Response by Eurodad to the *Consultation on Economic "Spillovers" in International Taxation*

Brussels, March 31 2014

Introduction

Eurodad acknowledges the IMF's initiative to assess the spillover effects in international taxation, as well as the opportunity to send input. This contribution by Eurodad responds to selected questions listed in the call for consultation, and additional areas we deem important.

A distorted picture

When assessing the impacts of today's international tax system on foreign direct investment, one must keep in mind that a large part of the so called 'investments' we see in the data are in fact symptoms of widespread rerouting of financial flows through tax havens with the aim of avoiding or evading taxation.
For example, according to UNCTAD's World Investment Report the British Virgin Islands was, in 2012, the fifth largest recipient of foreign direct investment and the tenth largest investor in the world.

The assessments of the impacts of the international tax system are further hampered by the lack of financial transparency, which among other things prevents us from getting the full picture of where the multinational corporations are located, where their economic activities take place, what profits they are making, and what taxes they are paying. Introduction of public country-by-country reporting for multinational corporations would provide the data necessary to ensure a fully informed debate about the consequences of the current international tax system.

Bilateral double-taxation treaties and treaty shopping

The harmful impacts of bilateral double taxation treaties on developing countries have been an issue of international attention for many years and are well documented.
One of the latest examples is the study '*Swiss Double Taxation Agreements: Current Policy and Relevance for Development*', conducted by researchers from the University of Bern[1], which among other things concludes that:

'*In order to create more favourable conditions for foreign investment, Switzerland is pursuing, together with other OECD countries, a unilateral strategy of committing developing countries to low withholding tax rates. It fails to take due account of the fact that sustainable foreign investment depends on a sustainable tax system based on a good balance between excessively high and low rates. Lastly, a fair division of tax revenues from multinational actors requires a fair division of tax claims between source and residence countries. In this context it is important to determine when a permanent establishment is created and how the tax rights are allocated. Swiss [double taxation agreements] with developing countries show a mixed picture. They are quite evidently the result of bargaining between stronger and weaker partners and tend to contain provisions that are more favourable to Switzerland'.*

Another recent study[2], which analyzes the effects of Dutch corporate tax policy on developing countries, concludes that:

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[1] Elisabeth Bürgi Bonanomi and Sathi Mayer-Nandi, University of Bern, October 2013. '*Swiss Double Taxation Agreements: Current Policy and Relevance for Development*'

'Treaty shopping is possible for many [foreign direct investment] routes where Dutch tax treaties specify relatively low withholding tax rates, (…) Furthermore, the Dutch tax system facilitates avoidance of withholding tax, (…) Various studies estimate that these effects lead to foregone dividend and interest withholding tax revenues in developing countries in the range €150-550 million per year'.
As regards the importance of bilateral tax treaties to the attraction of international capital, the same study highlights that:
'*[T]he tax treaties between the Netherlands and the Philippines, Bangladesh, Ghana, Uganda, and Zambia may not have had significant effect on the volume of regular [foreign direct investment] from the Netherlands in these countries. Although it is possible that Dutch tax treaties with other developing countries have had a positive volume effect, evidence of such effects is currently not available.'*

Although anti-abuse clauses can, if designed correctly, reduce these negative impacts, the real long-term solution lies in the development of new multilateral agreements, including on automatic exchange of information for tax purposes among governments, as well as alternatives to the arm's length approach, as described below.

Harmful tax competition

When the OECD in 1998 released its report 'Harmful Tax Competition. An Emerging Global Issue', the concept of harmful tax competition was linked to the practice of countries '*to redirect capital and financial flows and the corresponding revenue from other jurisdictions by bidding aggressively for the tax base of other countries. Some have described this effect as "poaching" as the tax base "rightly" belongs to the other country*'.
Following numerous examples of multinational corporations and wealthy individuals paying extremely low (and in some cases no) taxes, there seems to be a growing recognition of the fact that rather than simply redistributing tax income among governments, tax competition undermines the total government revenue. The growing evidence showing that lowering of taxes is not an effective approach to attracting foreign direct investment[3] further underlines this conclusion, and it is thus becoming clear that tax competition is a game with very few winners and many losers.

Unitary taxation or the arm's length approach

Despite the fact that the so called 'arm's length approach' has proven unable to solve the problems of base erosion and profit shifting (BEPS), the OECD BEPS process seems focused on maintaining this approach as the cornerstone of taxation of multinational corporations. A number of the problems encountered when applying the arm's length approach, including the general administrative burden and specific challenges such as the identification of 'comparables' for transfer pricing purposes, are likely even more cumbersome for low-income countries than for developed countries.
Eurodad believes that formulary apportionment and unitary taxation must be explored as alternatives to the arm's length principle since these approaches have the potential to provide the more fundamental repair that the international tax system needs to overcome the problem of base erosion and profit shifting.
The introduction of formulary apportionment and unitary taxation entail a number of political issues, including in relation to the design of an apportionment formula. Therefore, it is vital that a new global approach to taxation is developed in a process where all countries, including low-income countries, are able to participate in decision making on an equal footing.

Impacts of non-inclusive international processes

The fact that so called 'global' standards for taxation are developed by forums such as the OECD and G20, which due to limitations in membership exclude the vast majority of the world's developing countries, and in particular the low-income countries, from their decision making processes, is likely to lead to a number of negative impacts on developed as well as developing countries.

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[2] Francis Wayzig, Utrecht University, November 2013. '*Evaluation issues in financing for development. Analysing effects of Dutch corporate tax policy on developing countries*'
[3] A recent example is Tidiane Kinda, IMF WP/14/15, 2014. '*The Quest for Non-Resource-Based FDI: Do Taxes Matter?*'

Firstly, there is a high risk that the products resulting from the OECD and G20 processes do not integrate the interests of the low-income countries, and do not take into account the realities of these countries. For example, the current G20 proposal for a new international standard on automatic exchange of information for tax purposes include requirements on 'reciprocity' of information sharing, which low-income countries are unlikely to be able to comply with due to capacity constraints. The de facto outcome of such a demand is likely to be that low-income countries will not be able to access the information they need for tax purposes. Keeping in mind that developing countries broadly speaking have an interest in international tax regulations that favour host countries, whereas most developed countries have an interest in international tax regulations that favour the home countries of investors and multinational corporations, there is also a more fundamental risk that international tax instruments developed by the G20 and the OECD will be to the disadvantage of the many developing countries that are not included in the decision making process.

Secondly, a 'group pressure effect' from the countries and institutions that have developed the 'global' standards can make it difficult for low-income countries to insist on application of different standards in bilateral and multilateral negotiations.

Thirdly, the existence of the OECD and G20 processes can limit the political will of member states to engage in a dialogue with countries that are not members of the OECD nor the G20. For example, when a proposal by the Group of 77 and China to upgrade the UN Tax Committee to an intergovernmental body was rejected by OECD member states, the OECD's work on tax matters and the risk of duplication was mentioned as a key reason. Therefore, consequence of the current international institutional setup is that most developing countries, and in particular the low-income countries, lack a global forum where they can engage in international cooperation on tax matters on an equal footing with other countries.

Fourthly, there is a clear risk that the continued lack of global cooperation in tax matters will lead to new harmful tax practices by governments and a continuation of the current 'race to the bottom'. This will not only impact the developing countries, but all countries and the citizens who depend on corporate taxation as a key source of the public revenues needed to ensure well-functioning public sectors.

The solution to this problem lies in the establishment of an intergovernmental process on tax matters under the auspices of an organization where all countries can participate on an equal footing, namely the United Nations. While the existing tax related processes under the OECD, G20, the UN Tax Committee, and other international institutions can provide valuable expertise and input to such an intergovernmental process, they cannot replace it.

Impacts of tax related IMF conditionality and tax advice

When assessing the spillovers in international taxation, Eurodad finds it very important that the IMF includes an assessment of the impacts of its own tax related loan conditionality and advice on developing countries. The widespread use of tax policy conditionality by the IMF has had a strong impact on the design of tax systems in developing countries, and still today the influence of the IMF shapes the tax system and the distribution of the tax burden within many societies. Some of the policies promoted by the IMF, such as introduction and increase value added tax, have the potential to undermine development by imposing a higher tax burden on the poorest, measured in relation to their total amount of available resources.

Eurodad finds it important to ensure that tax policies contribute to development and poverty eradication strategies. The IMF should reviews its conditionality and tax advice procedures to avoid promoting tax policies and practices that undermine development and poverty eradication. Capacity development in the area of tax and wider public financial management should be fully demand-driven.

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