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**The role of taxation in sustainable development: a shared responsibility for  
developing and developed countries**

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The concept of sustainable development is about ensuring that the costs of one generation's activities do not compromise the opportunities of future generations. It stresses the long term compatibility of the economic, social and environmental dimensions of human well-being<sup>1</sup>. There are tax aspects of various significances in these three dimensions, some of which are under the primary responsibility of developing countries, while some others highlight the responsibility of OECD countries and also of private investors.

The current debate often centres on specific fiscal remedies to address sustainable development issues. From the perspective of developing countries, such measures would typically include the use of targeted taxes or tax incentives to encourage / discourage specific behaviour that affect economic, environmental or social sustainability, such as the adoption of environmental taxes; or tax incentives to attract Foreign Direct Investment; or tax incentives for continuing education. From the perspective of OECD countries, there is also a recurrent debate concerning the possible creation of new taxes in wealthy countries to collect funds that would be allocated to development projects in less developed countries (e.g. the Tobin tax or more recently the Chirac initiative).

This paper is not addressing such specific measures. It is focusing on a more structural aspect – a fundamental one for economic sustainability, although it does not receive a lot of media attention: domestic tax systems and administrations in developing countries as well as the international framework in which they operate with their wealthy trade partners, should both create an environment that is favourable to investment and innovation and provide developing countries with the revenues needed to implement long term policies. In other words, a domestic or international tax system that encourages investment, but does not provide the government with the tax revenues needed to effectively implement policies in the fields of economic, social and environmental sustainability, can still be considered inefficient.

### **The structural role of taxation in economic sustainability**

The key challenge for OECD countries as well as developing countries is to establish a strong policy and institutional framework that will help developing countries to attract increased trade and investment and to ensure that these flows benefit their societies and promote sustainable forms of development. In tax terms, this means:

- (a) Providing a fiscal environment that is favourable to Foreign Direct Investment and international trade in developing countries,

- (b) At the international level, cooperation between developed and developing countries to ensure that developing countries get a fair allocation of tax base in relation to the Foreign Direct Investment they attract,
- (c) Helping developing countries to develop efficient and fair tax policies and tax collection mechanisms that allow their governments to effectively fund sustainable policy measures in the economic, social and environmental fields, and
- (d) At the international level and in particular in investors' home countries, involving civil society by encouraging taxpayers and in particular MNEs to behave in a responsible way when managing their taxes.

**(a) Providing in developing countries a fiscal environment that is favourable to Foreign Direct Investment and international trade in developing countries**

At domestic level, in developing countries, a stable tax system and an enabling tax environment are essential pre-conditions to attract FDI that is the engine of development. An enabling tax environment does not necessarily mean that the developing country should adopt a general low rate of tax. Similarly, while tax incentives may be considered to encourage investment, they can have harmful side effects and are in any case only side measures (in the same manner as tax incentives to encourage continuous education can be considered in some cases to support social policies but are never central to social sustainability).

The most important features for a tax system in terms of sustainability would be:

- transparency in administrative decisions;
- stability of tax rules / reasonable certainty for taxpayers; and
- availability of fair jurisdictional recourses.

Wealthy countries also have a role in this respect. At international level, a sufficient network of bilateral tax treaties is necessary to limit the risk of double taxation on FDI and international trade. Otherwise, tax barriers may seriously impede the development of trade and investment and also affect the level of tax compliance of Multinational Enterprises (MNEs) in countries where investment is located. For example if a MNE that invests in a developing country (the "host country") obtains a tax credit in its country of origin (the "home country") for taxes paid in the host country under an applicable treaty, it is more likely to be willing to comply with tax rules in this host country than in the absence of a tax treaty where any taxes paid in host country would lead to double taxation.

The responsibility of developing countries to develop an enabling tax environment is obvious. However, wealthy countries and international organisations such as the OECD also have a role to play. Beside the provision of technical assistance, it is by entering into bilateral or multilateral tax agreements with developing countries that wealthy countries can help remove tax barriers to investment and induce compliance by investors.

**(b) Developing international cooperation to ensure that developing countries get a fair allocation of tax base in relation with Foreign Direct Investment they attract**

Attracting FDI and international trade into developing countries is not the end of the game. There is no guarantee that FDI and international trade will translate into tax revenues for the countries attracting them. A pre-requisite is that international tax mechanisms must be in place to ensure a fair allocation of tax base among home and host countries, among developed and developing countries. The basic mechanism in this respect is the network of tax treaties entered into on a bilateral basis to attribute taxing rights to home and host countries.

The arm's length principle of Article 9 of the OECD Model Tax Convention and the OECD Transfer Pricing Guidelines provide for principles and guidance that are of particular importance to ensure a fair allocation of tax base between home and host countries with respect to transactions undertaken by associated enterprises within a single Multinational Enterprise Group (MNEs). The significance of transfer pricing is clear when one realises that MNEs probably account for 60% of international trade and intra-group flows for half of MNEs' transactions. However, because intra-group transactions are not subject to the same market forces as transactions between unrelated parties operating on the free market, there is a huge potential for profit shifting via under or over pricing of intra-group transactions.

In other words, unless sufficient attention is given to transfer pricing issues, it is possible that in practice a developing country will derive little or no revenues from the FDI attracted to its territory.

The arm's length principle of Article 9 of the OECD Model Tax Convention stipulates that the pricing of transactions between associated enterprises should be the same as if the two companies involved were independents and the OECD Transfer Pricing Guidelines provide guidance as to how to apply the arm's length principle in practice. Implementing the arm's length principle in their legislation and developing relevant practices are essential for developing countries to protect their tax bases. It is also essential that these countries take measures to limit the risks of double taxation of MNEs on their intra-group cross-border transactions.

However, a reasonable application of the arm's length principle is a shared responsibility between home and host countries, developed and developing countries, that at the end benefits both administrations involved as well as investors and contribute to the wider objective of policy coherence.

**(c) Helping developing countries to develop efficient and fair tax policies and tax collection mechanisms that allow their governments to effectively fund sustainable policy measures in the economic, social and environmental fields.**

Responding to the challenge of sustainable development requires the institutional, technical and financial capacity to assess the economic, environmental and social implications of development strategies and to formulate and implement appropriate policy responses. Effective, well-functioning tax systems and administrations are an essential foundation for financing sustainable development. Malfunctioning tax structures and tax collection systems and administrations inevitably limit the ability of developing countries to effectively implement policy measures decided to meet sustainable development goals and may also make them permanently dependent on foreign aid.

There is a wide variety of issues involved, including the development of effective compliance strategies and collection mechanisms and fighting bribery.

While the responsibility to develop efficient and fair tax structures and collection mechanisms is primarily on the developing countries themselves, there is also a role for wealthy countries and international organisations to encourage sound tax practices by their investors. The conclusion of bilateral Exchange of Information Agreements can be one of the tools. On a wider basis, the OECD has developed specific instruments such as the “Convention on Combating Bribery of Foreign Public Officials in International Business Transactions”, and the “Guidelines for Multinational Enterprises” (the CIME Guidelines) that encourage corporate responsibility, including in the field of taxation<sup>2</sup>.

**(d) Involving civil society: Encouraging taxpayers and in particular MNEs to behave in a responsible way when managing their taxes**

Taxpayers, and in particular MNEs, are stakeholders in sustainable development policies, including in the taxation area. Responsible tax behaviours should be actively encouraged.

It is a striking fact that while the awareness of the importance of corporate responsibility and citizenship is rising (many major MNEs now have a sustainable development agenda), little attention is paid to the importance of responsible tax management. There is wide scope for improvement in this area.

In practice, two types of measures can be taken to encourage responsible tax behaviour by MNEs, using either the “carrot” or “stick” approach.

First, MNEs can be induced to improve their tax behaviour if tax administrations in the countries where they invest, and in particular developing countries, deal more effectively with cases of non compliance. One example would be where transfer pricing audits become more frequent and efficient. This goes with the efforts to improve local tax administration efficiency and international exchanges of information.

Second, MNEs can be encouraged to improve their fiscal behaviour if they see a positive effect in terms of image. Keeping in mind that all recent financial scandals have had a tax dimension, it is possible that shareholders of listed companies would in the future be

willing to ensure that companies in which they invest do not have an overly aggressive tax behaviour – this would be sound corporate governance. Raising awareness among shareholders and managers on topics such as the difference between tax evasion and legitimate tax optimisation, bribery issues, aggressive use of tax havens or of non-arm's length transfer pricing schemes is an important task in the longer term.

More generally, it is important to raise awareness of private sector decision makers of the significance of the fiscal dimension in sustainable development.

Because of the significance of investment flows to developing countries that originate from wealthy countries, the OECD and its Member countries have a key role to play in encouraging responsible tax behaviour of their MNEs.

Of course, there may be many reasons why MNEs fail to comply, for instance; an insufficient treaty network between a particular developing country and major trading partners; existence of arbitrary unilateral tax rulings; lack of transparency; relative inefficiency of tax audits in some developing countries, etc and it would be naive to count on a significant change in MNEs' attitudes without sufficient efforts being made by all the governments concerned.

## **Conclusion**

The role of taxation in sustainable development covers many aspects. The most commonly discussed ones are the use of taxes or tax incentives designed to encourage or discourage specific behaviour that affect economic, environmental or social sustainability.

However, there is a more fundamental, although less often advocated, dimension to this issue. Taxation is essential to sustainable development in that it provides governments with the necessary finance to effectively implement development policies. Objectives in terms of improving infrastructures, education, health, or environmental protection, cannot be achieved at no cost. There is a joint responsibility for developing economies, wealthy countries, investors and international organisations to promote fair and efficient tax systems, administrations and attitudes that will ensure each country derives the fruits of its own economic growth. This contributes to the wider objective of policy coherence.

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<sup>1</sup> See : OECD 2001, "Sustainable Development : Critical Issues"

<sup>2</sup> The CIME Guidelines state "*It is important that enterprises contribute to the public finances of host countries by making timely payment of their tax liabilities. In particular, enterprises should comply with the tax laws and regulations in all countries in which they operate and should exert every effort to act in accordance with both the letter and spirit of those laws and regulations. This would include such measures as providing to the relevant authorities the information necessary for the correct determination of taxes to be assessed in connection with their operations and conforming transfer pricing practices to the arm's length principle.*"