TAX JUSTICE FOCUS

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TAX AND DEVELOPMENT

Why tax is important for development

No country has succeeded in developing a well functioning market based economy without a broad based tax system and tax plays a key role in promoting democracy by making governments accountable to their citizens. Lack of dependence on citizens for tax revenues is a major cause of weak, unresponsive governance in many poor countries, especially those which are heavily dependent on aid.[1]

AID and TAX are both three letter words, but that's where the similarities stop. Tax encourages governments to be accountable to their citizens; aid to donors; tax can provide a predictable long-term source of revenue which is within the control of the government, aid is less predictable; tax enable governments to use the money where it is most needed, aid is often tied to specific projects.

Aid and tax should be seen as complementary: poor countries will continue to need aid as they set about building up their tax capacity. In fact, aid can play a vital role in helping developing countries build up their tax capacity, decreasing in the long term their overall reliance on aid.

The Monterrey Consensus recognised the key role of taxation in mobilising domestic resources (90% of domestic revenue is usually derived from tax with 10% coming from non-tax sources, e.g. fees and charges). This was confirmed at the recent UN Doha meeting where tax issues ran throughout the discussions.

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Yet as can be seen from Figure 1, the ratio of tax to GDP in lower income countries is, on average, about half of that in OECD countries. Nobody is suggesting that Sudan should move to the tax levels found in Sweden, but clearly there is fiscal space for many low income countries to increase their tax take through more effective tax systems.

1 See "Taxation and Governance", OECD, February 2008.

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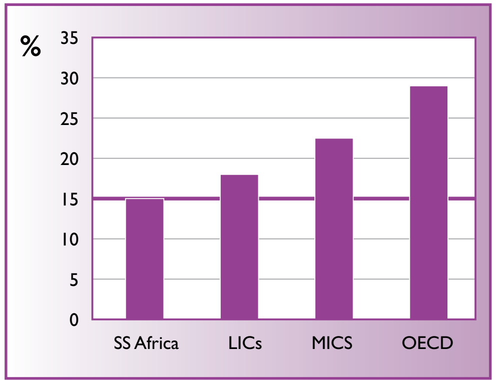
Figure 1. Tax to GDP ratio (2005)



What are the Constraints faced by Developing Countries in raising their Tax Take?

A typical developing country faces multiple constraints in improving its tax capacity: cultural attitudes towards government; weak tax administrations; narrow revenue tax base; competitive pressures from other countries; corruption; capital flight; aggressive tax planning and many more. I will focus on what I see as the three major constraints:

i) ***Heavy reliance on cross-border tariffs***: A typical African country relies on tariffs for more than half of its revenue. Yet this source of funding is under pressure from trade liberalisation promoted by the WTO and regional blocks (e.g. SADC). As countries join these initiatives so they are required to reduce their tariffs. Trade liberalisation is in itself desirable, but it comes at a price for a low income country since tariffs are far easier to administer than alternative sources of revenue (e.g. VAT). Consequently, low income countries are facing a major challenge just to maintain their current revenue base.

ii) ***Weak tax administrations***: Many, although not all, low income countries have tax administrations which are corrupt, with poorly trained and underpaid officials; antiquated administrative structures, often still based upon the old colonial model (e.g. separate departments to deal with income and consumption taxes); weak risk management and poorly articulated strategic goals. Yet a tax system is only as good as its tax administration and without a dramatic improvement in these administrations, it is unlikely that developing countries will meet the Monterrey commitments.

iii) ***Outflow of funds to tax havens***: Tax havens have been referred to as "sunny places for shady people". Whilst many tax havens are sunny places, today they can be found throughout the globe. OECD defines a tax haven as a jurisdiction which has no or nominal taxation and lacks transparency, effective exchange of information and "real activities". Many citizens of developing (and developed) countries now have easy access to tax havens and the result is that these countries are losing to tax havens almost three times what they get from developed countries in aid. If taxes on this income were collected billions of dollars would become available to finance development.

What Needs to be Done?

i) ***Phase-in trade liberalisation***: Before removing tariffs on cross-border trade, governments need to ensure that alternative sources of revenue are already in place. This suggests that as the process of liberalisation continues, there needs to be a phase-in period since all the sources of revenue which could replace tariffs – personal or corporate incomes taxes; sales or VAT; taxes on moveable or immoveable property – are far more complex to administer than tariffs.

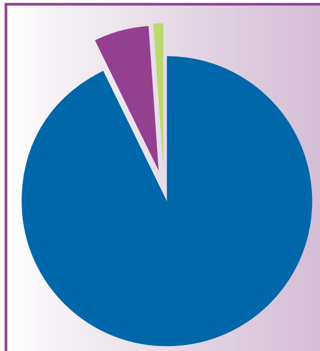
ii) ***Build up the capacity of the tax administration***: In most developing countries this will require creating an independent revenue service with well paid officials, free from corruption and political interference. The Commissioner must be a strong visionary individual, and be able to see tax in the broader perspective of developing a market based democracy. The old colonial divisions between direct and indirect taxes need to be replaced with an integrated administration arranged on functional lines. Risk management needs to replace a system based upon trying to control and audit the vast majority of taxpayers. A balance between enforcement and taxpayer service must be achieved with the revenue service being seen as a "friend" rather than "foe" of business. New technologies will have a role to play in modernising the tax administration but can never, by themselves, provide a substitute for a well designed administration.

iii) ***Broaden the tax base***: Developing countries need to explore how the tax base can be broadened and how people in the informal sector can be brought within the tax base. This may require reviewing the taxation of land and buildings; exploring new ways to tax households; re-examining the tax treatment of small-medium size enterprises; introducing simple environmental taxes. It may also require moving towards a heavier reliance on fees and charges.

iv) ***Reduce the outflow of funds to tax havens:*** Over the last 10 years OECD countries have established high standards of transparency and exchange of information in tax matters which have achieved a global endorsement from the G8, G20 and United Nations Committee on Taxation. Regular assessments are undertaken of how far on and offshore financial centres are meeting these standards.[2] Implementation of these standards is progressing. Twenty-six of the 30 OECD countries already meet the standards as do the vast majority of non-OECD countries. Of the 40 plus tax havens that the OECD identified in 2000, nine (The Netherlands Antilles, Aruba, Bermuda, British Virgin Islands, Cyprus, Isle of Man, Guernsey, Jersey and Malta) are actively implementing the standards either by means of Tax Information Exchange Agreements (TIEAs) or tax treaties and the international community needs to recognise this progress. Hong Kong is reviewing its position on exchange of information. Nevertheless, much remains to be achieved. There are still three jurisdictions on the OECD list of unco-operative tax havens

2 The latest assessment of 84 financial centres was issued in September 2008 under the title Towards a Level Playing Field.

Figure 2. Tax related assistance as a proportion of Official Development Assistance (ODA) in 2006



(Andorra, Liechtenstein and Monaco); some jurisdictions which made commitments to the standards in 2000 are refusing to implement them (e.g. Panama). Singapore has refused to even endorse the standards.

The UBS and Liechtenstein scandals have refocused political attention on the role of excessively strict bank secrecy and how this can be used as a barrier to effective exchange of information. The next 12–18 months will see a fresh impetus towards the implementation of the standards since the G8, G20 and a joint Franco-German initiative have all recently called for a rapid implementation of the standards and a reporting back in 2009.

Developing countries can directly benefit from this initiative. Once a financial centre establishes high standards of transparency these benefit all countries. Similarly a number of developing and middle income countries (e.g. China, India, and South Africa) are in the process of entering into negotiation of TIEAs. Developing countries can only continue to benefit from the move towards less political tolerance of countries that facilitate non-compliance with the tax laws.

What's the Future Role of International Institutions and NGO's?

NGO's have played an important role in linking tax havens and finance for development. They need to continue to build up political support for a truly global implementation of the international standards. They must, however, avoid endangering their case by unsupported claims of the amounts of tax revenues that are being lost by developing countries to tax havens.

The United Nations Committee needs to encourage all of its members to include in their tax treaties the new Article 26 of the UN Model Tax Convention (this is the article dealing with Exchange of Information) and to pursue its work on a Code of Conduct.

The OECD and its Member countries need to move away from a distinction between co-operative and unco-operative offshore financial centres based upon whether there is a commitment to the standards to one based upon whether the standards are being implemented. Also, there needs to be a renewed effort on the part of aid agencies to support projects in developing countries which are aimed at improving their tax capacity. As can be seen from Figure 2, in 2006 only 0.073% of aid went into the tax area yet as can be seen from the example of Rwanda (see Box 1), tax related aid can lead to a significant increase in revenue yields.

Box 1. Tax reform: The Governance Dimension in Rwanda

DFID's support to the Rwandan Revenue Authority (RRA) has resulted in a significant increase in domestic revenue (from 9% of GDP in 1998 to 14.7% in 2005). Costs of collection have also been reduced. This success is the result of strengthening internal organisational structures and processes and of building accountable relationships with external partners, such as central and local government, a growing tax profession and taxpayers themselves. The RRA now plays an important role in strengthening relationships between citizens and the state, helping to build a "social contract" based on trust and co-operation.

Source: Department for International Development (DfID), 2007

In this context the recent initiative of African and OECD Tax Commissioners to create an African Tax Administration Forum deserves strong support. This is an initiative designed by Africans, for Africa with bilateral and multilateral donors, including the African Development Bank and the OECD, playing a supportive role.[3]

The International Tax Dialogue – a grouping of the DFID, EU, IMF, Inter American Development Bank, World Bank and the OECD – can also play a key role in ensuring that the efforts of bilateral and multilateral donors are more co-ordinated and in providing benchmarks against which developing countries can measure the performance of their tax administrations. The ITD efforts in this respect could be reinforced if the UN and more national aid agencies were to join the ITD.

New efforts are required to develop an internationally accepted methodology to measure the size of the offshore sector and the amounts of revenue lost to tax havens. Ministries of Finance, Central banks and international organisations need to lead this work to give it creditability. Also, the focus must be on providing data which can lead to policy responses. From the perspective of a developing country it is more interesting to know how much revenue is lost to Singapore or Panama than what is the global loss of revenue to tax havens.

To conclude, Monterrey and Doha have raised the profile of tax in the finance for development debate. We need to maintain this political profile and to have all the actors – governments, international organisations, NGO's – pulling together, combining their efforts, so that we have a long-term co-ordinated approach to raising tax capacity in developing countries.

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The views expressed should not be taken to represent those of the OECD or its member countries.

3 See the Pretoria Communiqué (http://www.oecd.org/dataoecd/1/33/41227692.pdf)