

Taxing Rights: How developing countries can finance their own development

MDG Lecture Series, Trinity College Dublin, Thursday 1st April 2010

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[Thank Michéal and Trinity for the Invitation, and Hannah for assistance with travel arrangements]

Introduction [importance of the issue for development]

In September of this year, the world's governments will meet in New York to review the commitments they made to address extreme poverty. All the signs are the outcomes of this conference will not be positive. We are a long way away from meeting all of the Millennium Development Goals.

Along side that, the challenges of climate change, population growth and international terrorism would suggest an increasingly challenging environment for those seeking to alleviate or indeed *eradicate* poverty.

On top of this, the financial crisis has hit developing countries hard. The World Bank estimates that, in the next 5 years, between 1 million and 2 million children will die before their fifth birthday as a direct result of the financial crisis. To put that into context there are __ million children under 5 in Ireland.

Aid has played an important role in alleviating poverty and delivering much progress to date. But we need a much more ambitious plan. One

which addresses not only the symptoms, but also the *root causes* of poverty.

This is where tax comes in.

Taxing Rights

Tax provides a sustainable source of revenue for a government to invest in healthcare, education and the kinds of infrastructure and legal stability that will enable a country to attract investment.

Between 1998 and 2006, Rwanda's revenue take increased threefold. As a result, spending on water and sanitation and health increased fivefold, while the education budget doubled.

Yet it is not just about money. Tax can cement the accountable relationship between state and citizen. Again and again we hear of governments in developing countries being completely disconnected from their people.

Of people like Teodorin Obiang, son of the dictator of Equatorial Guinea, who bought a \$35 million mansion, a Gulfstream jet and a fleet of fast cars while the people of his country lived in poverty. This kind of disconnection is worst when governments are dependent on natural resource revenues.

And when governments depend on aid, they tend to act in the interests of the donor.

But when states are dependent on their citizens for revenue, the evidence suggests that they are more likely to be accountable to their citizens.

In fact, taxation has been a key part of the democratic process throughout history. The Boston Tea Party's campaign slogan 'No Taxation Without Representation' embodies what can be referred to as the '*fiscal social contract*'....

Citizen pay tax, contributing to the 'common pot' and in return can demand that the money is spent in their interest.

[SLIDE] In the words of Charles Abugre, Deputy Director of UN Millennium Campaign:

'Tax is a good thing! Without tax you cannot build democracy, without tax you cannot resolve poverty – you can't provide health, education and water.'

Challenges

Yet revenue authorities face huge problems in developing countries. In low-income countries, much of the population operate in the informal sector outside of the official channels of revenue collection.

And you might ask, why do we want to tax the poor? – but no matter how little they contribute, it is important that they do pay tax and therefore buy their right to democratic representation.

In February of this year, I travelled to Sierra Leone, where civil society was outraged over a new tax being implemented by the government. This goods and services tax has increased the cost of living dramatically.

The fact that the people I met were paying the taxes and were also speaking out against an unjust tax burden represents the democratic process in action.

At that meeting civil society were calling government representatives to account – demanding better roads, healthcare provision and jobs in return for their tax payments.

To add to the problem of the information sector, revenue authorities in developing countries are hugely under-resourced. On the same trip, I met with Sierra Leone's assistant tax commissioner. He told me about how they struggle to get staff with the right expertise.

He told me with great pride that for a country of 6 million people, they had 600 tax officials. That's one tax official for every ten thousand people. In contrast, Ireland's revenue commissioners have around 7000 staff for a population of 4.5 million. A ratio of one tax official to every 640 people.

You can see how these factors alone make raising revenue difficult. But the odds are stacked against developing countries in far more fundamental ways. To explore how the taxing rights of developing countries are undermined we need to take a look at the global economy.

How Taxing Rights are undermined

When it comes to taxation in the international sphere, developing countries are subject to disadvantage in three inter-related areas: They suffer from asymmetries of power, asymmetries of capacity, and asymmetries of information. I will look at each in turn.

Asymmetries of power

Under increasing pressure from the World Bank and others, developing countries have sought to offer tax breaks for multinational companies to attract them to exploit their natural resources. Mining stability contracts are often negotiated on a secretive basis, and signed for a 25 year term, and prevent the parliament imposing changes. The terms of these contracts, have, in some cases limited the ability of countries to benefit from their resource wealth, to benefit from price booms, such as the copper commodity boom in 2008, and limit the ability of countries to expand their industries to include the processing of raw commodities in the future.

Take Tanzania for example, a country that is rich in gold reserves, but yet is ranked 151 out of 182 on the Human Development Index.

In the past 10 years, Christian Aid estimates that it has lost out on four hundred million dollars as a result of low royalty rates and tax losses. To put this in perspective, in 2010 all of Tanzania's aid amounted to four hundred and seventy million dollars.

The first thing to note here is that in many cases these tax breaks are unnecessary. UNCTAD and others have demonstrated that in the case of the extractive industries, the companies are interested in the minerals they

are extracting, whether or not they get tax breaks. Secondly, given the secretive nature of these agreements, cases of bribery and corruption are rife.

However, the most stark thing is the asymmetry of power between those negotiating the contracts. An adviser to the President of Sierra Leone told me that in the past, officials who had not even completed a school education were negotiating contracts worth billions of dollars with the best lawyers in the world. Those lawyers are employed to do one thing – get the best deal for the company. And when governments of countries like Sierra Leone have not even completed audits on how much of the mineral is in the ground, they are in a position of weakness. This asymmetry of power enables unscrupulous businesses to take advantage.

Asymmetries of capacity – transfer pricing

Asymmetries of capacity are most stark in the area of transfer pricing. This is the system by which multinational companies operating in a number of countries, allocate profits and therefore taxing rights between those countries.

Multinational Companies play an increasingly important role in global trade. It is estimated that between 60% and 70% of international trade is intra-group trade – that is, it occurs within the same company.

When multinationals buy and sell goods and services with related subsidiaries, they are supposed to trade at market values. This is known as the arm's length price. The problem is that many of the goods and services traded, by definition, have no market value. Intellectual property rights, brands, or services, for example, are often unique to the company.

This leads to significant complexity for tax authorities trying to monitor the issue, and allows scope for companies to shift profits from where tax rates are high to where they are lower. As a result the company worldwide has a lower effective tax rate – but the country where the wealth was created, loses out.

A former tax manager at KPMG in Mozambique told a colleague of mine:

[SLIDE]

“Mozambique is losing a lot of money in tax to international operations. There is no adequate legislation governing transfer pricing...when there is a request for transfer pricing placed with the tax authorities, nobody knows how to deal with the request”

However, there is also an asymmetry between the tax authorities of rich countries and those of poorer countries.

The head of tax policy at a large multinational recently told me that companies are now allocating more profit and paying more tax to the most aggressive tax authorities to avoid expensive and difficult legal disputes over transfer pricing. As a result, fewer profits are allocated to developing countries.

Christian Aid estimates that as a result of this price and similar price fixing between unrelated companies, developing countries lose \$160bn dollars a year. This is greater than the global aid budget.

Rather than the commonly held wisdom that resources tend to flow from North to South, in reality, the world's poorest countries are subsidising us.

Asymmetries of information – financial secrecy

The third asymmetry relates to access to information.

When it comes to company accounts, multinationals are required only to file consolidated accounts. This means that you can see a global picture of the companies activities, but not it's operations in each country. As a result, it is all the more easy for companies to shift profits from one country to another.

Well resourced tax authorities in rich countries can demand this disaggregated information, but because of their lack of economic and political power, this privilege is not open to most developing countries.

Secondly, some states provide financial secrecy in an effort to attract financial services. We usually call these offshore financial centres or tax havens. It is not the low tax rate which is the problem. It is the unwillingness to exchange information with other states, which makes them so toxic.

Evidence from an excellent paper written by Phillip Lane from the Economics Department here at trinity shows that offshore financial centres played a significant role in the financial crisis. He shows that the Cayman Islands was the largest foreign holder of US Sub-Prime

Mortgage Debt - the toxic loans which precipitated the financial crisis in the first place.

However, the financial secrecy that allowed this to happen, also undermines the tax base of developing countries as companies and individuals can hide assets from the eyes of the tax man.

The conventional wisdom is that tax havens are a problem for richer nations and not for developing countries. But evidence from a recent paper by Alex Cobham, prepared for the World Bank suggests that overall, developing countries are, if anything, more exposed to tax havens as a share of their total economic linkages.

[SLIDE] [Talk about table.]

For example, in 2008, Cobham notes that half of Zambia's trade was conducted with Switzerland – a country renowned for its financial secrecy.

[SLIDE] If we look at Kenya almost half of the portfolio investment comes from Mauritius with the second largest proportion coming from Luxembourg.

It is this trade with tax havens that allows companies and individuals to hide financial activities and assets from the taxman, meaning that the country and ultimately the people lose out on tax revenue.

Solutions?

So what needs to happen to address these problems?

[SLIDE] Well the first thing to note is that we have seen significant progress over the past year in recognition of the importance of taxation and development. [SLIDE] In April 2009, the G20 committed to “develop...proposals, by the end of 2009, to make it easier for developing countries to secure the benefits of a new cooperative tax environment.”

Just this week, the European Parliament passed a resolution which noted its great concern about the:

“the negative impact of tax havens [which] may be an insurmountable hindrance to economic development in poor countries, encroaching on the sovereignty of other countries”

Aid donors too are starting to take this seriously. The OECD recently brought together its development and tax departments for the first time to discuss issues of tax and development, and the European Commission, in its preparation for the MDG summit is drafting a communication on tax and development.

We need to think carefully about just aid to build the capacity of revenue authorities in developing countries. This is a long term strategic investment.

To strengthen accountability, we need to build the capacity of civil society to understand their tax systems and advocate for more pro poor taxation.

But crucially, we need transparency at the international level.

An international accounting standard for which requires companies to report on a country by country basis, would allow tax authorities and civil society to hold companies to account for the tax they pay.

And if tax haven secrecy is a problem, then information sharing is the solution. The G20 has made some progress on forcing tax havens to sign information sharing agreements. But a haven only has to sign 12 of these agreements to get off the hook.

To date virtually none of these agreements have been signed with developing countries. This further compounds the information asymmetry which developing countries suffer.

A global agreement on the automatic exchange of tax information would mean that individuals and companies thinking of hiding assets offshore to avoid tax would know that their home country would know about it.
[pause]

On Monday of this week, I met with the Director of Economic Policy in Kenya's ministry of finance in Nairobi. As we discussed the importance and the challenges of raising revenue in Africa he said this:

"We are sitting on a potential platform that can change this continent."

He agreed that these are the structural changes which need to happen to ensure that in the long term, developing countries can raise their own revenue for development while building the accountability of governments to their citizens.

If poverty is a lack of social, economic and political power, then addressing poverty is putting that power back in the hands of the people. Tax is the way it can be done.