing countries is only 4.4% of GDP, which is very low compared to an average income and capital tax revenue of around 12.5–13% of GDP in OECD countries. In this study, we disaggregated aid according to type (i.e. grants and loans) and origin (bilateral and multilateral aid).

Finally, the statistical procedures used for estimating the aid–tax relationship might influence outcomes. Most importantly, adequate contextual variables should be used to guarantee un-biased estimates. We included country openness and the development level as the main control variables. Most studies draw on dynamic panel data analyses and OLS methods, distinguishing between fixed and random effects estimates. Feeny (2007) applied structural equation modelling to assess fiscal response to foreign aid. Agbeyegbe *et al.* (2004) perform GMM regressions to test the relationship between trade liberalization, exchange rates, and tax revenues. Following on from the main literature, this article relies on dynamic panel estimates with country-specific effects and lagged values for aid providing efficient and consistent estimates of the coefficient at robust standard errors.

The data analysis for this article differs from earlier studies in three respects. First, we cover a longer time period (till 2007) and are therefore able to capture specific changes related to new aid modalities implemented from early 2000 onwards. In addition, we include interaction effects between aid and time to account for effects of aid on the growth rate of taxation. The turning point from conditional structural adjustment loans to budgetary support programmes takes place precisely in the period under review. Second, we include development aid as a lagged variable, therefore capturing the time-lag between aid disbursements and corresponding tax implications more effectively. Third, we conduct more

disaggregated analyses of aid and taxation for different time periods and country categories to maintain an insight into the specificities of the incidence of development aid on domestic tax-raising capacities.

3. Data and approach

We composed a database of tax-raising revenues for 77 developing countries and clustered the data on the basis of six geographic regions (South Asia, Central Asia, Middle East and North Africa, Sub-Saharan Africa, Latin America and Caribbean, and East Asia and Pacific) and on the basis of development status (e.g. least developed, low income, lower middle income and upper middle income). A distinction was made between revenues from direct and indirect taxation. The data set covers the time period 1990–2007.¹²⁸ In addition, we collected data on development aid provided by OECD–DAC donors over the same period, making a distinction between bilateral and multilateral aid, and between loans and grants. Annex 1 provides a list of all the variables used in the analyses.

The data set is further enriched by including relevant parameters regarding the internal socio-economic and political development in the recipient countries. Therefore, we included time-series data on gross national expenditures, GDP per capita, income distribution (Gini), foreign trade dependency (exports and imports as share of GDP), and the structure of the economy (ratio of value added in agriculture and industry; mineral richness).¹²⁹

The main dependent variable for our analysis is the contribution of domestic tax revenues to covering gross national expenditures (GNE). This is considered to be a key indicator for the role of tax-raising in financing public development programmes and policies. Development aid per capita is used as the main independent variable (further disaggregated according to sources and types), whereas country characteristics are added to check for structural differences.

The data analysis consists of an explorative analysis (without imputations for missing cases) to outline the structure and characteristics of the data base, followed by a panel data analysis (using imputations for missing data) with fixed effects and time and country dummies to determine the relationships between taxation and aid. We start with a short descriptive analysis of the composition of the data set and a graphical presentation of tax and aid tendencies at country and sub-regional levels.

Table 1 provides descriptive statistics. On average, taxes cover about 14 % of gross national expenditures, but there is a variation of between 2 % and 36 %. The contribution of indirect

¹²⁸ The original data set included 108 countries. Following indications from Singer and Willet (2003) the initial strategy for exploratory analyses only used those countries that have valid entries for the dependent variables collected in at least three time points.

¹²⁹ We also considered using policy indicators, like the Kaufman dimensions of governance, the Polity IV indicators of democracy, and Business Climate indicators, but the time series proved to be too short to use a dynamic panel approach.

taxes is slightly higher than from direct taxation. Aid per capita is about US\$ 35, which is composed of 63 % bilateral aid (= 37 % multilateral aid) and 73% grants (= 27 % loans).

Table 1: Descriptive Statistics

| | N | Minimum | Maximum | Mean | Std. Deviation |
|--|--------|---------|---------|-------|----------------|
| Total tax revenues as % gross national expenditures | 812.00 | 2.45 | 46.06 | 14.11 | 6.13 |
| Indirect taxes as % gross national expenditures | 800.00 | 0.26 | 38.19 | 5.90 | 3.83 |
| Direct tax as % gross national expenditures | 803.00 | 0.22 | 37.97 | 4.17 | 3.81 |
| Bilateral aid per capita all DAC countries one year lagged | 808.00 | 0.43 | 231.63 | 25.99 | 29.23 |
| Bilateral aid per capita all DAC countries 2 years lagged | 808.00 | 0.40 | 177.40 | 25.86 | 27.55 |
| Bilateral aid per capita all DAC countries 3 years lagged | 808.00 | 0.40 | 145.40 | 25.70 | 26.62 |
| Multilateral aid per capita all DAC countries 1 year lagged | 808.00 | -13.90 | 296.45 | 15.10 | 25.69 |
| Multilateral aid per capita all DAC countries 2 years lagged | 808.00 | -6.28 | 177.77 | 14.09 | 18.86 |
| Multilateral aid per capita all DAC countries 3 years lagged | 808.00 | -3.60 | 138.99 | 13.65 | 16.95 |
| total donors total aid per capita lagged 1 year | 809.00 | -21.62 | 279.49 | 34.84 | 39.18 |
| total donors total aid per capita lagged 2 years average | 810.00 | -16.29 | 271.67 | 34.62 | 37.65 |
| total donors total aid per capita lagged 3 years average | 810.00 | -9.29 | 215.23 | 34.55 | 37.07 |
| total donors total grants per capita lagged 1 year | 809.00 | 0.00 | 389.41 | 29.83 | 39.28 |
| total donors total grants per capita lagged 2 years average | 810.00 | 0.00 | 278.44 | 28.70 | 34.10 |
| total donors total grants per capita lagged 3 years average | 810.00 | 0.00 | 215.54 | 28.20 | 32.50 |
| Total donors total loans per capita lagged 1 year | 809.00 | -267.49 | 162.88 | 5.01 | 22.00 |
| Total donors total loans per capita lagged 2 years average | 810.00 | -166.66 | 94.93 | 5.92 | 15.33 |
| Total donors total loans per capita lagged 3 years average | 810.00 | -107.60 | 77.93 | 6.34 | 12.93 |
| EU donors total aid per capita lagged 1 year | 808.00 | -1.78 | 132.32 | 11.72 | 14.86 |
| EU donors total aid per capita lagged 2 years average | 808.00 | -0.43 | 103.10 | 11.64 | 14.13 |
| EU donors total aid per capita lagged 3 years average | 808.00 | -1.50 | 88.39 | 11.60 | 13.83 |
| EU donors total grants per capita lagged 1 year | 808.00 | 0.03 | 162.59 | 11.04 | 14.62 |

| | | | | | |
|--|--------|--------|--------|-------|-------|
| EU donors total grants per capita lagged 2 years average | 808.00 | 0.03 | 118.78 | 10.92 | 13.73 |
| EU donors total grants per capita lagged 3 years average | 808.00 | 0.03 | 98.70 | 10.83 | 13.36 |
| EU donors total loans per capita lagged 1 year | 808.00 | -33.27 | 29.35 | 0.68 | 4.42 |
| EU donors total loans per capita lagged 2 years average | 808.00 | -18.84 | 27.18 | 0.72 | 3.67 |
| EU donors total loans per capita lagged 3 years average | 808.00 | -13.38 | 23.69 | 0.77 | 3.30 |
| Valid N (list wise) | 770.00 | | | | |

Closer inspection of the development of tax-raising over time indicates that, on average, taxes raised their contribution to GNE from 13.8 to 16.4 % (see Figure 1a) during the period 1990–2007. However, a major share of this growth can be attributed to indirect taxation that increased from 4.2% to 8.2% of GNE, whereas revenue shares from direct taxes remained largely unchanged. Figures 1b and 1c further illustrate these tendencies.

More detailed overviews of the taxation rates and tax revenue shares in GDP by country and region are presented in Annex 2 and 3 respectively. Substantial heterogeneity is revealed between countries (see also Table 2), but some general regional trends can be discerned. Taxes in East Asia and Latin America are generally higher and show a slight linear rising trend, while South Asia and sub-Saharan Africa maintain lower tax rates and more varied growth patterns.

Figure 1a: Tax revenues as share of Gross National Expenditures

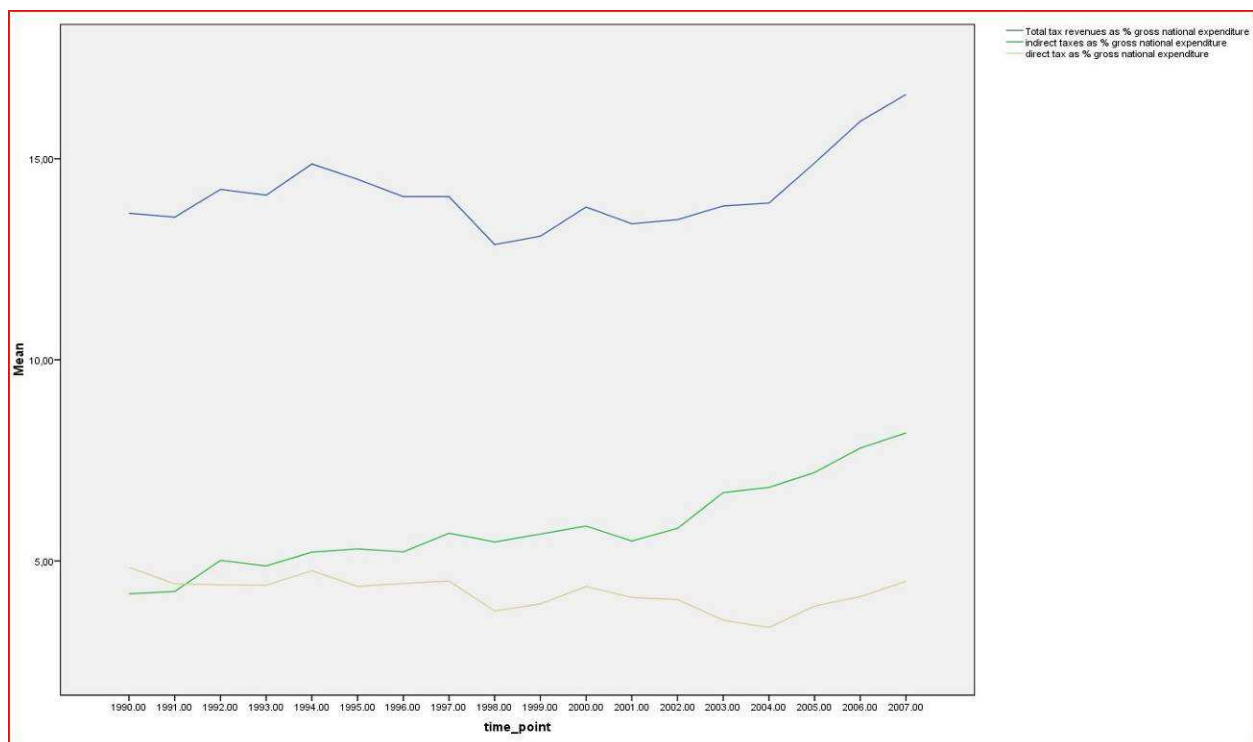


Figure 1b: Direct Taxes as % GNE

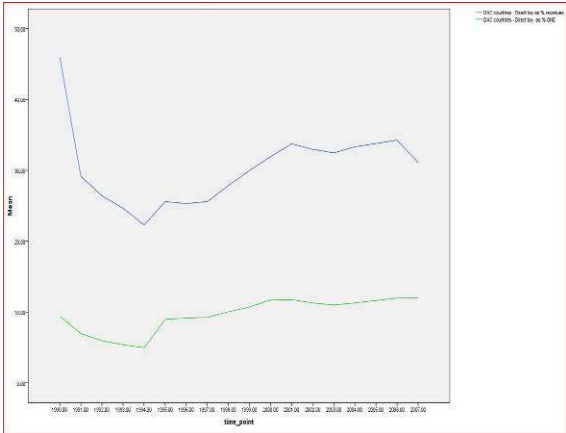


Figure 1c: Indirect Taxes as % GNE

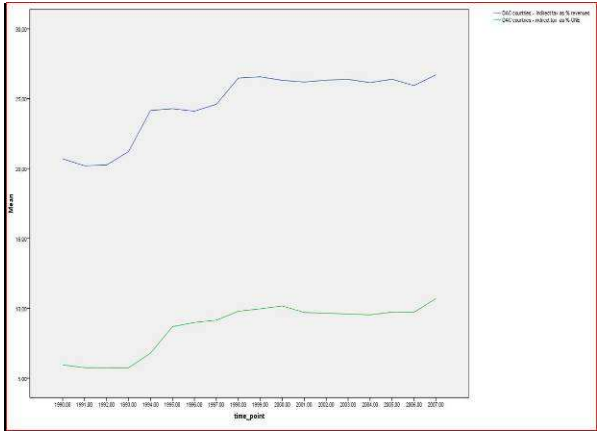


Table 2: Tax revenues by region (as % of GDP)

| | Total tax | | Direct tax | | Indirect tax | |
|-----------------------------|-----------|------|------------|------|--------------|------|
| | Min | Max | Min | Max | Min | Max |
| East Asia and Pacific | 2.0 | 25.3 | 5.7 | 61.8 | 9.0 | 79.5 |
| Central Asia | 6.8 | 29.4 | 4.2 | 40.7 | 6.3 | 59.8 |
| South Asia | 4.4 | 19.2 | 1.6 | 51.3 | 21.0 | 62.8 |
| Middle East and N. Africa | 4.1 | 36.9 | 5.4 | 79.5 | 0.7 | 64.1 |
| Sub-Saharan Africa | 2.6 | 58.4 | 3.3 | 53.1 | 1.8 | 50.4 |
| Latin America and Caribbean | 6.8 | 27.7 | 5.4 | 63.9 | 3.2 | 62.8 |

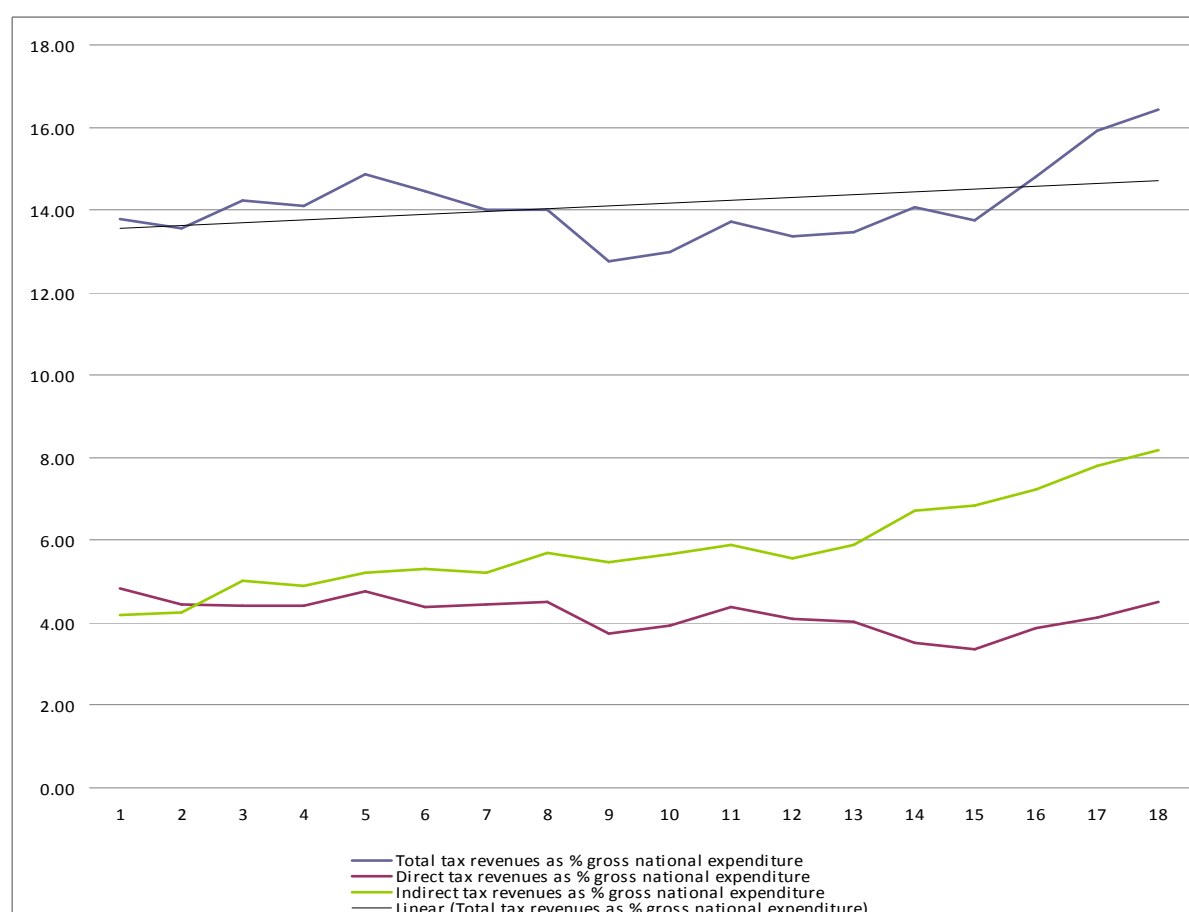
Finally we explored the main tendencies in the development of taxation over time (see Figure 2). A simple linear regression was conducted for each country, with tax income as the dependent variable and time as the independent variable. The coefficients for the intercept and the slope represent unbiased estimates of the initial status and the rate of change in taxation due to aid allocations. This provides us with some indicative measures of the average tax (direct, indirect and total) rates, as well as the standard deviations (e.g. observed heterogeneity between countries) and the rhythm of growth over time. The results are shown in Table 3.

Table 3: Changes in Taxation over Time (as % of GDP)

| | Initial status (intercept) | | Rate of change (slope) | | Bivariate Correlation |
|--------------|----------------------------|-------|------------------------|------|-----------------------|
| | Mean | SD | Mean | SD | |
| Total tax | 11.81 | 7.91 | 0.24 | 0.74 | -.490 ** |
| Direct tax | 17.03 | 20.04 | 0.14 | 1.40 | -.843** |
| Indirect tax | 29.16 | 20.83 | 0.24 | 1.50 | -.739** |

On average, the initial tax rate in the sample was 11.8 % in 1990 and increased by 0.24 % each year. The (negative) correlation of $-.49$ indicates that countries with a higher initial tax rate experience a slower increase compared to countries with lower starting values that tend to increase their tax revenues more rapidly. In a similar vein, average direct tax represented 17 % of GDP in the base year 1990 and increases by 0.14% yearly. Indirect tax rates were substantially higher (29.2 % of GDP) and also increase much faster (yearly with 0.24 %).

Figure 2: Tax Revenues as % of Gross National Expenditures (1990–2007)



4. Results

We relied on balanced panel regression analysis to understand the relationship between taxation and aid disbursements. Therefore, we used tax revenues (expressed as a percentage of gross national expenditures) as the dependent variable. Taxes were also disaggregated into direct and indirect taxes. The time effect was included to identify the trend over time. We used aid allocations by bilateral and multilateral donors as the independent variable, including further disaggregation into grants and loans. The control variables used were the degree of openness of the economy and the development status.

All independent variables were introduced into the analysis after centring to average, with the exception of Time which was centred at the beginning of the time series (1990). The intercept can therefore be interpreted directly as the initial status, e.g. the average value of tax revenues in 1990. The β coefficient of Time can be interpreted as the growth rate from one year to another. The coefficients of the other predictors can be interpreted as the effect on the initial status (from 1990) of the dependent variable. The interactions between Time and Aid test for significant effects of aid on the growth rate of taxation.

Several models were computed, introducing variables one by one and testing for any improvement in model fit. Several combinations of the substantive predictor (aid per capita) were used for each dependent variable (total tax / indirect tax / direct tax as a % of gross national expenditures). In addition to using yearly aid data, we included lagged aid (with 1, 2 and 3 years on average) as the explanatory variable. Moreover, the differentiation by type of aid (multi/bilateral and loans vs. grants) allowed us to acquire a closer insight into the specific effect of aid modalities on domestic taxation. Figures 3 and 4 provide a general insight into the development of taxation rates and aid per capita over time.

We conducted three types of data analysis. First, we estimated the panel regression models with different specifications, starting with an uncontrolled growth model (only intercept and time) and then gradually introducing aid (with 1–3 years time lag)¹³⁰, interaction terms between aid and time (growth rates) and control variables for the structure of the economy (openness) and the degree of development. We reported coefficient estimates (at different significant levels) and robust standard errors. In addition, we included variance and goodness of fit parameters. Second, we computed predicted values for tax revenues of some selected models specifications and plotted these on time for different levels of country development and by the level of aid received, compared to actual tax performance, to further test the robustness of model performance. Third, we took a closer look at the time pattern of tax revenues and analyzed whether or not differences in tax rates can be attributed to changes in aid modalities.

¹³⁰ We also disaggregated EU aid and total aid from all donors to infer differences between donors. On average, aid incidence on domestic taxation is slightly higher for EU donors.

Table 2: Total taxes as share of GNE (1990-2007)

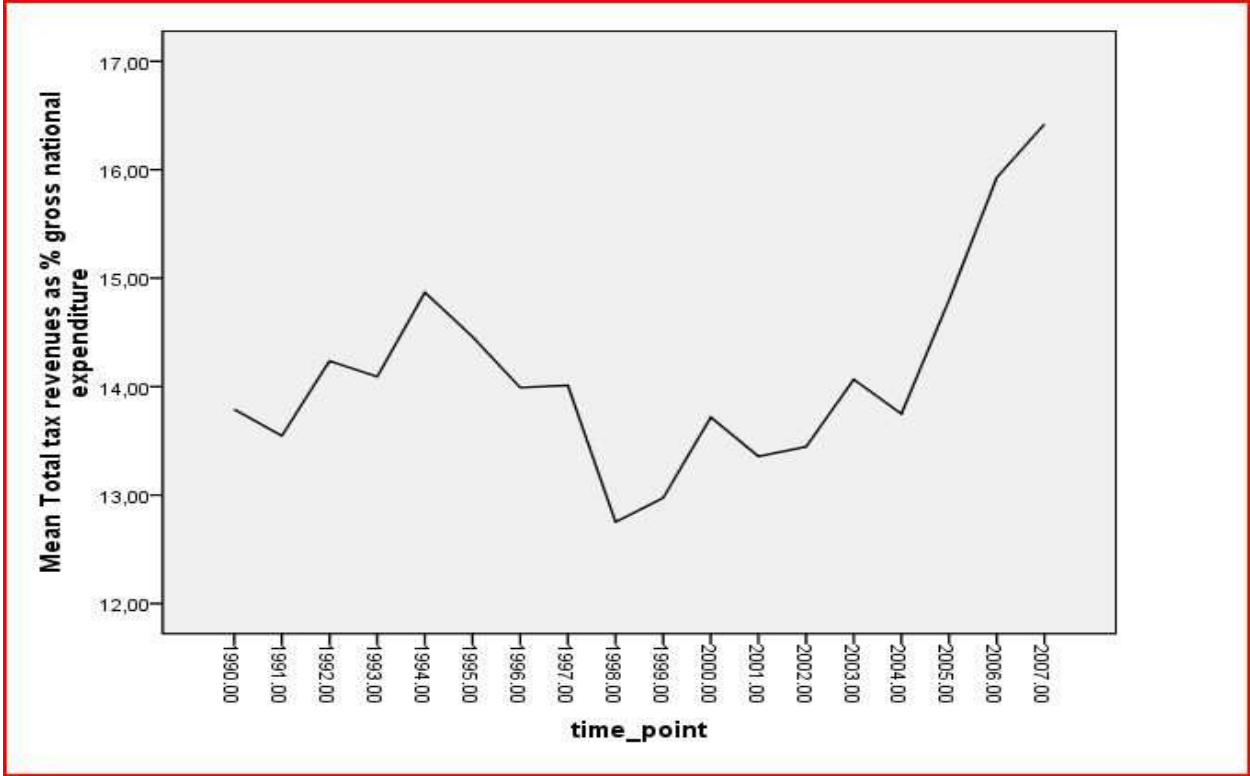
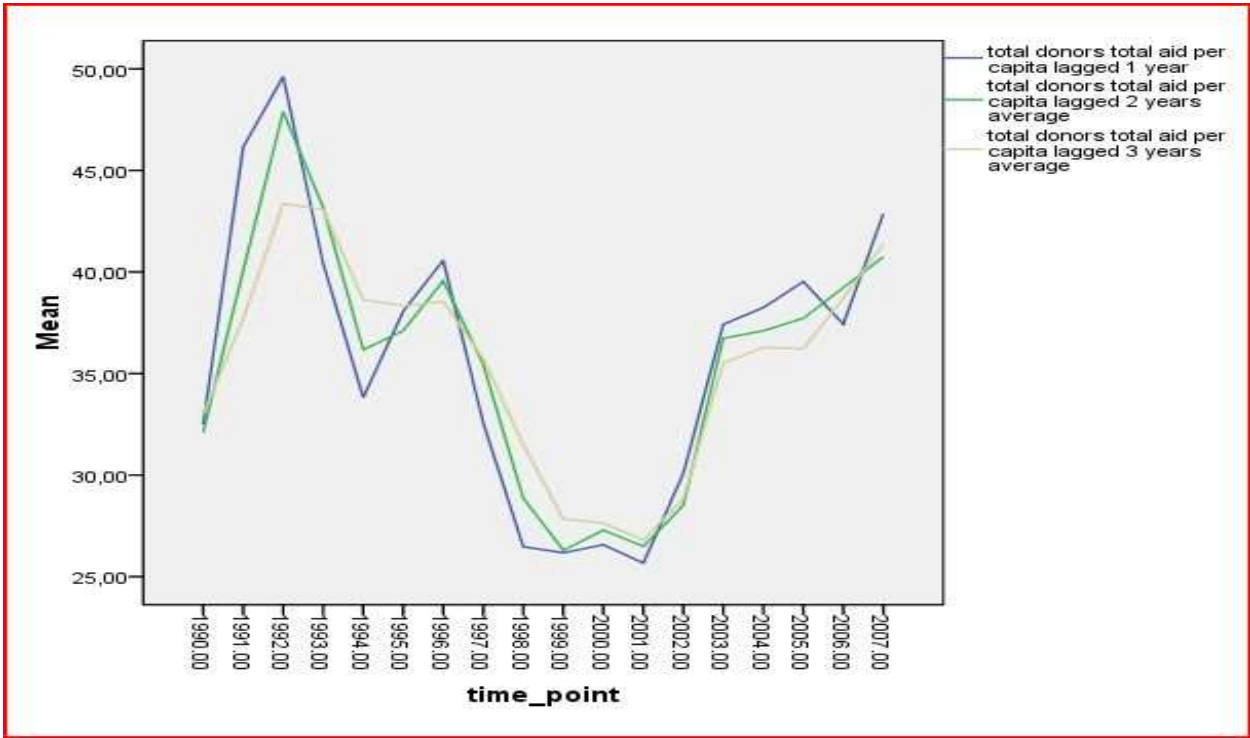


Table 3: Total donor Aid per capita (1990-2007)



4.1 Total tax revenues and aid

Table 4a/b analyses total tax revenues (as % gross national expenditures) against total aid per capita (from all donors). In 1990, average tax revenue as the share of gross national expenditure was 12.12 %.. The annual growth rate is 0.14, implying that until the end of the time series (in 2007) the average tax revenues in gross national expenditure increased by 2,38%.

The effects of aid can be traced as follows: a 1 \$ increase in per capita aid in the year prior to the year when total tax revenue was measured increases the initial status of dependent variable with 0.008%. A 1 \$ increase in per capita aid for 2 years earlier increases the initial status of tax revenue with 0.015% and a 1 \$ increase in per capita 3 years earlier increases the initial status of tax revenue with 0.017%. This implies that higher levels of aid sustained for longer periods of time tend to increase the initial status of tax revenues.¹³¹

More interesting are the effects of aid on the growth rate within the time range investigated. As can be seen in models B1 and B2, total aid per capita one year prior and two years prior does not significantly influence the growth rate of total tax revenues. However, Model B3 indicates that total aid per capita lagged by 3 years is shown to have a significant impact on the growth rate (but not on initial status). Models C1, C2 and C3 are the final specifications including controls that are proposed for modelling the effect of total aid per capita from all donors on the level of tax revenues as % GNE. The results found in previous models are stable.

The graphical representations of predicted values of the results of these analyses indicate that the model fits well there, despite the possibility of a structural breaking point around year 1998 (see Figure 4). Mean predicted values for each time point and for countries with different levels of development show some differences in initial status and growth curves (see Figure 5). We also divided total 3-year lagged and averaged aid into categorical variables, and plotted the predicted values. Countries with different levels of aid have different growth trajectories of taxation over time (see Figure 6). As can be seen, after year 2000 the total tax revenues as GNE share increased mainly for lower upper and middle income countries, while different growth curves were maintained in previous periods. This sustains the possibility of a structural break at around the end of the 1990s.

4.2 Total tax revenues: comparing bilateral and multilateral aid

Table 5a/b presents the results of the analysis regarding the differential impact of bilateral or multilateral aid on domestic taxation. In addition to the basic model, several lagged specifications of bi/multilateral aid and interaction terms are included.

¹³¹ However, we should mention the problem of causality here: countries that received higher levels of aid could have had already higher rates of tax revenues prior to start. This result does not necessarily mean that higher levels of aid per capita directly cause a higher level of tax revenues.

The final results (presented in model specifications D to F) generally support the previous outcomes. Most importantly, only bilateral aid from DAC countries has a significant impact on the initial status of total tax revenues as % GNE. Results vary strongly between types of countries. The results as regards the effect on lagged aid on the tax growth rate are rather inconclusive.

Figure 4: Total tax revenues (predicted and real)

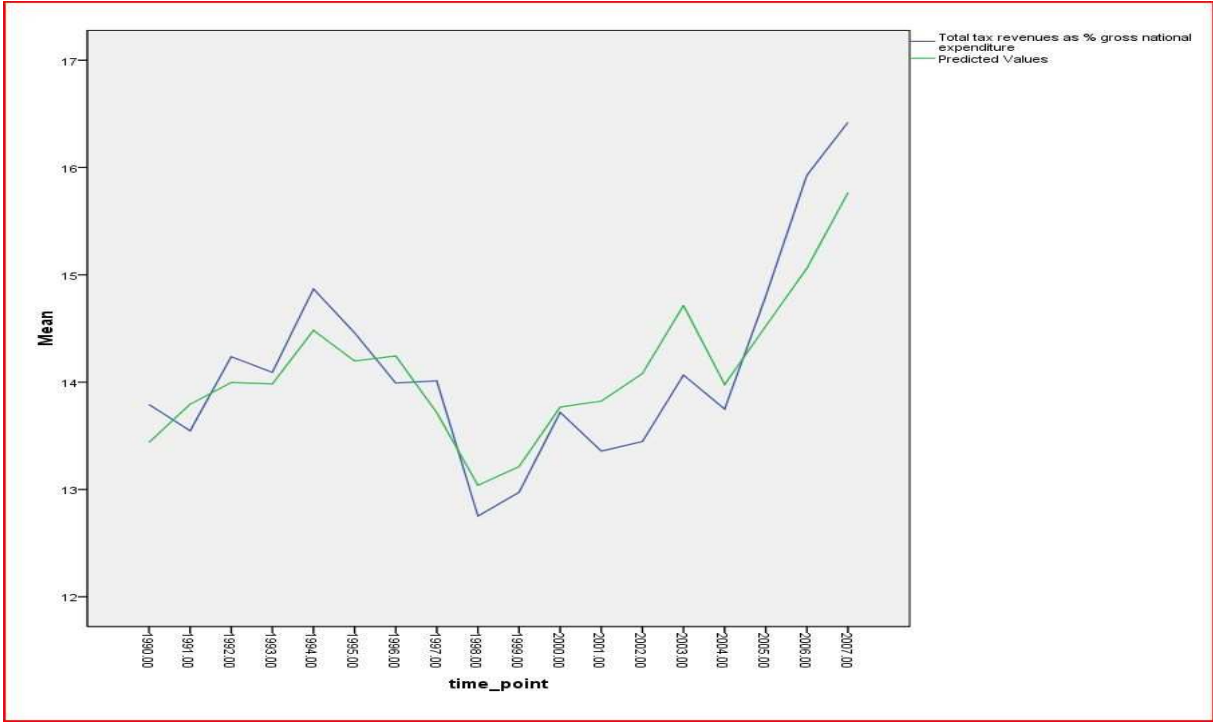


Figure 5: Predicted total tax revenues for countries by development level

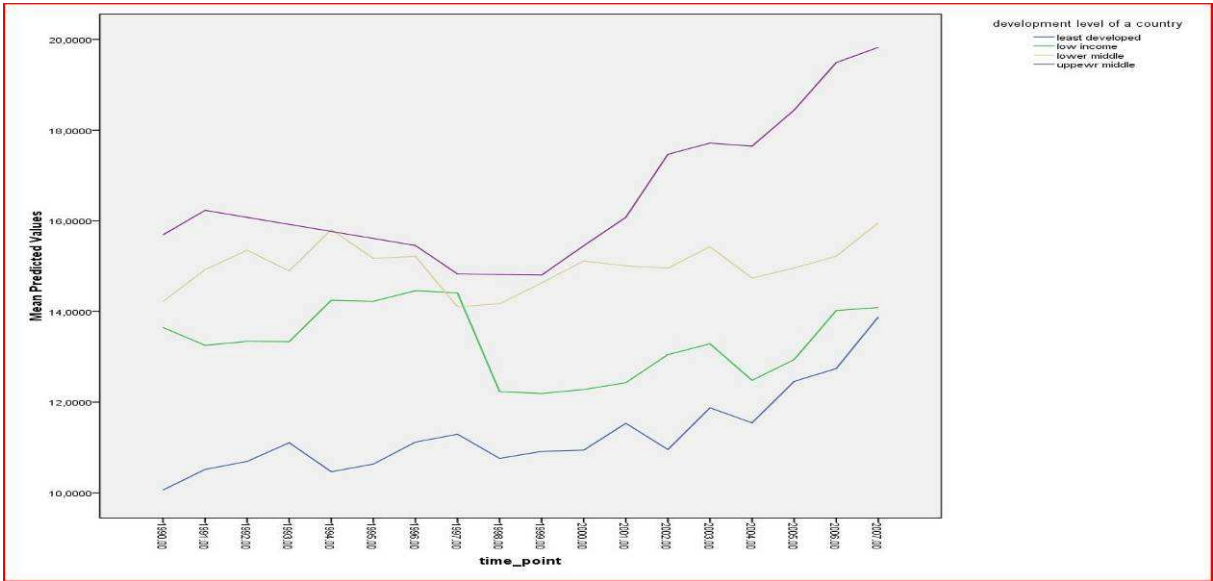
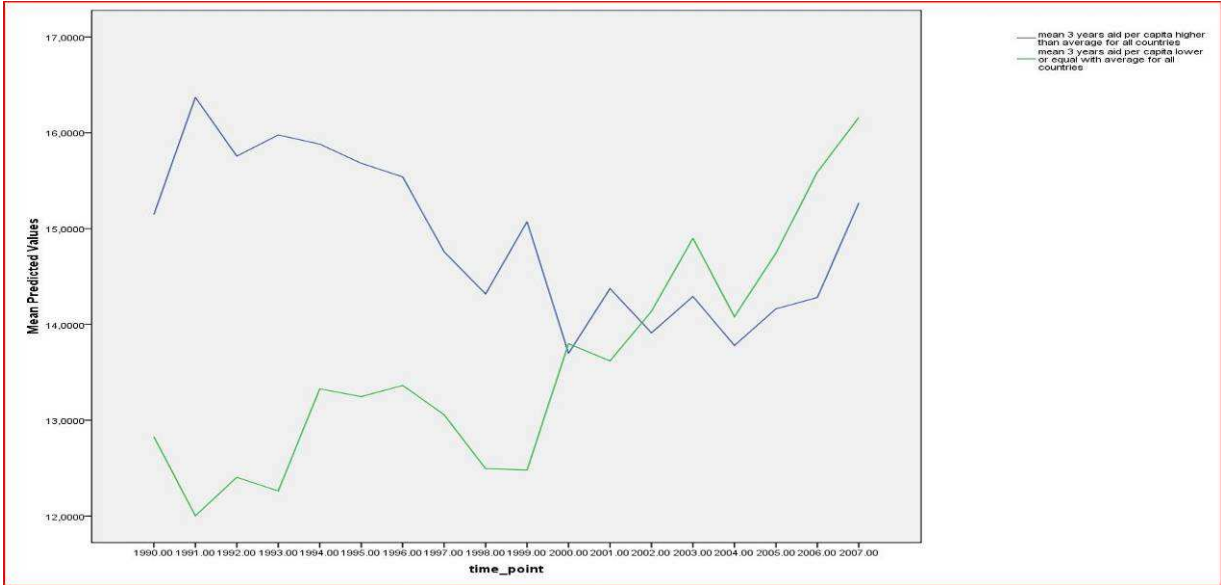


Figure 6: Predicted total tax revenues by level of aid disbursements



4.3 Total tax revenues: comparing grants and loans

Table 6a/b presents the result of the analysis of the differential impact of loans or grants on domestic taxation. In addition to the basic model, several lagged specifications of loans/grants and interaction terms are included.

Final results (model specifications G to I) generally support the tendencies outlined above. In addition, only grants have a sustainable impact on the initial status of tax revenues as % GNE. Interestingly, however, the effect of 3-year lagged grants on the tax growth rate also had a significant effect on the growth rate. This might indicate that aid grants have a significant long-term effect on domestic tax regimes.

4.4 Comparing direct and indirect taxation

Table 7 and 8 provide some more detailed estimates for the different effects on direct and indirect taxation. Results show that there is no significant effect of time on direct tax revenues as % GNE. Comparing mean predicted and observed values per year we notice strong shifts and therefore considerable variability over time. The effect of aid variables is generally not significant.

The growth rates of indirect taxation is significant over time, indicating that there is a general tendency towards increased reliance on indirect tax-raising. However, the aid variables do not reveal any significant effect either on the initial status or on the growth rate of indirect tax revenues as % GNE. An examination of the plotted predicted values for different categories of countries shows that there are hardly any differences in indirect taxation trends between countries receiving much or little development aid.

Figure 7: Direct taxes by country

development level

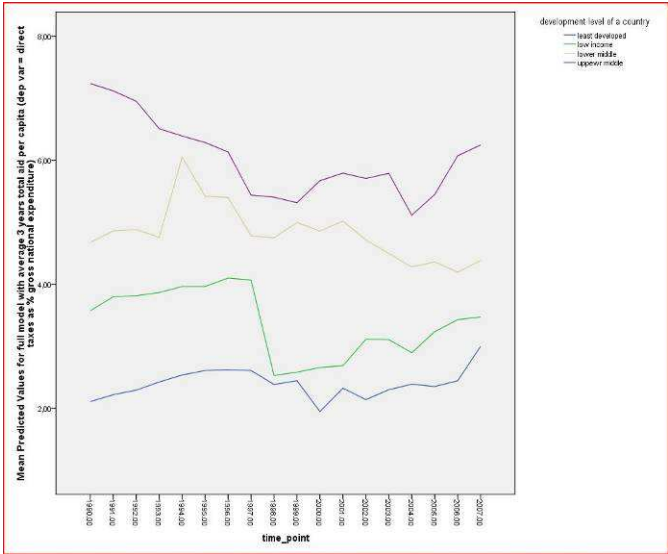


Figure 7b: Indirect taxes by country

development level

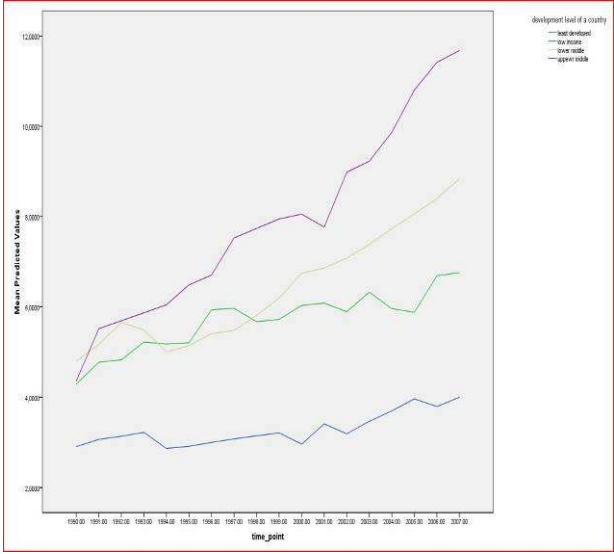


Table 4a: Total tax revenues as % gross national expenditure

| | | Uncontrolled growth model | | Model A1 | | Model A2 | | Model A3 | | Model B1 | | Model B2 | |
|---------------------|-----------------------------------|---------------------------|-------|-----------------|---------|-----------------|---------|-----------------|---------|-----------------|---------|-----------------|---------|
| Fixed effects | | coeff. | std.e | coeff. | std.er. | coeff. | std.er. | coeff. | std.er. | coeff. | std.er. | coeff. | std.er. |
| Composite model | Intercept (initial status) | 12.12*** | 0.76 | 12.08*** | 0.78 | 12.09*** | 0.78 | 12.09*** | 0.78 | 12.09*** | 0.78 | 12.14*** | 0.78 |
| | Time (rate of change) | 0.14** | 0.05 | 0.14** | 0.06 | 0.14** | 0.05 | 0.14** | 0.05 | 0.14** | 0.06 | 0.14** | 0.06 |
| Aid | Total aid p.c. 1 year lag | | | 0.008** | 0.003 | | | | | 0.006 | 0.005 | | |
| | Total aid p.c. 2 years lag | | | | | 0.015*** | 0.004 | | | | | 0.006 | 0.006 |
| | Total aid p.c. 3 years lag | | | | | | | 0.017*** | 0.005 | | | | |
| | Total aid p.c. 1 year lag *Time | | | | | | | | | 0.0003 | 0.0006 | | |
| Controls | Total aid p.c. 2 years lag *Time | | | | | | | | | | | 0.001 | 0.0008 |
| | Total aid p.c. 3 years lag * Time | | | | | | | | | | | | |
| | openness economy | | | | | | | | | | | | |
| | least developed (ref) | | | | | | | | | | | | |
| | low income | | | | | | | | | | | | |
| | lower middle | | | | | | | | | | | | |
| | upper middle | | | | | | | | | | | | |
| Variance components | | | | | | | | | | | | | |
| Level 1 | within countries | 3.16 | | 2.85 | | 2.83 | | 2.83 | | 2.84 | | 2.8 | |
| Level 2 | In initial status | 36.85 | | 38.17 | | 38.01 | | 37.94 | | 38.23 | | 38.22 | |
| | In the rate of change | 0.19 | | 0.21 | | 0.21 | | 0.21 | | 0.21 | | 0.21 | |
| Goodness of fit | | | | | | | | | | | | | |
| | - 2LL | 3745.22 | | 3573.09 | | 3572.37 | | 3572.47 | | 3572.85 | | 3569.28 | |
| | AIC | 3757.22 | | 3587.09 | | 3586.37 | | 3586.47 | | 3588.85 | | 3585.2 | |
| | BIC | 3785.41 | | 3619.76 | | 619.05 | | 3619.14 | | 3626.19 | | 3622.6 | |

Note: Lagged variable computed per capita and centered at average value

*** – significant for .01; ** – significant for .05; * – significant for .10

Table 4b: Total tax revenues as % gross national expenditure (continued)

| | | Model B2 | | Model B3 | | Model C1 | | Model C2 | | Model C3 | |
|----------------------------|-----------------------------------|-----------------|---------|-----------------|---------|----------------|---------|----------------|---------|-----------------|---------|
| Fixed effects | | coeff. | std.er. | coeff. | std.er. | coeff. | std.er. | coeff. | std.er. | coeff. | std.er. |
| Composite model | Intercept (initial status) | 12.14*** | 0.78 | 12.18*** | 0.78 | 9.77*** | 1.18 | 9.73*** | 1.17 | 9.86*** | 1.19 |
| | Time (rate of change) | 0.14** | 0.06 | 0.14** | 0.06 | 0.11* | 0.06 | 0.11* | 0.05 | 0.11* | 0.05 |
| Aid | Total aid p.c. 1 year lag | | | | | 0.007* | 0.004 | | | | |
| | Total aid p.c. 2 years lag | 0.006 | 0.006 | | | | | 0.01*** | 0.004 | | |
| | Total aid p.c. 3 years lag | | | 0.0005 | 0.008 | | | | | | |
| | Total aid p.c. 1 year lag *Time | | | | | | | | | | |
| | Total aid p.c. 2 years lag *Time | 0.001 | 0.0008 | | | | | | | | |
| | Total aid p.c. 3 years lag * Time | | | 0.003*** | 0.0009 | | | | | 0.003*** | 0.0006 |
| Controls | openness economy | | | | | 0.02*** | 0.006 | 0.02*** | 0.006 | 0.02*** | 0.006 |
| | least developed (ref) | | | | | | | | | | |
| | low income | | | | | 2.77 | 1.78 | 2.79 | 1.78 | 2.65 | 1.8 |
| | lower middle | | | | | 3.71** | 1.44 | 3.74** | 1.44 | 3.61** | 1.46 |
| | upper middle | | | | | 4.86*** | 1.79 | 5.05*** | 1.79 | 5.03*** | 1.81 |
| <i>Variance components</i> | | | | | | | | | | | |
| Level 1 | within countries | 2.8 | | 2.76 | | 2.86 | | 2.85 | | 2.78 | |
| Level 2 | In initial status | 38.22 | | 38.37 | | 30.7 | | 30.49 | | 31.36 | |
| | In the rate of change | 0.21 | | 0.23 | | 0.18 | | 0.18 | | 0.19 | |
| <i>Goodness of fit</i> | | | | | | | | | | | |
| | - 2LL | 3569.28 | | 3564.01 | | 3552.12 | | 3551.67 | | 3544.71 | |
| | AIC | 3585.2 | | 3580.01 | | 3574.12 | | 3573.67 | | 3566.71 | |
| | BIC | 3622.6 | | 3617.36 | | 3625.46 | | 3625.02 | | 3618.06 | |

Note: Lagged variable computed per capita and centred at average value

*** – significant for .01; ** – significant for .05; * – significant for .10

Table 5a: Total tax revenues as % gross national expenditure – bilateral and multilateral aid

| | | Uncontrolled growth model | | Model D1 | | Model D2 | | Model D3 | | Model E1 | |
|-------------------------------------|-------------------------------------|---------------------------|---------|-----------------|---------|-----------------|---------|-----------------|---------|-----------------|---------|
| Fixed effects | | coeff. | std.er. | coeff. | std.er. | coeff. | std.er. | coeff. | std.er. | coeff. | std.er. |
| Composite model | Intercept (initial status) | 12.12*** | 0.76 | 12.2*** | 0.78 | 12.22*** | 0.77 | 12.21*** | 0.77 | 12.18*** | 0.78 |
| | Time (rate of change) | 0.14** | 0.05 | 0.13** | 0.06 | 0.13** | 0.05 | 0.13** | 0.05 | 0.13** | 0.06 |
| Aid | Bilateral aid 1 year lag | | | 0.01** | 0.004 | | | | | 0.01** | 0.006 |
| | Multilateral aid 1 year lag | | | 0.006*** | 0.003 | | | | | -0.001 | 0.01 |
| | Bilateral aid 2 years lag | | | | | 0.02*** | 0.005 | | | | |
| | Multilateral aid 2 years lag | | | | | 0.008 | 0.006 | | | | |
| | Bilateral aid 3 years lag | | | | | | | 0.02* | 0.006 | | |
| | Multilateral aid 3 years lag | | | | | | | 0.008 | 0.008 | | |
| | Bilateral aid 1 year lag *Time | | | | | | | | | -0.0003 | 0.0006 |
| | Multilateral aid 1 year lag *Time | | | | | | | | | 0.0005 | 0.0007 |
| | Bilateral aid 2 years lag * Time | | | | | | | | | | |
| | Multilateral aid 2 years lag * Time | | | | | | | | | | |
| Bilateral aid 3 years lag * Time | | | | | | | | | | | |
| Multilateral aid 3 years lag * Time | | | | | | | | | | | |
| Controls | openness economy | | | | | | | | | | |
| Dev. Stage | low income | | | | | | | | | | |
| | lower middle | | | | | | | | | | |
| | upper middle | | | | | | | | | | |
| <i>Variance components</i> | | | | | | | | | | | |
| Level 1 | within countries | 3.16 | | 2.81 | | 2.78 | | 2.79 | | 2.81 | |
| Level 2 | In initial status | 36.85 | | 38.2 | | 37.42 | | 37.09 | | 37.93 | |
| | In the rate of change | 0.19 | | 0.21 | | 0.21 | | 0.2 | | 0.21 | |
| <i>Goodness of fit</i> | | | | | | | | | | | |
| | - 2LL | 3745.22 | | 3559.94 | | 3552.04 | | 3553.42 | | 3559.16 | |
| | AIC | 3757.22 | | 3575.94 | | 3568.04 | | 3569.42 | | 3579.16 | |

| | | | | | |
|-----|---------|---------|---------|---------|---------|
| BIC | 3785.41 | 3613.26 | 3605.37 | 3606.74 | 3625.81 |
|-----|---------|---------|---------|---------|---------|

Table 5b: Total tax revenues as % gross national expenditure – bilateral and multilateral aid (continued)

| | | Model E2 | | Model E3 | | Model F1 | | Model F2 | | Model F3 | |
|-------------------------------------|-------------------------------------|-----------------|---------|-----------------|--------|----------------|--------|----------------|---------|----------------|---------|
| Fixed effects | | coeff. | std.er. | coeff. | std.er | coeff. | std.er | coeff. | std.er. | coeff. | std.er. |
| Composite model | Intercept (initial status) | 12.23*** | 0.77 | 12.24*** | 0.77 | 9.91*** | 1.18 | 9.88*** | 1.17 | 9.88*** | 1.16 |
| | Time (rate of change) | 0.13** | 0.05 | 0.13** | 0.06 | 0.1* | 0.05 | 0.1* | 0.05 | 0.1* | 0.05 |
| Aid | Bilateral aid 1 year lag | | | | | 0.009** | 0.004 | | | | |
| | Multilateral aid 1 year lag | | | | | 0.006* | 0.003 | | | | |
| | Bilateral aid 2 years lag | 0.02*** | 0.008 | | | | | 0.02*** | 0.005 | | |
| | Multilateral aid 2 years lag | -0.01 | 0.01 | | | | | 0.009 | 0.006 | | |
| | Bilateral aid 3 years lag | | | 0.02* | 0.01 | | | | | 0.02*** | 0.006 |
| | Multilateral aid 3 years lag | | | -0.02 | 0.02 | | | | | 0.01 | 0.008 |
| | Bilateral aid 1 year lag *Time | | | | | | | | | | |
| | Multilateral aid 1 year lag *Time | | | | | | | | | | |
| | Bilateral aid 2 years lag * Time | -0.0001 | 0.0009 | | | | | | | | |
| | Multilateral aid 2 years lag * Time | 0.001* | 0.001 | | | | | | | | |
| | Bilateral aid 3 years lag * Time | | | 0.001 | 0.001 | | | | | | |
| Multilateral aid 3 years lag * Time | | | 0.002 | 0.001 | | | | | | | |
| Controls | openness economy | | | | | 0.02*** | 0.006 | 0.02*** | 0.006 | 0.02*** | 0.006 |
| Dev. Stage | low income | | | | | 2.7 | 1.78 | 2.71 | 1.77 | 2.72 | 1.77 |
| | lower middle | | | | | 3.7** | 1.44 | 3.72** | 1.43 | 3.73** | 1.43 |
| | upper middle | | | | | 4.9*** | 1.78 | 5.05*** | 1.78 | 5.08*** | 1.77 |
| <i>Variance components</i> | | | | | | | | | | | |
| Level 1 | within countries | 2.77 | | 2.76 | | 2.82 | | | | 2.8 | |
| Level 2 | In initial status | 36.96 | | 37.01 | | 30.82 | | | | 29.75 | |
| | In the rate of change | 0.2 | | 0.21 | | 0.18 | | | | 0.17 | |
| <i>Goodness of fit</i> | | | | | | | | | | | |
| | - 2LL | 3548.83 | | 3547.98 | | 3538.29 | | 3530.85 | | 3531.83 | |
| | AIC | 3568.83 | | 3567.98 | | 3562.29 | | 3554.85 | | 3555.83 | |
| | BIC | 3615.49 | | 3614.63 | | 3618.28 | | 3610.84 | | 3611.82 | |

Table 6a: Total tax revenues as % of Gross National Expenditures – Loans and Grants

| | | Uncontrolled growth model | | Model G1 | | Model G2 | | Model G3 | | Model H1 | |
|---------------------------------|---------------------------------|---------------------------|---------|-----------------|---------|-----------------|---------|-----------------|---------|-----------------|---------|
| Fixed effects | | coeff. | std.er. | coeff. | std.er. | coeff. | std.er. | coeff. | std.er. | coeff. | std.er. |
| Composite model | Intercept (initial status) | 12.12*** | 0,76 | 12.19*** | 0,78 | 12.24*** | 0,77 | 12.21*** | 0,77 | 12.19*** | 0,78 |
| | Time (rate of change) | 0.14** | 0,05 | 0.13** | 0,06 | 0.13* | 0,05 | 0.13** | 0,05 | 0.13** | 0,06 |
| Aid | Total grants 1 year lag | | | 0.009*** | 0,003 | | | | | 0,008 | 0,006 |
| | Total loans 1 year lag | | | 0,003 | 0,004 | | | | | 0,005 | 0,009 |
| | Total grants 2 years lag | | | | | 0.02*** | 0,004 | | | | |
| | Total loans 2 years lag | | | | | 0,005 | 0,006 | | | | |
| | Total grants 3 years lag | | | | | | | 0.02*** | 0,005 | | |
| | Total loans 3 years lag | | | | | | | 0,007 | 0,007 | | |
| | Total grants 1 year lag *Time | | | | | | | | | 0,0002 | 0,0006 |
| | Total loans 1 year lag *Time | | | | | | | | | -0,0001 | 0,0008 |
| | Total grants 2 years lag * Time | | | | | | | | | | |
| | Total loans 2 years lag * Time | | | | | | | | | | |
| Total grants 3 years lag * Time | | | | | | | | | | | |
| Total loans 3 years lag * Time | | | | | | | | | | | |
| Controls | openness economy | | | | | | | | | | |
| Dev. Stage | low income | | | | | | | | | | |
| | lower middle | | | | | | | | | | |
| | upper middle | | | | | | | | | | |
| <i>Variance components</i> | | | | | | | | | | | |
| Level 1 | within countries | | 3,16 | | 2,84 | | 2,81 | | 2,82 | | 2,83 |
| Level 2 | In initial status | | 36,85 | | 37,45 | | 37,18 | | 37,28 | | 37,54 |
| | In the rate of change | | 0,19 | | 0,21 | | 0,2 | | 0,21 | | 0,21 |
| <i>Goodness of fit</i> | | | | | | | | | | | |
| | - 2LL | | 3745,22 | | 3569,36 | | 3566,45 | | 3568,4 | | 3569,22 |
| | AIC | | 3757,22 | | 3585,36 | | 3582,45 | | 3584,4 | | 3589,22 |
| | BIC | | 3785,41 | | 3622,69 | | 3619,8 | | 3621,7 | | 3635,89 |

Table 6b: Total tax revenues as % of Gross National Expenditures – Loans and Grants (continued)

| | | Model H2 | | Model H3 | | Model I1 | | Model I2 | | Model I3 | |
|----------------------------|---------------------------------|-----------------|---------|-----------------|---------|-----------------|---------|----------------|---------|----------------|---------|
| | | coeff. | std.er. | coeff. | std.er. | coeff. | std.er. | coeff. | std.er. | coeff. | std.er. |
| Fixed effects | | | | | | | | | | | |
| Composite model | Intercept (initial status) | 12.27*** | 0,78 | 12.25*** | 0,78 | 9.86*** | 1,17 | 9.81*** | 1,17 | 9.87*** | 1,18 |
| | Time (rate of change) | 0.13** | 0,06 | 0.13** | 0,06 | 0.1* | 0,05 | 0.1* | 0,05 | 0.1* | 0,05 |
| Aid | Total grants 1 year lag | | | | | 0.009*** | 0,003 | | | | |
| | Total loans 1 year lag | | | | | 0,003 | 0,004 | | | | |
| | Total grants 2 years lag | 0,01 | 0,008 | | | | | 0.02*** | 0,004 | | |
| | Total loans 2 years lag | -0,003 | 0,01 | | | | | 0,006 | 0,006 | | |
| | Total grants 3 years lag | | | 0,004 | 0,009 | | | | | 0,004 | 0,009 |
| | Total loans 3 years lag | | | -0,002 | 0,01 | | | | | 0.02** | 0,008 |
| | Total grants 1 year lag*Time | | | | | | | | | | |
| | Total loans 1 year lag*Time | | | | | | | | | | |
| | Total grants 2 years lag * Time | 0,0009 | 0,0008 | | | | | | | | |
| | Total loans 2 years lag * Time | 0,001 | 0,001 | | | | | | | | |
| | Total grants 3 years lag * Time | | | 0.002** | 0,0009 | | | | | 0.002** | 0,0008 |
| | Total loans 3 years lag * Time | | | 0,002 | 0,001 | | | | | | |
| Controls | openness economy | | | | | 0.02*** | 0,006 | 0.02*** | 0,006 | 0.02*** | 0,006 |
| | least developed (ref) | | | | | | | | | | |
| | low income | | | | | 2,78 | 1,78 | 2,82 | 1,78 | 2,68 | 1,79 |
| | lower middle | | | | | 3.73** | 1,44 | 3.78*** | 1,43 | 3.68** | 1,44 |
| | upper middle | | | | | 4.85*** | 1,78 | 5.05*** | 1,78 | 5.02*** | 1,79 |
| <i>Variance components</i> | | | | | | | | | | | |
| Level 1 | within countries | 2,79 | | 2,76 | | 2,85 | | 2,83 | | 2,8 | |
| Level 2 | In initial status | 37,37 | | 37,88 | | 30,31 | | 30,12 | | 30,74 | |
| | In the rate of change | 0,21 | | 0,22 | | 0,18 | | 0,17 | | 0,19 | |
| <i>Goodness of fit</i> | | | | | | | | | | | |
| | - 2LL | 3564,75 | | 3562,28 | | 3548,95 | | 3547,1 | | 3544,31 | |
| | AIC | 3584,75 | | 3582,28 | | 3572,95 | | 3571,1 | | 3570,31 | |
| | BIC | 3631,43 | | 3628,96 | | 3628,95 | | 3627,12 | | 3631 | |

Table 7: Direct tax revenues as % gross national expenditure

| | | Uncontrolled growth model | | Model A1 | | Model A2 | | Model A3 | | Model B1 | | Model B2 | | Model B3 | |
|-------------------------------|------------------------------|---------------------------|---------|----------------|---------|----------------|---------|----------------|---------|----------------|---------|----------------|---------|----------------|---------|
| | | coeff. | std.er. | coeff. | std.er. | coeff. | std.er. | coeff. | std.er. | coeff. | std.er. | coeff. | std.er. | coeff. | std.er. |
| Fixed effects Composite model | Intercept (initial status) | 3.5*** | 0.68 | 3.49*** | 0.7 | 3.49*** | 0.7 | 3.49*** | 0.7 | 2.23*** | 0.86 | 2.23*** | 0.86 | 2.23*** | 0.86 |
| | Time (rate of change) | 0.03 | 0.04 | 0.03 | 0.04 | 0.03 | 0.04 | 0.03 | 0.04 | 0.01 | 0.04 | 0.01 | 0.04 | 0.01 | 0.04 |
| Aid | Total aid 1 year lag | | | -0.002 | 0.003 | | | | | -0.002 | 0.003 | | | | |
| | Total aid 2 years lag | | | | | -0.002 | 0.004 | | | | | -0.003 | 0.004 | | |
| | Total aid 3 years lag | | | | | | | -0.003 | 0.004 | | | | | -0.003 | 0.004 |
| | Total aid 1 year lag *Time | | | | | | | | | | | | | | |
| | Total aid 2 years lag * Time | | | | | | | | | | | | | | |
| | Total aid 3 years lag * Time | | | | | | | | | | | | | | |
| Controls | openness economy | | | | | | | | | 0.01*** | 0.005 | 0.01* | 0.005 | 0.01* | 0.005 |
| | least developed (ref) | | | | | | | | | | | | | | |
| | low income | | | | | | | | | 0.82 | 0.99 | 0.83 | 0.99 | 0.83 | 0.99 |
| | lower middle | | | | | | | | | 2.17*** | 0.8 | 2.17*** | 0.8 | 2.17*** | 0.8 |
| | upper middle | | | | | | | | | 3*** | 1 | 3*** | 1.01 | 2.99*** | 1 |
| <i>Variance components</i> | | | | | | | | | | | | | | | |
| Level 1 | within countries | 2.54 | | 2.61 | | 2.6 | | 2.61 | | 2.62 | | 2.61 | | 2.61 | |
| Level 2 | In initial status | 28.68 | | 29.47 | | 29.47 | | 29.47 | | 27.08 | | 27.06 | | 27.06 | |
| | In the rate of change | 0.11 | | 0.11 | | 0.11 | | 0.11 | | 0.1 | | 0.1 | | 0.1 | |
| <i>Goodness of fit</i> | | | | | | | | | | | | | | | |
| | - 2LL | 3426.49 | | 3338.47 | | 3341.6 | | 3341.57 | | 3322.5 | | 3325.7 | | 3325.69 | |
| | AIC | 3438.49 | | 3352.47 | | 3355.6 | | 3355.57 | | 3344.5 | | 3347.7 | | 3347.69 | |
| | BIC | 3466.62 | | 385.06 | | 3388.2 | | 3388.16 | | 3395.71 | | 3398.92 | | 3398.92 | |

Note: Lagged variable computed per capita and centred at average value

*** – significant for .01; ** – significant for .05; * – significant for .10

Table 8: Indirect tax revenues as % gross national expenditure

| | | Uncontrolled growth model | | Model A1 | | Model A2 | | Model A3 | | Model B1 | | Model B2 | | Model B3 | |
|----------------------------|------------------------------|---------------------------|--------|----------------|--------|----------------|---------|----------------|---------|----------------|---------|----------------|---------|----------------|---------|
| | | coeff. | std.er | coeff. | std.er | coeff. | std.er. | coeff. | std.er. | coeff. | std.er. | coeff. | std.er. | coeff. | std.er. |
| Fixed effects | Composite model | | | | | | | | | | | | | | |
| | Intercept (initial status) | 4.14*** | 0.51 | 4*** | 0.53 | 4.02*** | 0.53 | 4.02*** | 0.53 | 1.89*** | 0.72 | 1.86** | 0.72 | 1.87** | 0.72 |
| | Time (rate of change) | 0.16*** | 0.05 | 0.16*** | 0.05 | 0.16*** | 0.05 | 0.16*** | 0.05 | 0.17*** | 0.04 | 0.16*** | 0.05 | 0.16*** | 0.05 |
| Aid | Total aid 1 year lag# | | | 0.0001 | 0.002 | | | | | 0.0004 | 0.002 | | | | |
| | Total aid 2 years lag | | | | | 0.003 | 0.003 | | | | | 0.003 | 0.003 | | |
| | Total aid 3 years lag | | | | | | | 0.002 | 0.004 | | | | | 0.002 | 0.004 |
| | Total aid 1 year lag *Time | | | | | | | | | | | | | | |
| | Total aid 2 years lag * Time | | | | | | | | | | | | | | |
| | Total aid 3 years lag * Time | | | | | | | | | | | | | | |
| Controls | openness economy | | | | | | | | | 0.004 | 0.005 | 0.003 | 0.005 | 0.004 | 0.005 |
| | least developed (ref) | | | | | | | | | | | | | | |
| | low income | | | | | | | | | 2.74*** | 0.87 | 2.75*** | 0.88 | 2.75*** | 0.88 |
| | lower middle | | | | | | | | | 2.54*** | 0.73 | 2.58*** | 0.73 | 2.58*** | 0.73 |
| | upper middle | | | | | | | | | 3.69*** | 0.88 | 3.8*** | 0.89 | 3.78*** | 0.89 |
| <i>Variance components</i> | | | | | | | | | | | | | | | |
| Level 1 | within countries | 2.01 | | 1.93 | | 1.93 | | 1.93 | | 1.94 | | 1.93 | | 1.94 | |
| Level 2 | In initial status | 15.39 | | 15.87 | | 16.28 | | 16.25 | | 15.14 | | 15.5 | | 15.48 | |
| | In the rate of change | 0.15 | | 0.15 | | 0.15 | | 0.15 | | 0.15 | | 0.15 | | 0.15 | |
| <i>Goodness of fit</i> | | | | | | | | | | | | | | | |
| | - 2LL | 3264.7 | | 3140.9 | | 3145.6 | | 3145.99 | | 3120.77 | | 3125.29 | | 3125.71 | |
| | AIC | 3276.7 | | 3154.9 | | 3159.6 | | 3159.99 | | 3142.77 | | 3147.29 | | 3147.71 | |
| | BIC | 3304.8 | | 3187.4 | | 3192.2 | | 3192.56 | | 3193.94 | | 3198.47 | | 3198.89 | |

Note: Lagged variable computed per capita and centred at average value

*** – significant for .01; ** – significant for .05; * – significant for .10

5. Discussion and outlook

While most previous studies of the relationship between development aid and domestic taxation focused on the implications for economic growth and income distribution, we used the tax share in gross domestic expenditures (GNE) as the dependent variable, thereby facilitating more thorough insights into the internal contribution of tax revenues to the public budget. On average, taxes account for about 14% of GNE, but the tax contribution is substantially higher in East Asian and Latin American countries, whereas South Asia and sub-Saharan countries maintain lower tax rates and a variable growth pattern. Indirect taxes prevail in most developing countries as a major source of internal funding.

The estimation results provide robust evidence of the positive and significant effect of development aid on domestic tax revenues, while the effect becomes substantially stronger 2–3 years after aid disbursements. The crowding-out hypothesis is therefore not registered. The tax effect of aid is stronger for bilateral aid (compared to multilateral aid), for grants (compared to loans) and for middle income countries. Differences between direct and indirect taxation could not be confirmed.

The panel data analysis also reveals that the tax share in GNE declined steadily during the 1990s while, from the year 1998 onwards, the tax contribution started to increase from an average of 13% to more than 16 % of GNE. This is remarkable, even more so considering the fact that aid per capita also increased in the same period. The most likely cause is that the shift from project aid to budget support programmes obliged many developing countries' governments to provide better guarantees of domestic counterpart funding (Koeberle *et al.*, 2006). In some countries an increase in tax revenue is even part of the agreement between the government and the donors. Harmonizing donor practices also reduces the opportunities for using donor aid from one agency to cover local contributions required by another agency. There are therefore sound reasons to expect that aid in the form of general budget support enhances the incentives for the developmental state to raise local tax-raising contributions to the public budget.

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Appendix 1 – Data sources

World Bank, World Development Indicators online

- Total tax revenue (% GDP / % of Government Expenditures)
 - Indirect tax revenues: Taxes on goods and services (% revenue)
 - Direct tax revenues: Taxes on incomes, profits and capital gains (% revenue)
- Agriculture value added (% of GDP)
- Industry added value (% of GDP)
- Exports of goods and services (% of GDP)
- Imports of goods and services (% of GDP)
- Revenues (excluding grants) as % GDP
- Fuel exports (% of merchandise exports)
- Ore and metal exports (% of merchandise exports)
- Population
- Population density
- Rural population (% of total population)
- Gini Index
- Employment in agriculture sector as % total labour force

OECD–DAC , Foreign Aid variables

- All donors: Total aid from all donors sent to a country (grants and loans)
- DAC EU countries: Total aid from DAC EU countries sent to a country (grants and loans)
- Categories of development: 1 (least developed countries) 2 (other low income countries) 3 (lower middle income countries) 4 (upper middle income countries)
- Initial country list followed OECD DAC list 2006, excluding countries categorized by United Nation as Small islands developing states. Resulting list consisted of 108 DAC countries

World Bank list of economies

- By geographical region: 1 (South Asia) 2 (Europe and Central Asia) 3 (Africa) 4 (Sub Saharan Africa) 5 (Latin America and Caribbean) 6 (East Asia and Pacific)

Time interval and computed variables

The time interval of the study extends from 1990 to 2007 (due to lack of data on tax revenues prior to 1990 and to changes in the OECD DAC list that occurred from 2008). The data set is not balanced, since not all countries have observations on all time points for the dependent variables (tax revenues).

Computed variables are:

- Ratio of agriculture added value to industrial added value.
- Openness of the economy – sum of imports and exports shares in GDP.
- Mineral exports – sum of fuel and ore / metals exports as % of merchandised exports.
- Development aid per capita – all development aid divided by the population of a country.

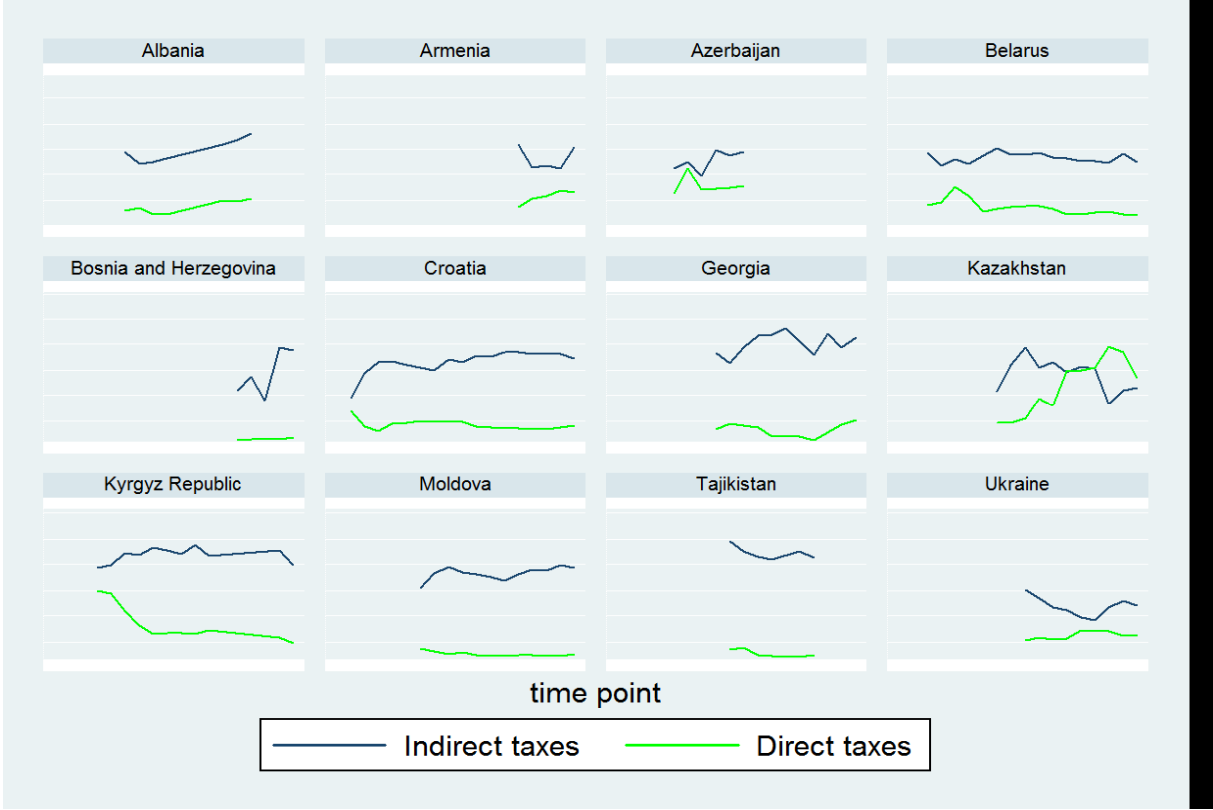
After an initial analysis we concluded that using development aid data from the same year as the tax revenues data leads to misspecification of the model. We therefore used lagged aid – one year prior to the year when tax revenue is measured, and conducted robustness checks for 2 and 3 years of lagged aid.

Data file structure

The data file is stored as country – period data set. Initial working data set has 1,386 cases (18 time points based in 77 countries). Missing cases were deleted.

Appendix 2 – Taxation rates and tax structures (by countries and region)

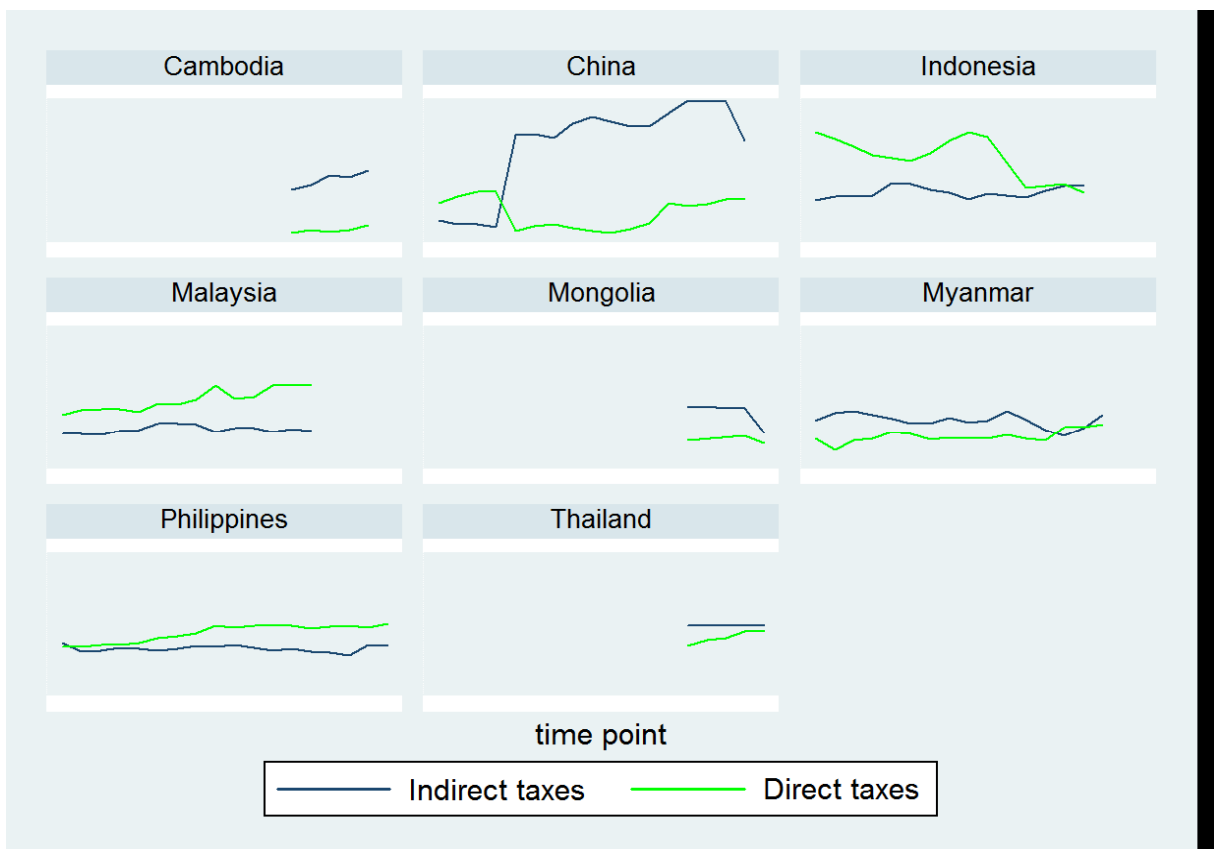
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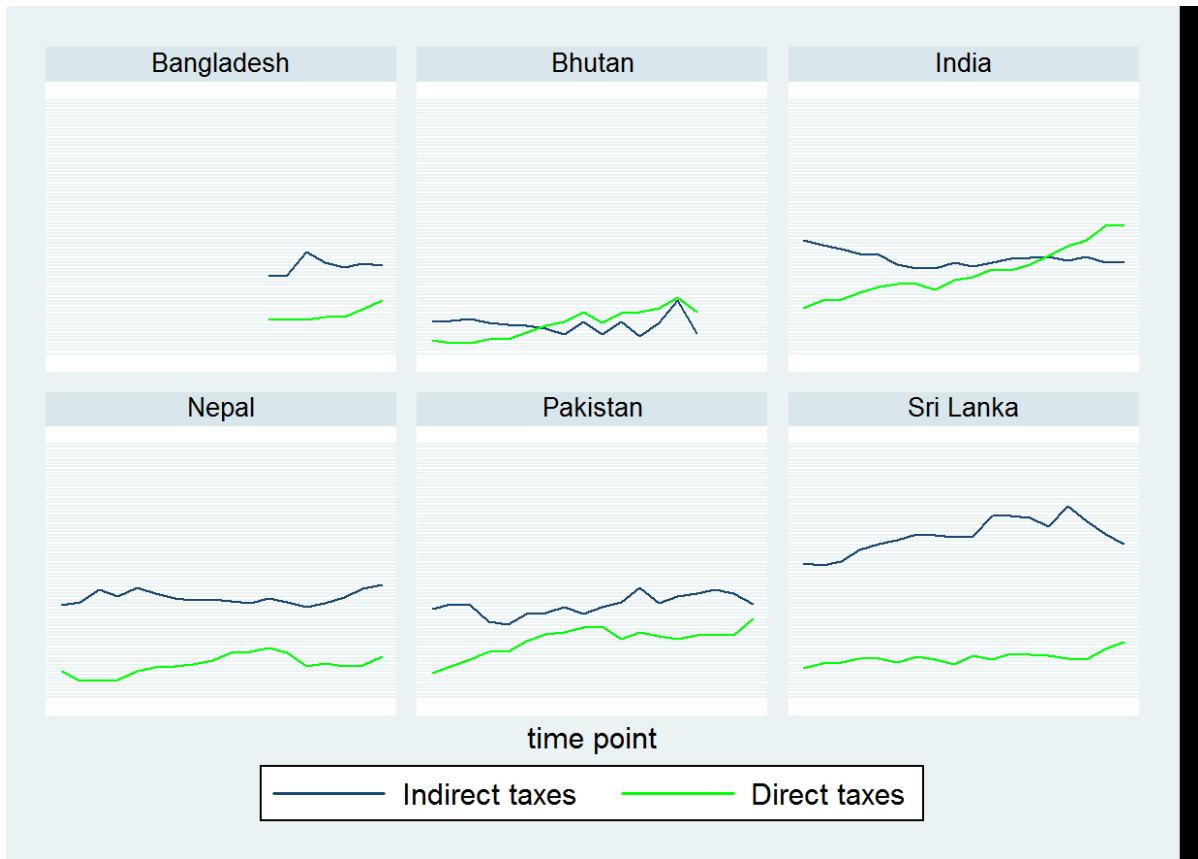


Latin America and Caribbean



South Asia





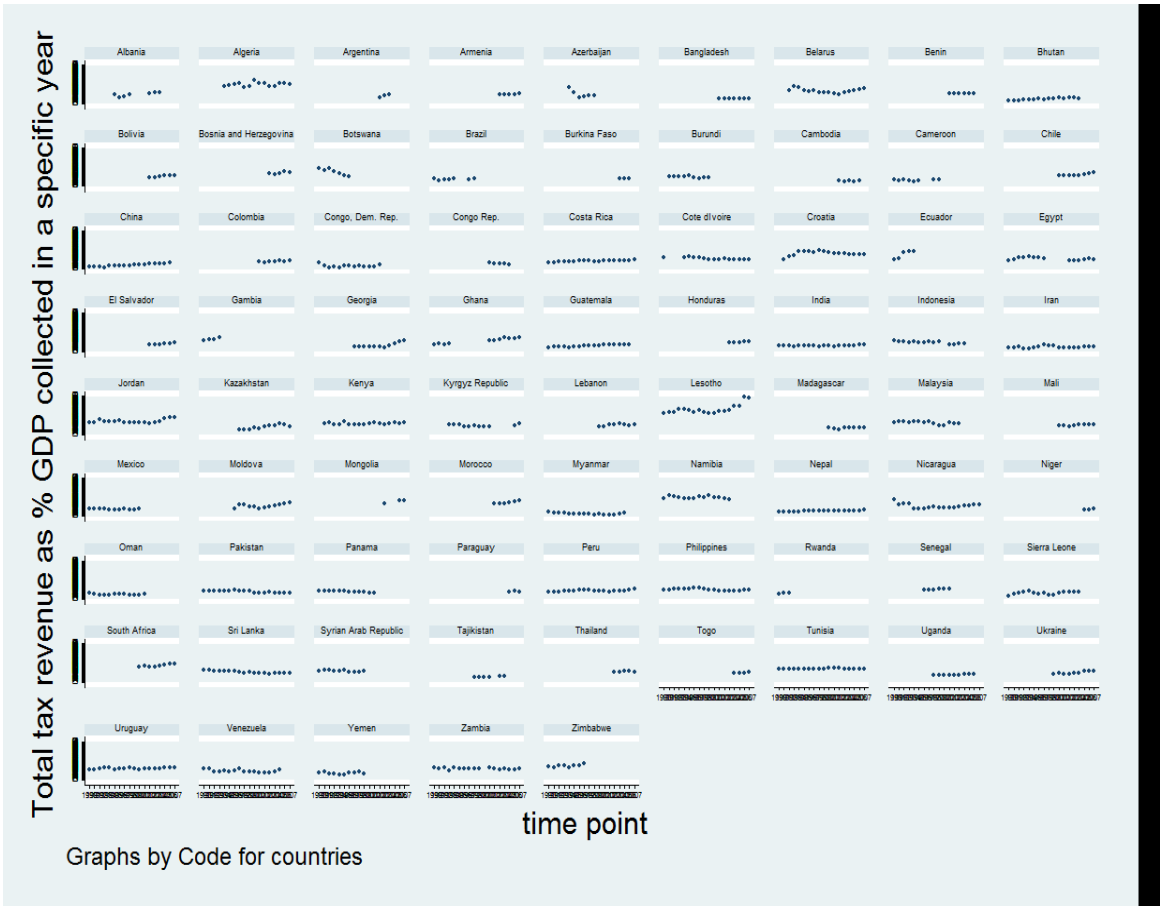
Middle East and Northern Africa



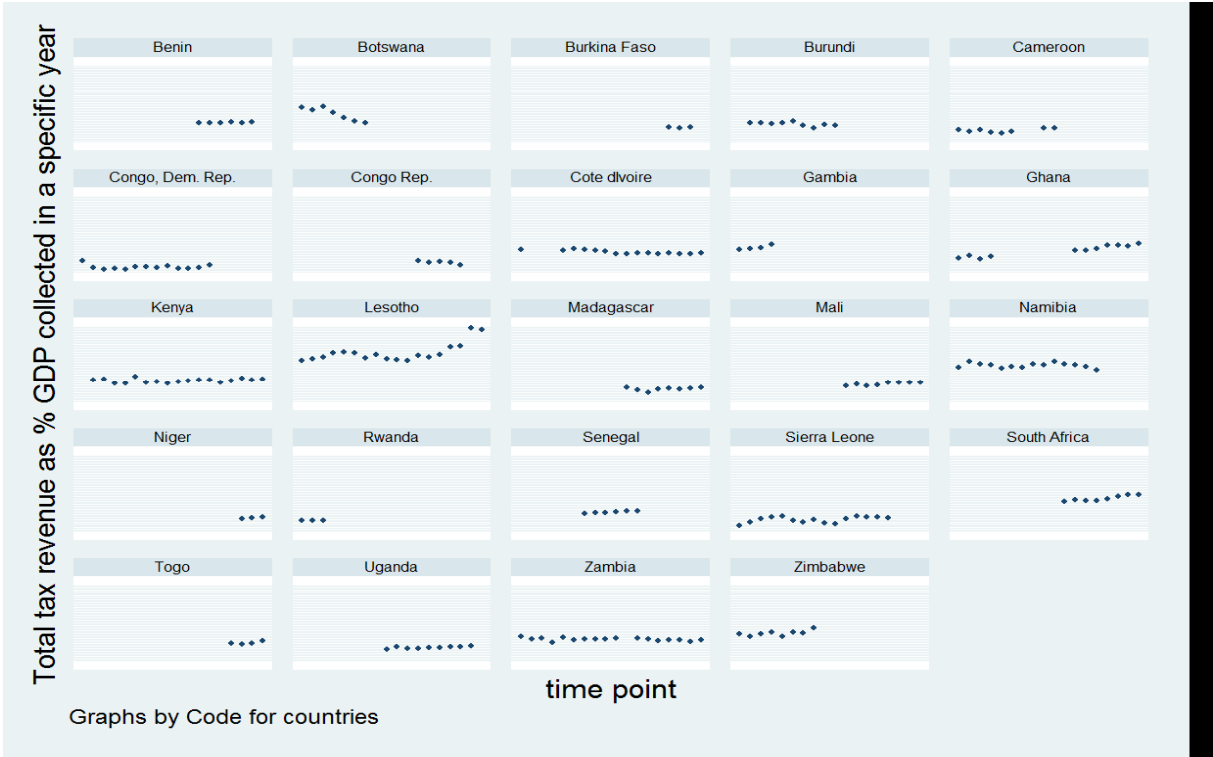
Sub-Saharan Africa



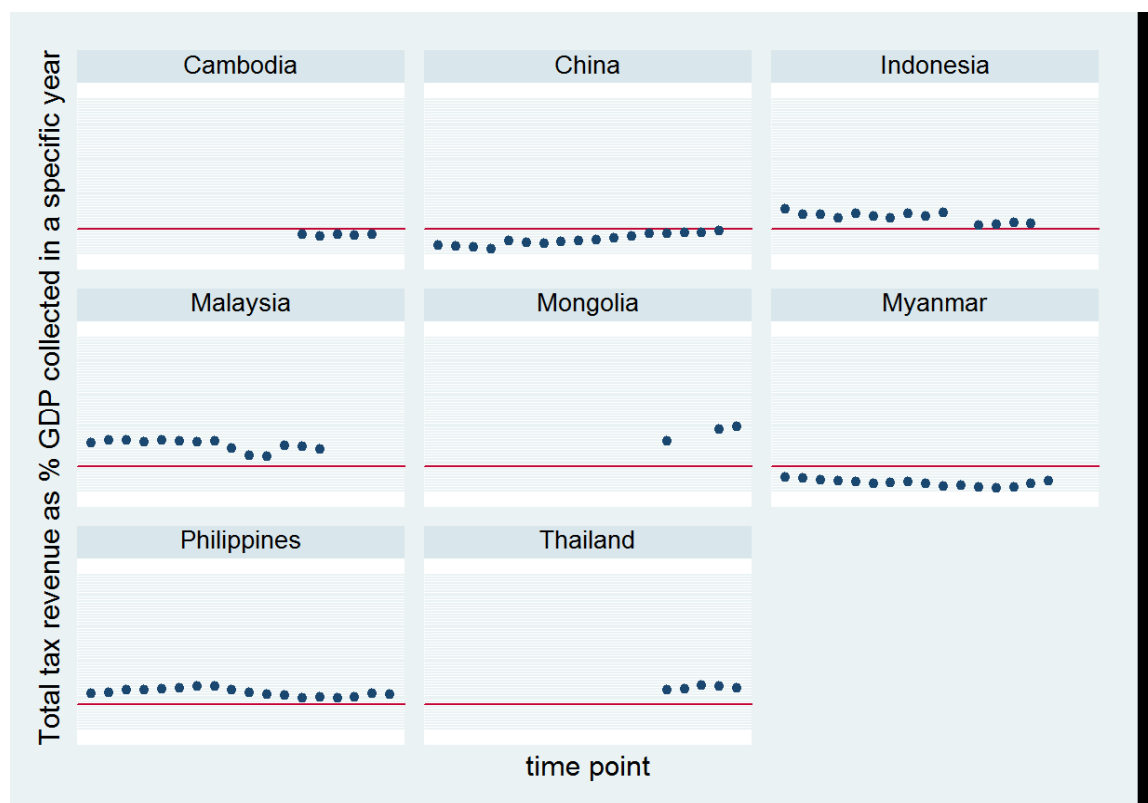
Appendix 3 – Total tax revenues as share of GDP (by countries and regions)



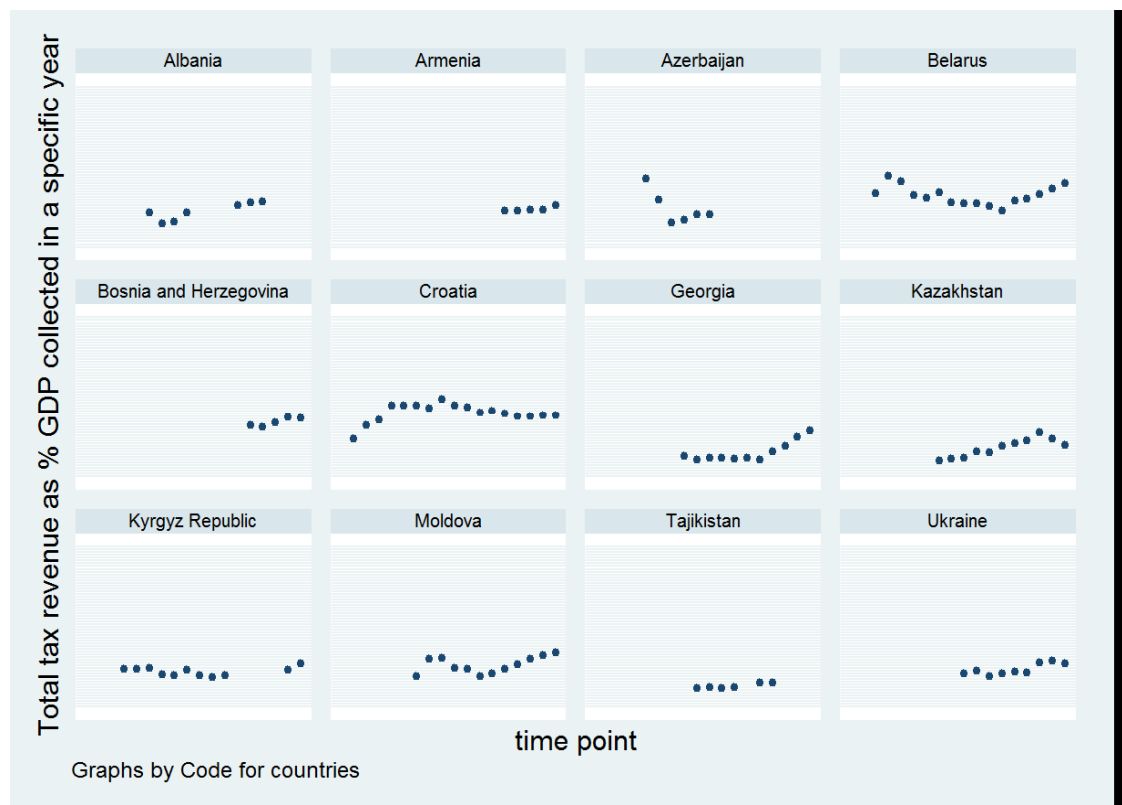
Sub-Saharan Africa



South Asia



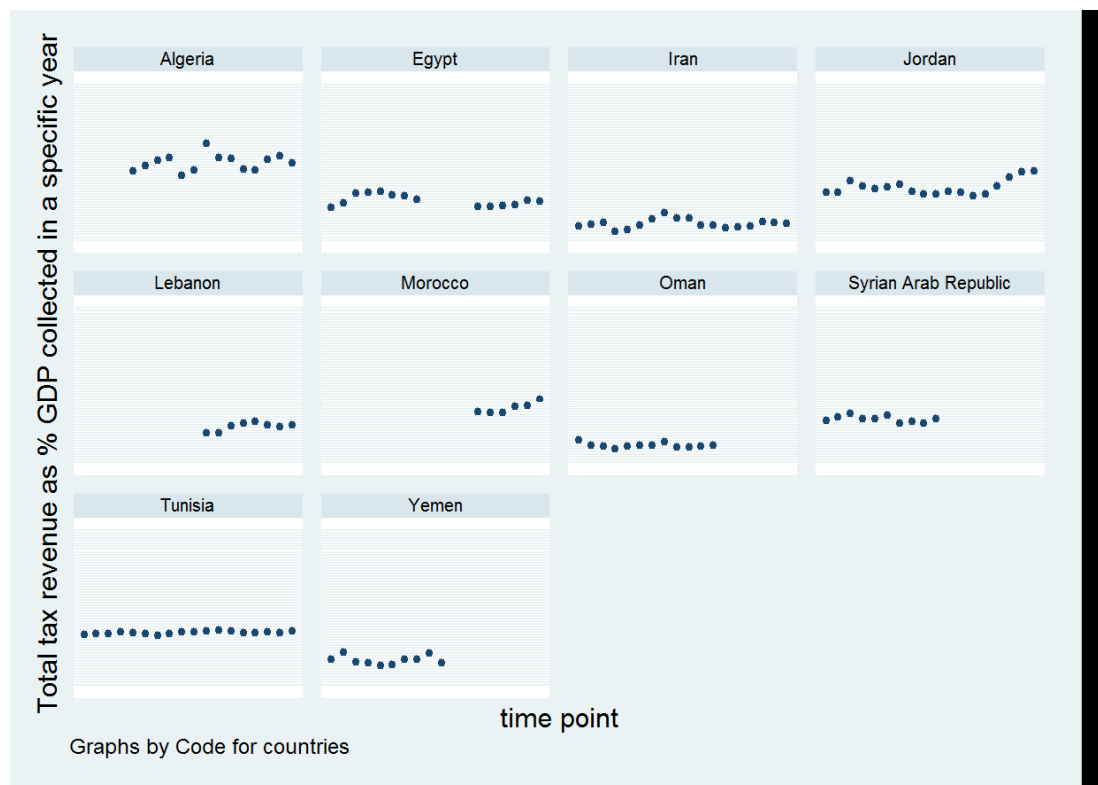
Eastern Europe



Latin America

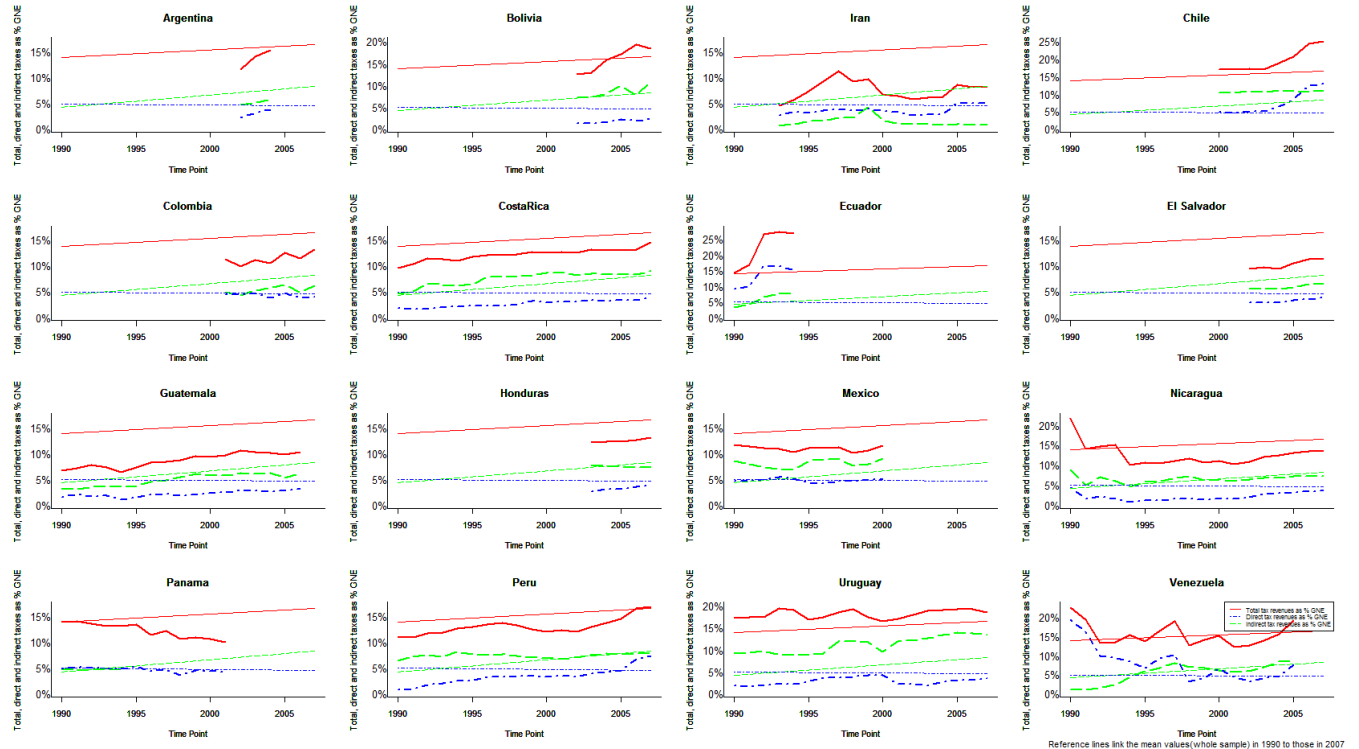


North Africa and Middle East

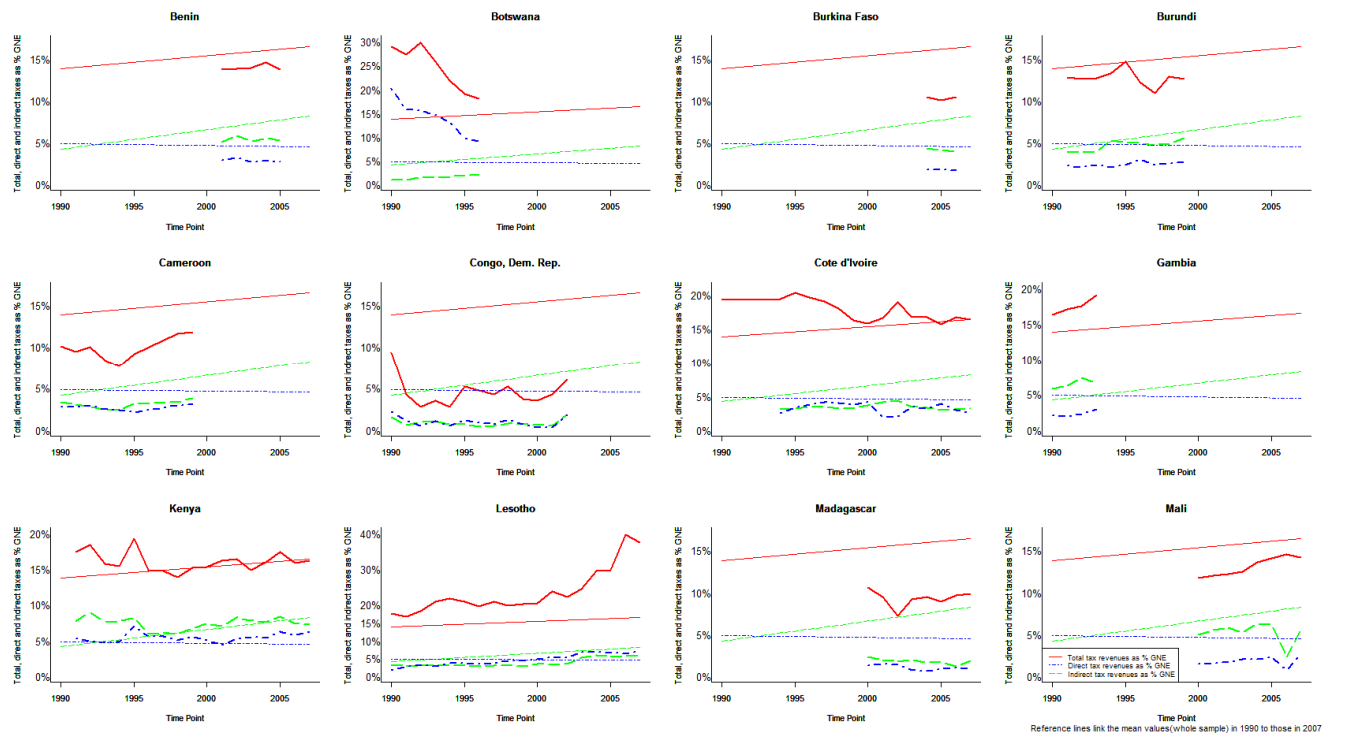


Appendix 4 – Tax revenues as a share of GNE

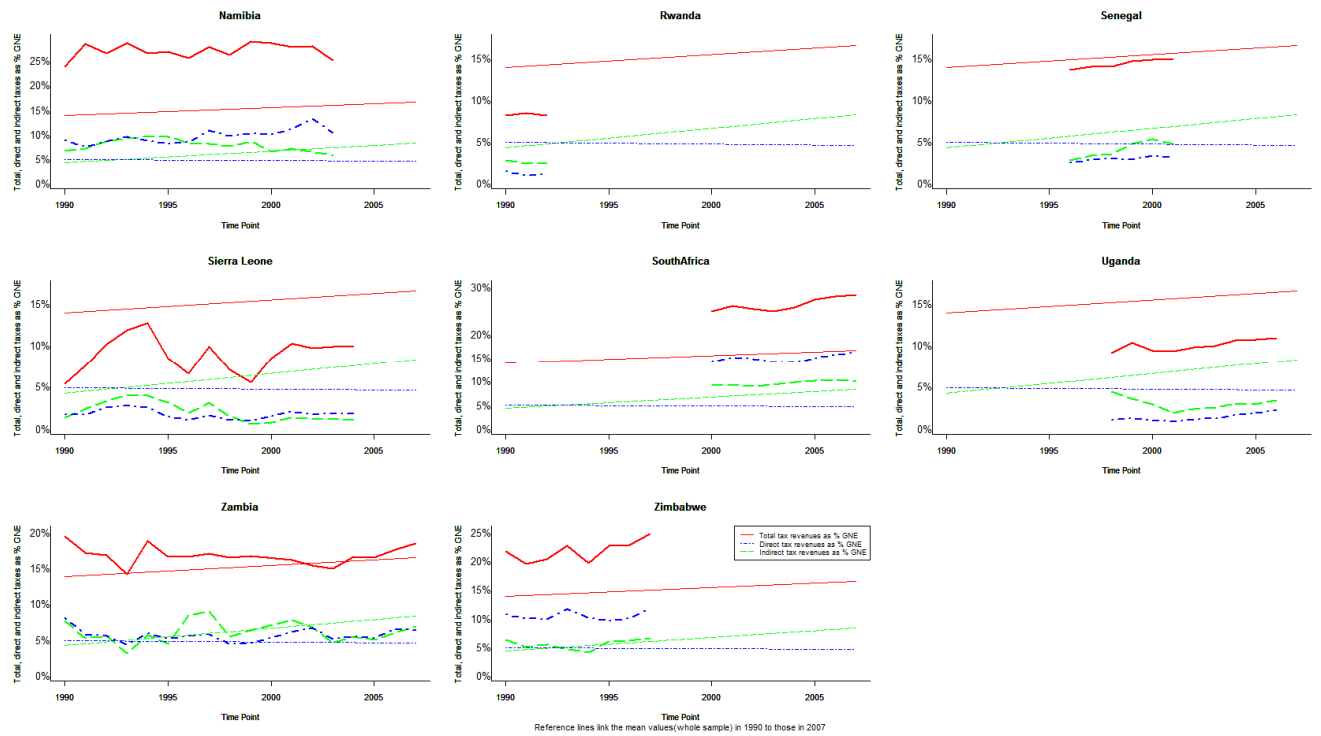
South America



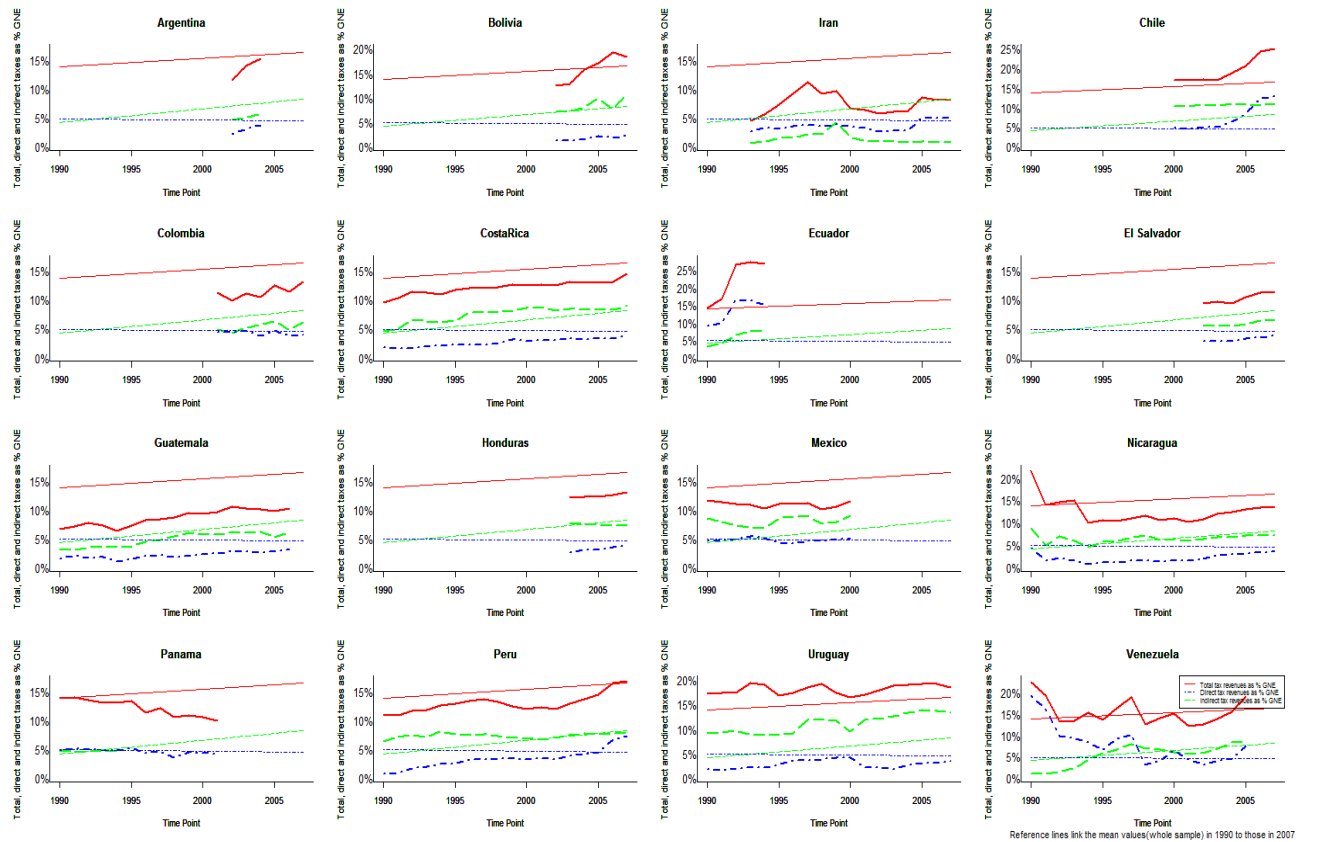
Sub-Saharan Africa



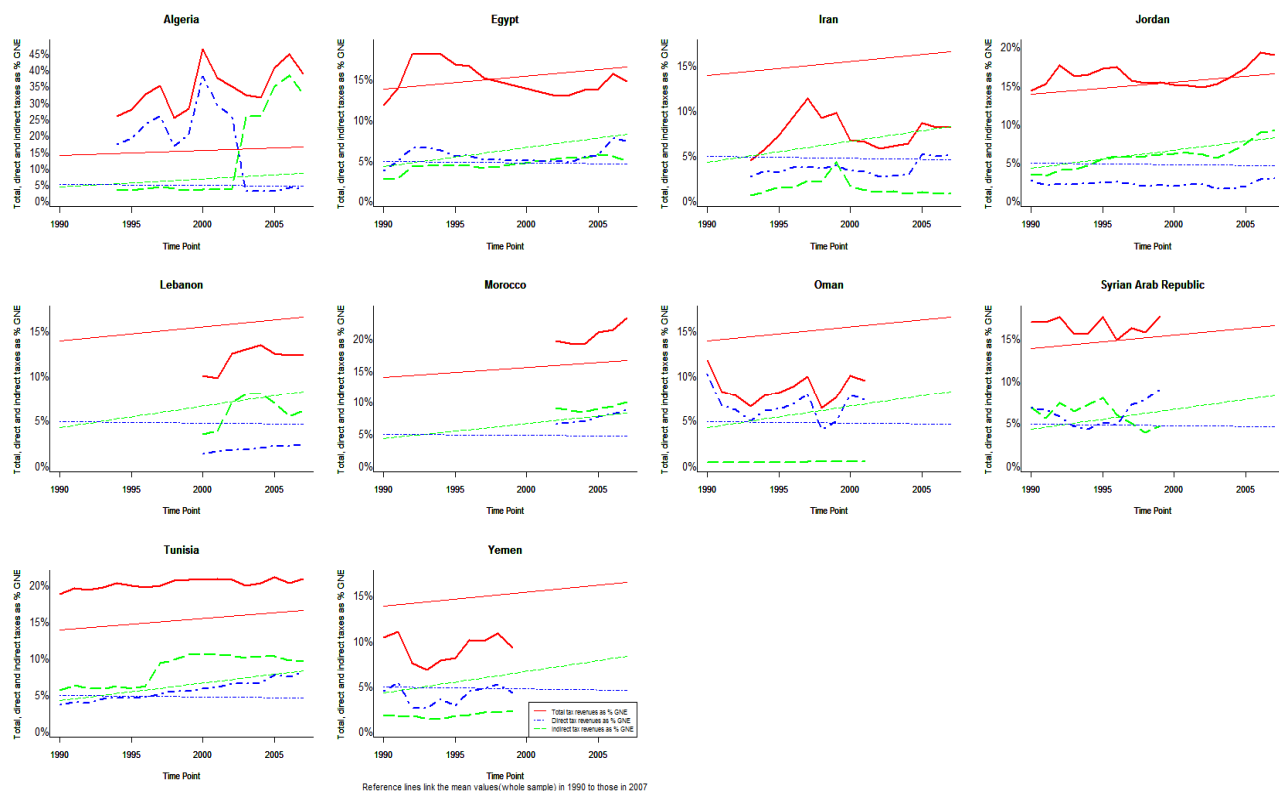
Sub-Saharan Africa



Latin America and Caribbean



North Africa and Middle East



Appendix 5 – Recommendations Discussion Group 3

The third discussion group of the DRPN seminar was focused on “Development Assistance & Tax Revenues. Development aid is frequently considered as an important engine for economic growth. Recently, it has been acknowledged that long-term growth should also be based on domestic tax-raising. Therefore, attention is given to the relationship between aid and taxation. The CIDIN Study Development Assistance & Tax Revenues provides robust evidence for the positive and significant effect of development aid on domestic tax revenues, while the effect becomes substantially stronger 2–3 years after aid disbursements. The tax effect of aid is stronger for bilateral aid (compared to multilateral aid), for grants (compared to loans) and for middle income countries. Differences between direct and indirect taxation could not be confirmed. During the group discussion the following points were raised:

1. The relation and interaction between 'Aid architecture' and 'Fiscal architecture' deserve much more attention. These aspects have been discussed separately for too long.
2. Aid turns out to be rather effective to increase local taxation, but does not have any or very little influence on the local tax structure (direct vs. indirect). There is no evidence for a 'crowding out' effect, in which aid substitutes for tax.
3. Long term concessionary bilateral aid has a large impact on the local contribution to government spending. Multilateral aid and loans play a much more restricted role. Apparently, bilateral aid is more coherent over time (better predictability) and the commitments made are better enforceable.
4. General budget support (since the end of the 1990s) did incite developing countries to pay more attention to the local tax contribution to the financing of government spending.
5. The reinforcement of the local tax-raising capacity primarily calls for better democratic relations. Good experiences in countries such as Lesotho, Ghana and Rwanda indicate that civilians first need to consider the civil administration accountable, before tax payments will increase.
6. In the Least Developed Countries specific development cooperation for the advancement of poverty reduction continues to be the central goal.
7. Tension exists between the emphasis laid on the increase of the effectiveness of tax raising (with focus on indirect taxes) and the objective to come to a just distribution of the tax incidence between rich and poor (with focus on direct taxes).
8. Development cooperation projects that are focused on population and property registration should have the explicit goal to lay the foundation of a fairer national tax system.
9. It is unknown whether countries that receive a larger share of the development aid through NGO channels score better or worse with respect to their national tax culture. However, it is desirable to revise the tax exemption of NGOs in order to prevent disloyal competition. In addition, NGOs also benefit from an improved public infrastructure.