EDITED BY KRISHEN MEHTA,
ESTHER SHUBERT & ERIKA DAYLE SIU

TAX JUSTICE AND GLOBAL INEQUALITY

Practical Solutions to Protect Developing Country Revenues

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TAX JUSTICE AND GLOBAL INEQUALITY

PRACTICAL SOLUTIONS TO PROTECT DEVELOPING COUNTRY REVENUES

Edited by Krishen Mehta, Esther Shubert, and Erika Dayle Siu

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This book is dedicated to policy makers and tax administrators in developing countries who face the daily battle of protecting their tax revenues. This protection is especially important in the post-pandemic world when resources for developing countries become all the more critical.

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Krishen Mehta, Esther Shubert, and Erika Dayle Siu
Editors

PRACTICAL SOLUTIONS TO PROTECT DEVELOPING COUNTRY TAX REVENUES

Krishen Mehta, Esther Shubert, and Erika Dayle Siu

> Do now what nature demands of you. Get right to it if that is in your power. Don't await the perfection of Plato's Republic, but be satisfied with even the smallest step forward.
>
> – Marcus Aurelius, Meditations, 9.29

Taxation is nothing more than a mechanism to fund the 'social contract'. The global pandemic has made clear to the world the many inequities that exist currently in our social contract. The essays in this book offer practical tax policy solutions to support developing country priorities.

As Marcus Aurelius implies in his dictum, developing countries need not wait for others to articulate rules to ensure a fair distribution of the fruits of globalization. It is their obligation to do what is within their power to achieve fiscal justice and to protect their revenues. Within the bounds of international commerce, there are a number of policy options to ensure that the tax revenue that is rightfully theirs can be protected and harnessed.

For good or ill, tax has been the means by which we have funded our collective endeavors. Historically, it has been a great enabler. But now we face the reality that the international financial architecture as it has evolved over the past four or five decades has made the payment of tax by a number of major corporations *an increasingly optional* matter. How has that happened? About 60 percent of all global trade takes place within the subsidiaries of multinational companies, and about half of these subsidiaries are located in tax havens or other secrecy jurisdictions. The most recent estimates report that 45 percent of all multinational's profits are shifted to these jurisdictions from the countries where they are generated.

To address this reality, this book brings together a group of authors who present practical solutions to protect developing country tax revenues. The authors also present these solutions from varied vocational perspectives—those of tax auditors, academics, development actors, and human rights advocates—all with the aim of presenting practical policy solutions against the backdrop of why these tax revenues matter.

In that spirit, let this journey begin with a few questions.

What is the scale of the problem? How much tax loss are developing countries facing on an annual basis?

The International Monetary Fund has estimated that the annual tax loss from corporate tax avoidance in both developing and developed countries is about US$ 500 billion a year. And out of this amount, the share of the developing countries is about US$ 200 billion a year. This is the amount of tax revenue that the developing countries *could have retained each year* were it not for tax avoidance by multinational companies operating within their borders.

If we compare the annual tax loss by developing countries to the investment in the Marshall Plan to rebuild Europe after the Second World War, which was about US$ 100 billion in today's dollars, it means that the developing countries have been losing in tax revenue *every year* an amount equal to about twice the entire Marshall Plan investment.

These are resources that legally could have belonged to these countries rather than to the multinational corporations operating within their borders. That is why it is so urgent to address the fault lines in the global financial architecture before the situation becomes much worse.

What if we do nothing?

In Myanmar, 50 out of every 1,000 children that are born die before the age of five; in Norway the equivalent number is two. In Equatorial Guinea 342 women die in childbirth for every 100,000 births; in France, the equivalent number is eight. In Japan, 100 percent of the primary school age children are enrolled in school; in West and Central Africa, more than 25 percent of the children are not enrolled in any school at all.

There are many reasons for the current situation, and there is no doubt that poor management, lack of transparency in governance, and the role of local elites are all part of the problem. But the existence of limited resources to meet their needs is a crucial part of the problem too. Corruption, and the resultant competition for limited resources, is a natural outcome of the lack of resources.

If the countries concerned had access to the above resources, would they need any loans or aid? Would they not be able to build their own infrastructure, schools, roads, hospitals, and make investments for their future? Would their citizens be facing the difficult choice that they do now – which is that of migration to other countries, or facing a dismal future in their own land? Would they actually be having devastating civil wars, as we are seeing today in a number of these countries? Such wars and ethnic conflicts generally happen when resources are limited, and this gives rise to a number of groups that then compete for the control for these resources.

What are some of the future consequences of these tax losses?

There is the risk that a large number of the lower-income countries in the Global South, particularly in Africa, Latin America, and parts of Asia could face greater instability in the years to come as a result of these tax losses. This has implications not only for these countries and regions, but also for countries beyond, including in the Global North.

If the refugee migration from some of these countries thus far has already had negative implications for the Global North, then what will happen if the situation becomes much worse economically in the Global South in the years to come? Clearly, the shortfall of tax revenues will make it very difficult for these countries to invest for the future and provide hope for their citizens, especially the younger generations. If this situation is left unchecked, it could have major spillover effects on the Global North that could make the current refugee and migration crisis seem modest in comparison.

What then is the answer to the current situation?

Based on various estimates, it is believed that the resources needed to address the scourge of *extreme poverty* globally are about US$ 80 billion a year. As mentioned earlier, the IMF has shown that tax revenue of about US$ 200 billion a year may be lost by developing countries due to aggressive corporate tax avoidance. That means that if the current faults in the global financial architecture did not exist, the challenge of extreme poverty could very well be addressed. This extreme inequality is not caused by nature. It is the product of laws and the exercise of power. It is these laws that we need to address, if we are to achieve just and efficient fiscal systems. Thus, in order to understand the present, we must look to the past.

What is the historical background of the tax laws, and which have had the consequence of causing so much inequality?

An important question is why international tax laws continue to facilitate profit shifting, often from lower-income countries, and why such shifting remains insulated from successful challenge. To understand this, one should step back to the inception of corporate law in the last century. Modern corporation law is based on the premise that the shareholders of a corporation should not face personal liability for debts arising from the business that the corporation conducts. Over time, as a result of this premise, corporate law developed a strong presumption that a corporation's conduct is based on contracts, and that it is the corporation which is conducting the contractual activity and not the shareholders. This corporate veil and corresponding 'respect' under corporate law to the terms of contract began to extend over time not only to contracts with unrelated parties, but also to contractual arrangements among subsidiary corporations within the same ownership group, including how income is allocated among them. Historically, tax authorities and courts began to honor these arrangements as they had no way of evaluating independently how the income within each entity should be allocated. This became a pervasive pattern that was accepted over time.

The only ways to challenge the above arrangements were through the 'business purpose' doctrine and 'substance over form' arguments, which started to be included in tax statutes around the world under the 'general anti-avoidance rules'. Under this argument, courts have typically re-characterized the arrangement if the economic reality is materially different from the contractual form. However, this is typically done only when tax avoidance is the sole motivation. In general, the courts accepted the contractual form, following the oft-quoted opinion of Judge Learned Hand of the US Court of Appeals for the Second Circuit in *Gregory v. Helvering* (1935): 'Anyone may so arrange his affairs that his taxes shall be as low as possible . . . there is not even a patriotic duty to increase one's taxes.'

It is against this backdrop that the practice of tax avoidance has become embedded among multinational companies with aid from the professional service firms. Some of this 'planning' became quite aggressive over time, especially since transfer pricing rules are often subject to a wide range of interpretations. And, in the absence of a World Tax Authority similar to the World Trade Organization, it was unclear which jurisdictions had the right to challenge such a contractual arrangement. Combined with the high levels of legal resources required for such challenges, tax avoidance strategies began to unduly favor the larger multinationals and their home countries, rather than the developing countries.

Between the First and Second World Wars, the League of Nations tried to come up with a fractional apportionment method – similar to the apportionment system devised for taxing cross-border corporate profits among the US states. In this effort, the capital exporting nations held sway and made decisions that favored themselves rather than the developing countries that were largely still under colonial rule and thus had very little say in the final arrangement. After the Second World War, when global trade became more extensive, the arm's length 'contractual' model expanded in both scope and scale. Again, this was not challenged by the newly independent developing countries in light of their need for inbound investments as a way to facilitate growth, even though it allocated a relatively limited amount of taxable income to them.

There was a ray of hope in 1961 when President John F. Kennedy in a message to Congress urged action to end the deferral of US taxation of income by foreign companies that were part of US-owned multinational firms. Such action, if implemented, would have made it pointless to accumulate income in tax havens or low-tax countries, and also would have removed any motivation that the developing countries may have had to offer tax incentives since any income untaxed in those jurisdictions would immediately become income in the US. If enacted, the Kennedy proposal would have ended many of the tax planning strategies that were in vogue at the time and would have made possible a larger revenue base for the developing countries. Once again, corporate interests objected strongly to the proposal on the grounds that it put US companies at a comparative disadvantage to non-US companies. The final bill that was signed into law in 1962 was a much weaker version of the one that President Kennedy originally intended.

The process of base erosion and profit shifting under the arm's length principle continued unabated for the next five or six decades until the OECD's Base Erosion and Profit Shifting (BEPS) project that commenced in 2013. The global political environment had shifted after the 2008 financial crisis, and it generated calls for reform of the international tax laws to achieve better equity for all countries involved in global enterprises. Initially there were promising proposals for reform by the OECD in a number of key elements of the international tax laws. At that time, in 2013 and 2014, the discussion was limited largely within the OECD countries. But then, as implementation of the proposed solutions was being discussed it became clear that excluding the developing countries was no longer viable as they were also party to whatever was being decided. That gave rise to the 'Inclusive Framework' which enabled these countries to at least participate in the process, even if they did not have an equal footing in the dialogue.

As a result of the pressure of many multinational companies and their governments to dilute the effectiveness of OECD's BEPS proposals, the progress that was made by these proposals was relatively modest. But at least for the first time in recent history there was open discussion of the fault lines in the global tax architecture, and the need to do something about it. This was something that had never happened before.

In light of the above history, it is all the more urgent for the developing countries to move forward on initiatives that serve their interests. The time to wait is long past. And that is what makes the content of this book more relevant today than ever before.

Are there any steps that the Global South can take under the tax rules as they exist today, and which do not require major changes on a global scale?

Yes, there are areas where the Global South can take charge of its own tax destiny without relying on major changes in the current tax laws. The chapters in this book provide a number of examples of such steps.

There is also opportunity to learn from steps that some countries have taken successfully that may merit adoption in other developing countries. These also are outlined in the chapters that follow.

What are some of the practical solutions proposed by the authors who have contributed to this book?

Alexandra Readhead presents what resource-rich countries can learn from certain success stories in other countries in making the extraction of their natural resources a win for both sides. Tovony Randriamanalina then deals with the current transfer pricing system, and how it can be made to work more effectively for developing countries.

In the following two chapters, Annet Ogutto explores how international tax competition can lead to harmful tax practices and what can be done about it. Mustapha Ndajiwo then delves into the challenges faced by developing countries in the expanding area of taxing the digitalized economy, and what may be equitable approaches for taxation in this space.

The next two chapters also have significant bearing for developing countries. Victoria Lee examines the use of bilateral investment treaties and free trade agreements, and how the interests of developing countries can be better protected.

And Kerrie Sadiq takes us into an application of formulary apportionment as a possible solution to address multinational entity debt financing schemes. The opportunity for countries to pursue the formulary apportionment method for taxation as it applies to their jurisdiction is clear and evident and does not need any global agreement to come into effect.

Next, Jörg Alt and Charles Chilufya present an idea whose time has come – that of joint tax audits in the current environment of information exchange and country-by-country reporting to ensure that multinational corporations are paying their fair share of taxes in each jurisdiction. And Lauri Finér presents a good case study for tax avoidance in development finance, and how both countries involved can ensure development objectives in such an environment.

In the two chapters that follow, we have Erika Siu, Estelle Dauchy, Evan Blecher, and Frank Chaloupka explore how taxation can address the production and consumption of harmful goods, such as tobacco, alcohol, and sugary drinks to achieve better outcomes for health. And then Tatiano Falcão discusses environmental taxation and a multilateral carbon treaty as a pathway for the protection of our common future.

Finally, we look at the *human rights* dimension of tax justice. Nikki Reisch examines the close linkage between fiscal policy, inequality, and human rights, under the challenging paradigm of 'taxing for justice'. And then Monica Iyer looks at a more just international tax order that gives content to Article 28 of the Universal Declaration of Human Rights through the lens of the global tax system.

***

The global pandemic has already led to major increases in public spending and debt to address the need of health care and employment in both developed and developing countries. These costs will need to be paid for through tax revenues. This makes it all the more urgent that all countries receive in an equitable manner the tax revenues to which they are entitled. The solutions proposed herein are intended to do exactly that.

There is an ancient African word, *Ubuntu*, which means 'humanity to others' or 'I am who I am because of who we all are'. It is this humanity (or shared destiny) that needs to be our compass as we go forward. In doing so we need not act alone, but through cooperation with others. In the final analysis we are on this journey together.

1 | SECURING MINING, OIL, AND GAS REVENUES: LESSONS FROM SEVEN RESOURCE-RICH COUNTRIES

Alexandra Readhead[1]

Executive Summary

For many resource-rich developing countries, mineral resources present an unparalleled economic opportunity to increase government revenue through effective taxation of mining companies. Multinational tax avoidance, particularly transfer pricing manipulation, threatens this prospect. However, the conventional legal response – the arm's length principle – is difficult for developing country tax authorities to implement. They lack appropriate regulations, data on comparable independent transactions, the necessary administrative structures, and access to tax information from other jurisdictions.

One way to potentially overcome the difficulties of the arm's length principle, is to identify areas of transfer pricing risk along the extractive industry value chain, and develop context-relevant legal and institutional responses at the country level. This chapter will describe the alternative legal and institutional mechanisms that Zambia, Angola, South Africa, Indonesia, Guinea, and Sierra Leone have put in place to control the price of related-party sales, operational and capital expenditures, and the cost of intra-company debt, as well as to improve inter-agency coordination and institutional oversight in extractive industries. These rules may not perfectly adhere to global standards, but the trade-off from their application can be justified by the challenges developing countries experience implementing the arm's length principle, and the urgency of capturing revenues from non-renewable resources.

Introduction

For many developing countries, natural resources present a significant economic opportunity to increase government revenue through effective taxation of mining, oil, and gas companies.

The substantial funding needs of developing countries to provide basic public services make this critically important.[2] However, the challenge of ensuring that natural resource wealth contributes to government revenues – and prosperity and economic development moreover – is formidable.

A critical area of reform is to counter aggressive tax avoidance in the extractive industries. Tax avoidance is the use of legal methods to minimize the amount of income tax owed.[3] One of the principal instruments of tax avoidance is transfer pricing. The transfer price is the price of a transaction between two entities that are part of the same multinational corporation, and 'transfer pricing' is the process of setting it. The risk is that companies will manipulate the transfer price to make higher profits in lower-taxed jurisdictions and lower profits in higher-taxed ones, as a means of reducing their overall tax bill.

To address the risk of transfer pricing manipulation, many countries have put in place legal rules that require taxpayers to price transactions between related parties as if they were taking place between unrelated parties.[4] This 'arm's length principle' is at the core of most global standards on controlling transfer pricing, led by the Organization for Economic Cooperation and Development (OECD). If a related-party transaction does not conform to the arm's length principle, transfer pricing rules give governments the legal right to adjust the price in the reported profits of the company.[5] However, enforcement of the letter and the spirit of these rules depends on the administrative capacity of countries, and the political will of governments to actively enforce legislation and accurately set the adjusted price.

The difficulty of applying the arm's length principle for both developed and developing countries has led many stakeholders to consider the alternatives. Most recently, the OECD has proposed a 'new taxing right' that would not require a physical presence and would allocate profits by means of a formula.[6] Other proposals to overhaul the international tax system have included global formulary apportionment, which allocates a multinational corporation's total worldwide profit (or loss) across the jurisdictions in which it operates,[7] and a destination-based cash flow tax, which levies corporate income tax based on where goods end up (destination), rather than where they were produced. But, as this chapter will illustrate, none of these proposals are particularly suited to the extractive industries in developing countries.

Insofar as source-based taxation is likely to remain a major part of the resource tax landscape, the purpose of this chapter is to consider a targeted, incremental approach to tackling transfer pricing risks in the extractive sector in developing countries. The approach involves (1) identifying transfer pricing risks along the value chain, and (2) developing corresponding context-relevant legal and institutional responses at the country level. The appropriate legal solutions may not always perfectly adhere to global standards, but the trade-off can be justified by the challenges developing countries experience in implementing the arm's length principle, and the urgency of capturing revenues from non-renewable resources.

The chapter is divided into four sections:

First, the chapter provides a brief overview of the challenges to implementing transfer pricing rules in the mining sector specifically. These are broadly the same in oil and gas, although for oil-producing countries that use contractual systems the main challenge will be verifying cost claims, which have the potential to significantly erode government's share of production.

Second, the chapter highlights the transfer pricing risks along the extractive industry value chain.

Third, the chapter discusses global formulary apportionment and a destination-based cash flow tax, and why they may not be appropriate solutions to corporate tax avoidance in the extractive industries.

Fourth, the chapter presents examples of alternative legal and institutional mechanisms that Zambia, Angola, South Africa, Indonesia, Guinea, Tanzania, and Sierra Leone have put in place to control the price of related-party sales, operational and capital expenditures, and the cost of intercompany debt, as well as to improve inter-agency coordination, and institutional oversight in extractive industries. These examples represent innovative ways for resource-rich developing countries to reduce reliance on the arm's length principle, limit the opportunities for multinational extractive companies to avoid taxes, and increase government revenue collection from finite resource endowments.

1. Challenges to Implementing Transfer Pricing Rules in the Extractive Industries

The limitations of the arm's length principle have been discussed in detail.[8] These arguments will not be rehashed here. However, this section provides a brief overview of key challenges to implementing transfer pricing rules in the mining sector, which are drawn from this author's research in Guinea, Ghana, Sierra Leone, Tanzania, and Zambia.[9]

Box 1.1 Challenges to implementing transfer pricing rules in the mining sector in Africa

1 Introducing the concept of the arm's length principle into a country's income tax law is only a first step. Few countries have followed up with the regulations, or administrative guidance to clarify documentation requirements and methods for determining an acceptable transfer price based on the arm's length principle.

2 Laws or contracts that impose taxes on the mining sector do not always refer to generally applicable transfer pricing rules, leaving an ambiguity that could be exploited by, or lead to disputes with mining companies.

3 Assessing transfer pricing in a way that is consistent with the arm's length principle requires data on comparable independent transactions. Data specific to Africa's mining sector is extremely limited. Consequently, authorities have had to adjust comparable data for other regions, which may be expensive, complex, and yield unsatisfying results. For some transactions, for example, loans, and intellectual property, a market price may not exist.

4 The administrative structures of revenue authorities are rarely adapted to the efficient implementation of transfer pricing rules. A dedicated transfer pricing unit, the common approach recommended by international organizations, may not be appropriate in developing

countries with limited resources and a small number of multinational corporations.

5 Information and expertise exist in silos, preventing revenue authorities and the agencies responsible for mining sector regulation from developing a comprehensive picture of transfer pricing risks created by the mining industry and deciding which risks warrant an audit.

6 Revenue authorities have difficulty accessing taxpayer information from other jurisdictions. Consequently, they are unable to develop a full picture of a company's global operations for the purpose of investigating transfer pricing risks. At times, they are also lax at enforcing domestic reporting obligations leaving them ill-equipped to review complex transactions.

7 The political economy of many resource-rich countries undermines the implementation of transfer pricing rules. The privileged relationship between the mining industry and the political leadership can prevent the systematic implementation of transfer pricing rules, adequate funding of revenue authorities, and better governmental organization.

2. Transfer Pricing Risks along the Extractive Industry Value Chain

Generally, problematic related-party transactions in the extractive industries fall into two categories:

- *Undercharging* for mineral products exported and transferred to related parties, and
- *Overcharging* for a range of both routine and specialized goods and services.

In developing countries, multinationals often carry out large-scale mining, oil, and gas operations, selling their production either directly to affiliated smelters or refineries, or to an associated marketing or trading company, created for the sole purpose of receiving ownership of the product. Companies may deliberately undercharge related-party sales to pay less tax in the country where the minerals are extracted, allowing profits to accumulate offshore, usually in a low-tax jurisdiction. Many countries lack facilities to assess the quality and quantity of exports, putting them at a further disadvantage when assessing the price of related-party sales.

Goods and services, including financing, are commonly provided to locally based extractive companies by foreign-based affiliates. For example, many multinational mining groups centrally procure equipment and machinery on behalf of mine subsidiaries; in return they charge a fee for service. In most countries, these costs can be deducted from taxable income, creating an incentive to inflate the expense incurred with related parties located in a lower tax jurisdiction. Cost claims are arguably an even greater risk in oil and gas given that the production-sharing arrangement typically divides production between the government and the producer only after the producer has recovered its costs.

With related-party transactions divided into two areas – sales and inputs – legal and institutional measures should focus on preventing companies from undercharging exports, and from overcharging goods and services provided by foreign affiliates. All the measures described in this chapter aim to fulfill one or both these objectives.

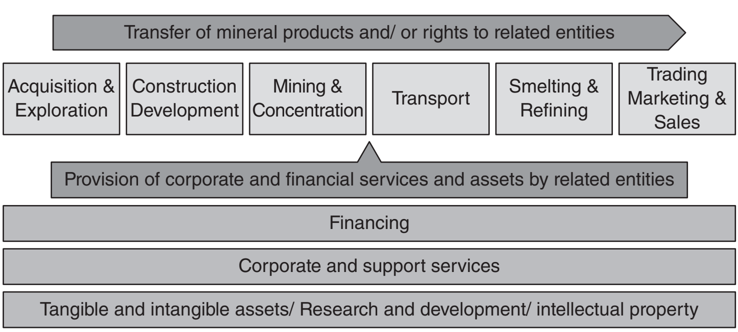

FIGURE 1.1 Mining value chain showing nature and timing of related-party transactions

Source: Institute for Mining for Development, 2014.

3. Alternative Approaches to International Taxation

Global Formulary Apportionment

Among several alternatives to the arm's length principle, global formulary apportionment (GFA) has been the most widely discussed. GFA allocates a multinational corporation's total worldwide profit (or loss) across the jurisdictions in which it operates, based on some formula proxying the extent of activities in each.[10] The formula usually discussed involves three allocation factors: destination-based sales, assets, and payroll in that jurisdiction. The advantage of GFA is that it dispenses with the need to identify arm's length prices for intra-company transactions, instead taxing profits on a consolidated basis.

It is generally agreed that, for GFA to be implemented, global consensus on an allocation formula would be needed. Otherwise, countries would start a new kind of tax competition over the selection of allocation factors.[11] However, as with most international tax architecture, any uniform formulation of GFA is likely to be heavily influenced by the interests of developed countries. This is clear from the OECD Base Erosion and Profit Shifting (BEPS) deliberations, which were limited to developed countries, who are now binding developing countries to the new international tax standards through the Inclusive Framework.[12] Once again, commentators are questioning whether the outcome of the OECD's new program of work to tax the digital economy will be of benefit to non-OECD countries.[13]

Setting aside the political challenge of reaching a consensus on the allocation formula for GFA, which is arguably more soluble now than in the past, there remain particular issues for extractives.[14] First, a formula that appropriately compensates the producing countries would need to be determined. The destination-based sales factor is generally understood as relating to sales in the location of the purchaser. It is unlikely that producing countries will agree to let profits from their natural resources be taxed in the customer's location. To ameliorate this concern, researchers have suggested that a specialized 'production volume' factor or a source-based sales factor (those in the location of production) be incorporated into the allocation formula. Alaska, for example, has a special formula for unitary taxation of the oil and gas sector that includes an extraction factor, based on the amount of oil and natural gas extracted. While this may be technically feasible, Alaska's decision has not been without litigation from oil and gas companies.[15]

This next section analyses the impact of different formulas for GFA on the allocation of profits of two mining companies, Rio Tinto and Anglo American, for 2017. It should be noted that the data used is illustrative, taken from publicly available information that would need further breakdown to arrive at a more robust position. Rio Tinto and Anglo American were selected because of their advanced disclosure of data.

The results in Figures 1.2 and 1.3 suggest that the worst scenario, from the perspective of producing countries, is if profits are allocated to where the minerals are sold, for example, China, Europe, and the US. A better model is if profits are apportioned equally between sales, assets, and employees.

Surprisingly, the 'Alaska model' does not always offer the best result for producing countries. Rio Tinto's mines, while better off under the Alaska model than the traditional three-factor approach, receive the greatest share of global profits under assets and employees, although Australia is an exception. It may seem

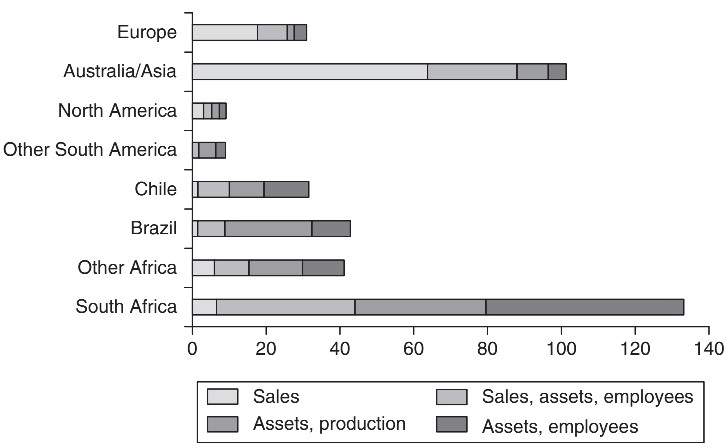

FIGURE 1.2 Allocation of Anglo American's global profits under four models of GFA (2017) (%)

Source: Anglo American's annual report (2017) for accounting information.

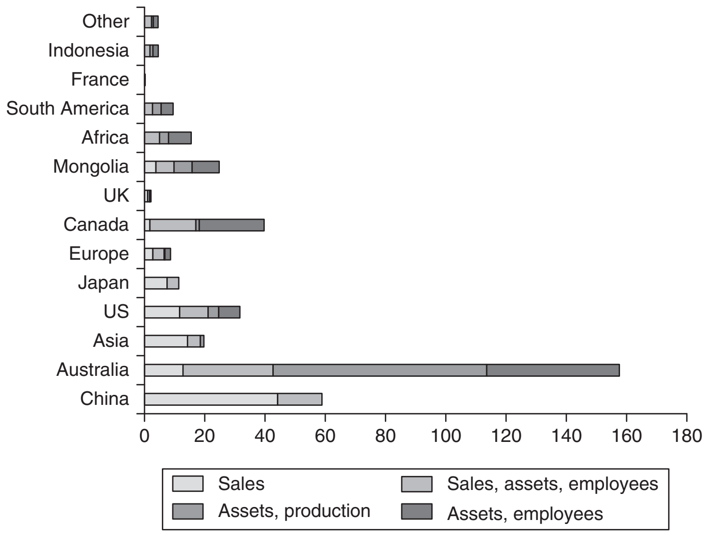

FIGURE 1.3 Allocation of Rio Tinto's global profits under four models of GFA (2017) (%)

Source: Rio Tinto's annual report (2017) for accounting information.

counterintuitive that producers would get more global profit under assets and employees than assets and production, however a mine's contribution to total production will depend on its stage of development. In Mongolia, for example, Rio Tinto's Oyu Tolgoi mine is under construction and yet to ramp up production. Consequently, Mongolia's share of total production is less than its share of total employees; thus, Mongolia receives less profit when production, rather than employees, is used to allocate profits.

In the case of Anglo American, the Alaska model offers the best result for producing countries, although South Africa and Chile are exceptions, receiving a greater share of global profits if assets and employees are used. This is probably because some commodities are more labor intensive than others. Platinum mines, for example, are typically more labor intensive than other commodities, which is why Anglo American's employment data for South Africa is significantly higher than elsewhere. These examples demonstrate the need for careful analysis of allocation factors over life-of-mine and for different commodities.

Another challenge for the application of GFA to the extractive industries is the presence of intermediary mineral products. Many resource-rich developing countries export unfinished raw materials that are transferred to a related-party refinery for further processing before sale. Rio Tinto, for example, operates a mineral sands project in Madagascar. It produces ilmenite, which contains 60 percent titanium oxide. The raw material is shipped to Rio Tinto's Fer et Titane processing plant in Canada, where it is transformed into a 90 percent titanium dioxide chloride slag.[16] A formula would need to apportion profits for the raw material extracted in Madagascar, as well as value added outside the country. While many diversified miners produce financial information by business unit (for example, iron ore, copper), further disaggregation of the relative costs of production and overheads would be required to set an appropriate formula for each commodity.

There is also a question of whether to use assets' accounting value or fair market value. The difference may be quite substantial. For example, the accounting valuing of Rio's Australian iron ore operating assets are $16 billion, whereas the market value is more than $50 billion.[17] While the market value may be a more relevant basis for profit allocation – Australia's tax take would be much higher, for example – the historical cost of purchase is more objective and easily verified.

Finally, resource-rich countries would need to be willing to accept global offsetting of corporate losses. Consider Anglo American's operations in Brazil and Chile. If the Brazil mine incurs a loss, the company can offset that against the tax base of the mine in Chile, whose government thus gets less revenue from its minerals. From the taxpayer's perspective, it is only fair that if income from Brazil can be included in Chile's tax base, so too should a corollary loss. Chile, however, may disagree that the compensation it gets for its minerals should be impacted by activities in Brazil. Whether it is worthwhile for Chile and Brazil will depend on careful analysis of the risk to revenue under international tax rules and whether both countries would on average be better off under GFA.

Destination-Based Cash Flow Tax

The destination-based cash flow tax (DBCFT), or 'border adjustment tax' as it has become known in US tax policy debates, is a proposal to levy corporate income tax based on where goods end up, rather than where they were produced. In this sense, it is like a value added tax which applies to the domestic sale of imported goods and is exempt on exports. The objective is to tax companies where they are least mobile (that is, where consumers are) to reduce opportunities for tax avoidance. Sales volume is the only factor for apportioning income under DBCFT, in contrast to GFA.

Despite being more robust to profit shifting, resource-rich countries are unlikely to agree to let the profits from their natural resources be taxed in the customer's location. The International Monetary Fund estimates that resource-rich countries stand to lose 1 percent of GDP under such a tax.[18] That is not a concern just for developing countries: In 2017, 63 percent of Australia's mineral and metal exports ($60.2 billion) went to China, whereas China accounted for only 24 percent of Australia's imports.[19] The academic proposal acknowledges this limitation: 'Governments of resource-rich countries are unlikely to be content to receive, as they would under a DBCFT, no revenue from their exploitation.' The authors advise resource-rich countries to exclude extractive projects from DBCFT and continue to apply origin-based taxes.[20]

Considering these factors, it is likely that source-based taxation will remain the most appropriate form of taxation for the extractive industries. However, this is not without its challenges. Important policy choices – the subject of the next section - must be made to ensure that resource-rich countries are able to collect the taxes owing to them from the exploitation of their finite, non-renewable natural resources.

4. Incremental Measures to Combat Transfer Pricing Manipulation in Extractives

Alternative Tax Policy Rules

This section will describe and evaluate some of the incremental legal measures that resource-rich developing countries have put in place to control the risk of transfer pricing manipulation in relation to sales and inputs. The measures dealing with related-party sales include the sixth method for metal exports in Zambia and norm pricing of crude oil sales in Angola and Norway. Rules to control costs include South Africa's limit on the deduction of interest expense and Indonesia's move to replace cost recovery for oil and gas projects with a gross-split approach to production sharing.

Measures to Control Related-Party Sales

The Sixth Method[21]

The sixth method has become a popular way for resource-rich developing countries to simplify the application of the arm's length principle to related-party mineral sales. Typically, the sixth method uses publicly quoted prices, for example, the London Metals Exchange, with some adjustments based on the actual conditions of sale, to calculate sales revenue for income tax purposes.[22] By contrast, the arm's length principle would require that a comparable transaction between similar independent entities, not a quoted price, be used to benchmark the related-party sale. The sixth method itself does not apply to the calculation of mineral royalties (non-tax revenue) although the basis for valuation may be the same. The sixth method originated in Argentina in 2003, when the government was seeking to evaluate the sale of raw materials to related parties in countries with lower tax rates. Argentina's legislation requires that taxpayers selling commodity products to offshore-related parties use the publicly quoted price of the traded goods on the date of shipment, unless the price the related parties agree to is higher than the quoted price.[23]

Zambia is the only African country currently using the sixth method. In 2008, the Ministry of Finance amended Section 97A of Zambia's Income Tax Act, to require mining companies to calculate all related-party sales of precious and base metals (for example, copper and cobalt) according to global reference prices. The Ministry of Finance authorized the following price indices: London Metals Exchange, the Metal Bulletin, or any other metal exchange market approved by the commissioner-general of Zambia Revenue Authority (ZRA). The Ministry of Mines and Mineral Development cross-referenced Section 97A of the Income Tax Act in the Mines and Minerals Development Act, aligning valuation of mineral sales for royalties and income tax.

There is consensus between ZRA and the mining industry that companies are complying with the sixth method and use the London Metals Exchange as the basis for mineral pricing of their sales to related parties. Some companies had been engaging in aggressive transfer pricing in the past, but ZRA has identified and rectified these.[24] In the case of Mopani Copper Mines, the

Zambia Tax Appeals Tribunal ruled that it must pay ZRA approximately half a million US dollars in outstanding taxes for the period 2006–2010. This adjustment is based on the taxes on copper sales between Mopani and its parent company Glencore International that should have been paid according to the sixth method. Mopani is likely to appeal the decision. While the judgment is yet to be released, this case will help ZRA quantify the impact of the sixth method, comparing variation in pricing, as well as income tax collection, before and after the rule was introduced.

In addition to tightening up prior pricing practices, ZRA reports that the sixth method has simplified income tax administration with respect to mineral sales, freeing up valuable time and resources to focus on other transfer pricing issues. When a mining company submits its tax return online, the system automatically inputs the relevant London Metals Exchange prices for related-party sales and calculates the tax accordingly, reducing the need for transfer pricing analysis. According to one ZRA official, 'Section 97 acts as a deterrent. It removes a free kick for companies'.[25]

However, the sixth method may not be applicable to all mineral products. The sixth method works best for minerals that are traded into terminals or stock markets and priced on an international index, for example, gold. Daily quoted prices for minerals sold into terminal commodity markets are easily obtainable from a range of indexes to value related-party sales.[26] Applying the sixth method to other substances, for example, metal concentrates, will depend on the quality specifications, marketing modalities, and availability of pricing information.

Norm Pricing

Oil is generally valued for tax and royalty purposes based on the actual sale price used. However, some major producers such as Norway, Angola, and Indonesia, have chosen to value oil based on norm (sometimes called 'administrative') prices set by government. Under a norm pricing regime, the government, rather than the taxpayer, determines the value of the oil.[27] For example, at the beginning of each quarter, the Petroleum Price Board in Norway publishes the daily norm price for each oil-producing field for the next three months. It also publishes the daily exchange rate for Norwegian kroner to US$.[28]

The benefit of norm pricing is that the tax authority has the first-mover advantage in setting an arm's length price. If the taxpayer disagrees, the onus is on them to demonstrate that the government's valuation is incorrect. Norm prices should not be confused with benchmark or reference prices, which are based on the current market price (sometimes called 'spot price') alone. The intention of norm pricing is to achieve a reasonable approximation of arm's length sales values, whereas a valuation rule based on benchmark prices will only achieve this if the prices are for comparable natural resources and adjusted for difference in value.[29]

Norway pioneered the approach in 1974. This chapter, however, focuses on Angola's experience of norm pricing as it is more representative of how other developing countries are likely to fare. According to the Law on Taxation of Petroleum Activities (2004), the State Concessionaire and associates must provide the Ministry of Petroleum with a report 15 days before the start of the quarter; this should include a forecast for world supply and consumption of petroleum, as well as estimates of the market prices that can be obtained for the crude oil produced in their field that quarter. They then submit, 15 days after the end of the quarter, a second report that includes the actual prices obtained in sales to third parties, detailed information on the terms of the sales, and relevant market data. Using the two reports, the Ministry of Petroleum and Ministry of Finance jointly determine the norm price that the State Concessionaire and its associates should use to calculate taxable income. If there are no third-party sales, pricing will be based purely on market conditions. Companies can dispute the administrative price. Typically, this will be adjudicated by a panel of independent experts, and whichever party submits the case pays the fees.

The challenge to effective implementation of the norm pricing rule by the government of Angola is technical capacity. Price determination requires significant technical expertise, as well as knowledge of oil markets. In Angola, there are four tax officials who determine the norm price. In Norway, the Petroleum Price Board also has four members, but these are independent experts drawn from business schools as well as economic and law faculties in Norway. The lack of expertise in Angola has sometimes meant a willingness to rely on the information received from companies, creating a risk that the Ministry of Finance will set the norm price too low. In addition to expertise, the credibility of norm prices hinges on an independent process, otherwise the approach may be seen as an attempt by government to 'grab' extra revenue. For this reason, the Norwegian government made the Petroleum Price Board independent – to put distance between the arm of government that sets the norm price, and the arm that collects taxes. Independence is even more important in a developing country context where decision making is often highly centralized, as well as politicized.

More research is required to determine whether norm pricing in Angola is effective in preventing undercharging of crude oil sales. According to government officials, complaints from companies are uncommon; although, in Angola's case the lack of disputes may be due to government's reliance on company reports to set the norm price, in which case it's 'business as usual'. The Norwegians also cite a high level of compliance, demonstrated by limited pricing disputes as compared to cost recovery. In both cases, norm pricing appears to reduce the administrative burden for tax authorities.

Measures to Control Costs

Limiting Interest Deductions in South Africa

Companies can finance an investment in the extractive sector through various instruments that fall into two broad categories: debt or equity. Debt is treated differently to equity for tax purposes: interest payment on the debt can be deducted from taxable income, reducing a company's overall tax bill. Consequently, companies have an incentive to increase their leverage (that is, increase the proportion of debt in their sources of financing), in particular for subsidiaries in high-tax countries. Shareholders practice 'thin capitalization' when they finance an investment with little equity compared to debt for the sole purpose of minimizing their taxes. Thin capitalization is not a practice unique to extractives, but it is a more significant risk for industries requiring high levels of investment, which is often the case for mining, oil, and gas projects due to their capital-intensive nature.

The South African Revenue Service (SARS) has sought to avoid complex transfer pricing analyses, preferring clear, objective rules to limit interest deductions.[30] In 2013, SARS amended the Income Tax Act to include Section 23M. Section 23M limits the deduction of interest expense on related-party loans to 40 percent of earnings before income tax, depreciation, and amortization (EBITDA). Interest disallowed can be carried forward to the following year. Section 23M was introduced before OECD BEPS Action 4,[31] which recommends a limit on interest deductibility between 10 and 30 percent of EBITDA.[32] There has been no indication from South Africa that it intends to revise its ratio to accord with the recommendation in BEPS Action 4. While Section 23M does not limit the rate of interest charged, which is another policy option, the cap on deductibility should at least discourage companies from excessive interest expense, albeit moderated by the carry forward rule. If not, and the rate is found to be non-arm's length, SARS can fall back on transfer pricing rules to make an adjustment.

There are some early lessons that other countries may wish to bear in mind when developing their own interest limitation rules. First, governments may experience pressure, due to economic and political circumstances, to adopt a flexible, rather than a fixed ratio. In South Africa, weak economic growth, high inflation, and low commodity prices meant that SARS had to move from a fixed cap of 40 percent, to a flexible formula linked to the South African Reserve Bank interest rate to account for volatility in the South African rand.[33] While the South African context may have required this adjustment, developing countries with less capacity and resources should adopt the fixed ratio rule recommended by BEPS Action 4 to avoid the added complexity.

Secondly, governments should formulate interest limitation rules to cover interest on all forms of debt, payments economically equivalent to interest, and expenses incurred in connection with the raising of finance. This includes foreign exchange (FOREX) losses connected to raising finance. For example, when a South African company operating in rand and borrowing in another currency, for example US dollars, must buy dollars to pay back the loan; if the rand loses value against the dollar, the company must use more rand to repay the loan, increasing the total loan amount to be repaid. To protect against this scenario, the company may purchase from a broker the right to buy dollars at a specified rate in the future, called a FOREX hedge. To purchase this right, the company has to pay a premium, which for tax purposes is treated as a FOREX loss. In South Africa, unlike for interest payments, there is no limit on deduction of FOREX losses; thus, the cost of borrowing may continue to erode the tax base, undermining the objective of Section 23M.

Countries should introduce a cap on interest deductions on related-party debt. The proposal is not exclusive to the extractive industries; indeed, the South African approach covers all sectors of the economy. However, it is badly needed for this sector given the high levels of debt financing involved. A limit on interest deductibility, in combination with a debt-to-equity rule, and the arm's length principle, should protect the tax base against excessive interest deductions, and offer certainty, clarity, and simplicity of administration for both tax authorities and taxpayers.

Eliminating Cost Recovery in Indonesia

For petroleum-producing countries using contractual systems, cost deductions represent a major tax avoidance risk. Roughly two-thirds of petroleum-producing countries use production-sharing contracts (PSCs) as the core component of their fiscal regime.[34] Under a PSC, the contractor is entitled to take a share of total production to cover its exploration and development costs ('cost oil'), and what is left is then split between the contractor and the government ('profit oil') according to some formula set out in the PSC. This mechanism for apportioning production is called 'cost recovery'. While countries may vary the ratio of cost oil to profit oil, cost recovery has been the defining feature of the PSC.

Under cost recovery, the risk is that contractors are incentivized to inflate costs to increase their share of production, the result being that government's share is reduced. Cost deductions may correspond to a range of related-party transactions, including the provision of engineering and technical services, as well as management, administrative, and other operations-related services. Over the last decade, the government of Indonesia has become increasingly concerned that petroleum companies operating the country's oil and gas fields have been inflating costs through overspending. In 2016, a report by the Supreme Audit Agency (BPK), revealed that several petroleum companies ('contractors') had inflated the reimbursement of their operating claims by US$ 300 million.[35] In the same year, the cost of cost recovery reached US$ 13.9 billion, which was more than the sector raised in non-tax revenues.[36]

There are also administrative challenges involved in applying cost recovery. According to the Deputy Energy Minister, Arcandra Tahar 'the problem with cost recovery is, there have been endless debates between SKK Migas (the government regulator for oil and gas), and contractors as to how much exactly the production costs should be. It's not easy to calculate technology costs, especially in cases where only one company has a particular technology.'[37] SKK Migas has 750 staff; roughly 80 percent are involved in administering cost recovery.[38] Indonesia is not the only petroleum-producing country to struggle: Tanzania's former upstream regulator, the Tanzania Petroleum Development Corporation (TPDC), has expressed concern that the country's status as an underexplored petroleum province makes it easy for companies to record the maximum rental price for drilling rigs, and the TPDC lacks the appropriate benchmarks to challenge these cost claims.[39]

Consequently, in January 2017, the government of Indonesia abandoned the cost recovery approach. In its place the government will apply a 'gross-split' method, apportioning production solely based on a percentage, leaving all capital and operating costs to be borne by the contractor. Under gross-split, the contractor is effectively 'paying' a royalty by handing over a share of production to government before recovering its costs. This is attractive because government can collect revenue as soon as production commences. There is still a risk that contractors will inflate cost claims applied to income tax computations, but at least it is contained rather than potentially eroding government's share of production as well. However, this objective should also be weighed against the potential impact on production efficiency, and, as such, future investment flows.

At the time of writing, the main challenge for the government has been to calibrate the proposed production splits, as well as accompanying adjustments for factors such as the location of the field (that is, at sea, on land, in an underexplored area), oil price, and the level of supporting infrastructure. Industry's initial response to the policy proposal was lukewarm; however, their position is more positive since the government has adjusted the terms of the policy proposal to improve the internal rate of return for investors.[40] In particular, the minister has been given full discretion to adjust the production split where a project does not meet a 'certain economic level'.[41] Unlimited ministerial discretion may serve as a 'pressure release' which functions to get investors onside with the proposal. But, without clear criteria there is a risk that discretion may be misused, and lead to difficult negotiations with each investor on a case-by-case basis.

The success of Indonesia's gross-split model ultimately depends on industry's response to the current bid round. However, if Indonesia can get the balance right between ease of administration and attracting investment, the move away from cost recovery may prove to be a pragmatic solution for developing countries with finite audit resources, and limited benchmarks to evaluate cost claims.

Strong Government Institutions

This section explores some of the institutional arrangements put in place by developing countries to improve extractive industry revenue collection. Two themes emerge from the examples from Guinea, Sierra Leone, and Tanzania: exchange of information and expertise between the tax authority and the extractive industry regulatory agencies; and capacity to monitor quantity and quality of exports.

Inter-agency Coordination in Guinea and Sierra Leone

Fiscal administration of extractive industries is often fragmented. Responsibility for collecting information may be shared by many government agencies. For example, in Zambia, the Ministry of Mines, the tax authority, and the Bank of Zambia, are all collecting different copper production figures, and in the past, this has led to allegations of missing copper.[42] In most cases, information and expertise exist in silos. Unless there is an effective system for sharing information and expertise, revenue authorities may struggle to develop a comprehensive picture of transfer pricing risks and decide which risks warrant an audit.

To improve inter-agency coordination for mining revenue collection, governments should establish an inter-governmental mechanism between the relevant institutions to automatically share all information related to companies operating in the mining sector.

There should also be a technical coordination group to oversee implementation of the information sharing agreement and support the administration of transfer pricing rules in relation to the mining sector. There are some strong examples emerging from West Africa, specifically Guinea and Sierra Leone.

Guinea Interministerial Task Force on Mining and Revenue

In 2017, the Guinea Ministry of Mines officially launched the Interministerial Task Force on Mining and Revenue. The taskforce comprises the ministries of mines and geology, economy and finance, and budget, the central bank, and the Extractive Industries Transparency Initiative Secretariat (EITI).[43] The tax authority and the customs agency also attend as part of the delegation from the Ministry of Budget.[44] The objectives of the taskforce are strong inter-agency coordination, and systematic exchange of information; better tracking of extractive revenues with a view to improving revenue collection; and improved compliance of mining companies with respect to their tax obligations. There are plans to organize joint monitoring missions to mine sites. The tax authority is especially eager to have the Ministry of Mines involved in tax audits due to their own limited mining expertise.

Achieving inter-agency coordination can be very difficult, with individuals and institutions wanting to maintain control of their own domain. In Guinea, the taskforce was possible due to three factors. The first was the leadership of the Ministry of Mines, which recognized the lack of coordination was working against them particularly with respect to revenue collection. The second factor was that the taskforce was proposed at the technical level. Although the taskforce has been agreed to by the ministers of mines, finance, and budget, the political leadership are not involved in the day-to-day workings. The third factor was the support of development of partners; the German Agency for International Cooperation and the Natural Resource Governance Institute. Both organizations have provided considerable input; however, there is concern that without these partners the taskforce may not be self-sustaining. For example, at the outset, some members regarded the taskforce as simply a way of getting funding for pet projects, such as field audits and laboratory equipment.

One of the main successes of the taskforce so far has been providing a home for existing inter-agency initiatives in the mining sector. For example, the German Agency for International Cooperation began a project with the Revenue Development Foundation to establish an online platform for information sharing between the ministries of mines, and finance, as well as the customs agency and central bank. The taskforce is now driving this project to improve information exchange to enhance revenue collection. The next step for the taskforce is to develop its own work plan.[45]

Sierra Leone Extractive Industries Revenue Taskforce

Coordination of mining sector policy at the technical level has improved considerably following the establishment of the Extractive Industries Revenue Taskforce (EIRT). The EIRT is hosted by the division for Tax Revenue Policy at the Ministry of Finance and Economic Development and includes the Ministry of Finance, National Revenue Authority, National Minerals Agency, Petroleum Directorate and the Extractive Industries Transparency Initiative (EITI) secretariat.

The EIRT began informally to troubleshoot various issues relating to EITI reconciliation reports. Members of the group found it to be so useful in terms of sharing information and solving problems that they decided to formalize it and extend its mandate beyond EITI challenges. One achievement of the EIRT was to reduce the export duty on gold to levels more comparable to the other Mano River Union countries (Guinea, Liberia, Ivory Coast), which is seen to be the main factor in recent decreases in smuggling and increases in official gold exports.[46]

Mineral Audit Capacity in Tanzania

While tax avoidance risks are not unique to the extractive industries, some experience of the sector is necessary to determine whether a risk area has been manipulated. As such, the government of Tanzania recognized that tax officials alone could not detect and mitigate tax avoidance by mining companies. They need support from industry experts. Consequently, in late 2009, the government established the Tanzania Mineral Audit Agency (TMAA). TMAA was a semi-autonomous government institution set up to audit the quality and quantity of minerals produced and exported by mining companies, conduct financial and environmental audits, and monitor smuggling of minerals.[47]

In 2017, as part of a series of government reforms to strengthen administration of the extractive sector, TMAA was merged with the Office of the Commissioner for Minerals, to create a single Mining Commission. The purpose was to combine the monitoring functions of TMAA, with the mineral licensing role of the Office of the Commissioner for Minerals. The Commission reports directly to the president. The reorganization of TMAA was part of a suite of reforms including: the breaking up of the Ministry of Energy and Mines into two separate ministries to ensure adequate oversight of both sectors,[48] new laws requiring petroleum companies to procure workers, goods, and services locally ('local content'),[49] and to list on the Dar Es Salaam stock exchange. While the TMAA has been merged into the Mining Commission, the substance is intact, hence it remains the focus of this paper.

TMAA had many functions, but the two that relate most directly to revenue collection are mineral testing and financial audits. First, TMAA was responsible for monitoring the quantity and quality of all mineral exports of large and medium-sized mining companies. TMAA staff were stationed at every large-scale mine in the country to witness production and export. Their role involved weighing, documenting, and taking samples of minerals before export; the samples were then tested by TMAA's internationally accredited mineral laboratory in Dar Es Salaam. Secondly, TMAA was responsible for auditing revenue, capital investment, and operating expenditure of large and medium-scale mines. In 2015 TMAA carried out 16 audits: three large-scale mines, and 13 medium-sized mines. Once an audit was complete, the findings were shared with the Tanzania Revenue Authority (TRA). TMAA staff had received some limited training on transfer pricing from the OECD and the former Institute for Mining for Development; this meant they could identify and flag transfer pricing issues for TRA's attention.

TMAA was equipped with human and financial resources. It had 114 staff, which included approximately 70 specialized staff, for example, financial analysts, engineers, and gemologists. The annual running costs were $4.8 million, which were funded by the state budget. The arrangement with TMAA was more cost efficient than outsourcing the monitoring function to the private sector, which in the past had cost government 1.9 percent of the market value of exported gold, equivalent to 64 percent of royalties payable to the Ministry of Energy and Mines.[50]

Corporate income tax from the mining sector increased dramatically since TMAA was established. In 2008/09 TRA collected US$ 1,251,984, but by 2013/14, it was US$ 296 million. However, TMAA's operationalization coincided with a large increase in mining activity and a period of higher prices, making it difficult to isolate its precise impact. Notwithstanding, there were some specific interventions that led to increased revenue collection. First, in 2012/13, TMAA found that the sales revenue verified by its mineral auditors was significantly higher than the sales revenue declared in a company's financial statement and tax returns. TMAA alerted TRA which adjusted the company's taxable income upwards by $US 86 million and its income tax by $US 25.8 million. Also in 2013, TMAA identified a mining company that was merging income from two projects at different development levels, each with a separate Mining Development Agreement. As a result, the company agreed to separate its tax affairs, including an income tax adjustment, and ultimately paid $US 39 million after deduction of value added tax credits.

TMAA's knowledge of the industry meant it could spot sector-specific tax issues. It was also monitoring mining projects from start to finish; thus, it could identify and investigate irregularities early on, for example inflated exploration and preproduction costs, which may affect future tax payments. Establishing a dedicated institution with a specific mineral audit mandate enhances monitoring of the mining sector. It is unlikely that tax authorities will have the appropriate skills, or time, to inspect, audit, and review all mining companies' operations over the typically very long life of projects. A specialized mineral audit agency can devote its resources to monitoring the sector.

Conclusion

The arm's length principle is extremely difficult for developing countries to implement, primarily due to the lack of comparable data, as well as limited audit resources. However, the alternative proposals, namely GFA, and a DBCFT, face significant technical and political barriers when applied to the extractive industries. At least in the short to medium term, developing countries require concrete proposals for incremental legal and institutional responses to multinational tax avoidance they can enforce, that stop revenue leakage.

As the examples in this chapter have shown, it is possible to design rules that limit the scope for transfer pricing manipulation at key points along the extractive industry value chain. The easiest area to contain is sales due to the availability of publicly quoted prices. The sixth method may not be available for all mineral products, but in countries where audit resources are limited, if it can reduce transfer pricing risk for some sales this is an improvement. Setting norm prices for crude oil sales should be even easier given it is a deep liquid market with a range of price indices, and less quality variation.

Despite cost deductions being the major technical challenge for tax authorities, as well as a significant risk to revenue, they have been largely overlooked by governments and experts. Urgent action is required by developing country governments to limit the deduction of interest expense on related-party loans. It is no longer adequate to limit the quantum of debt; a cap on interest expense, and potentially the rate, are also necessary. Further research is needed to see if countries can go a step further to set a limit on the cost of borrowing to avoid complex transfer pricing analyses in the event of non-arm's length rates. While Indonesia's move to a gross profit split in oil and gas is untested, it may present a solution to the administrative challenge of implementing cost recovery. Their experience thus far demonstrates the difficulty of balancing the need to attract investment, and simplify tax administration, which is an important test for all tax proposals in this chapter.

All these policy measures only work if administered by credible institutions with sufficient knowledge and expertise. While most transfer pricing risks are not unique to the extractive industry, evaluating whether these risk areas have been manipulated is. Resource-rich developing country governments must set up institutions with the requisite industry knowledge and expertise to monitor the sector. Extractive companies incur enormous costs during exploration and development, all before the tax authority begins monitoring, which makes specialized audit agencies like the former TMAA, now the Minerals Commission, a vital check on future tax deductions. Extractive industry tax administration is fragmented, with responsibilities for information collection dispersed across government. Transfer pricing manipulation will thrive in such an environment unless agencies find ways to coordinate; to share information and expertise.

More work needs to be done to highlight the measures that developing countries themselves are innovating, as examples for others to follow. The threshold should be clear, objectively verifiable, and easy to administer tax rules, and strong government institutions to oversee the extractive sector. While the tax policy measures may not perfectly adhere to global standards, there is growing recognition that these standards must evolve, particularly as they apply to taxes owing from finite natural resource endowments.

Notes

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Valderrama, Irma Mosquera (2018) 'The BEPS vis-á-vis developing countries' in *Stop the Bleeding: Protecting Poor Countries Revenues* (London: Zed Books).countries with limited resources and a small number of multinational corporations.

2 | TRANSFER PRICING RULES AND ALTERNATIVE PATHS FOR THE TAX ADMINISTRATIONS OF DEVELOPING COUNTRIES

Tovony Randriamanalina[1]

Executive Summary

Transfer pricing rules aim to accurately reflect the economic contribution of a multinational company (MNC) in each of the various jurisdictions in which it operates. The objective of these rules is to ensure that the various constituent entities of a MNC report the correct taxable profits in their jurisdiction. However, this objective is not always achieved in practice. There are two main approaches in international tax law for allocating the income of MNCs. The first is the 'separate entity' or the 'arm's length principle', which treats affiliates of MNCs as if they were independent. The second is the 'unitary taxation' approach, which treats each MNC as a single firm. The arm's length principle, which is favored by the OECD, requires an individual analysis of facts and the situation of each taxpayer. There are five approved methods for undertaking this analysis, and as a result it is highly subjective, incentivizing MNCs to structure themselves so as to minimize their tax costs.

Following the OECD/G20 BEPS Project, the arm's length principle has remained the international standard for assessing transfer prices. However, the arm's length principle is not a practical approach for developing countries, as it allows for many loopholes that can jeopardize the tax base. This chapter has two main arguments. First, it proposes some short-term strategies to make the arm's length principle workable for developing countries' tax administrations. However, these strategies are only stopgap solutions since they are still based on a flawed approach. Second, this chapter supports unitary taxation with formulary apportionment as the best long-term solution that is fair to all parties.

1. Introduction

One way for multinational corporations (MNCs) to minimize their global tax liability is to aggressively exploit the loopholes inherent in the transfer pricing rules (Picciotto, 2018; IMF, 2019). The objective is to lessen their overall tax bill by shifting profits from jurisdictions with high corporate income tax rates to jurisdictions with lower rates. This 'profit shifting' between fiscal jurisdictions is a common phenomenon which undermines the tax base of countries where real activities take place, and reduces government revenues worldwide, in both developed and developing countries. Given that developed countries have more robust tax administrative capability, and the missing tax revenues constitute a smaller percentage of their overall GDP, this phenomenon is especially problematic for developing countries, and results in the loss of significant tax revenues (IMF, 2019). This loss deprives developing countries of important domestic resources that could be used for high potential and socio-economic impact services such as security, healthcare, education, and clean water.

African tax administrations have reported that the defects of transfer pricing rules represent one of the highest risks to their tax base (ATAF, 2018). The current challenge for tax administrations is to strike the right balance between protecting the tax base (by collecting more tax revenues through increased enforcement, in particular, through transfer pricing audits) and attracting MNC investments. Performing transfer pricing audits is complex and costly, and therefore challenging for developing country tax administrations. It creates a battleground between two forces that are not necessarily equal: developing countries' tax administrators, who are resource constrained, vulnerable to political pressure, and subject to high turnover, on the one hand; and the well-staffed and expensive law firms and accounting firms that are arguing on behalf of the MNCs, on the other.[2] Within this context, this chapter will present several practical alternative methods for how developing country tax administrations can collect tax revenue through transfer pricing audits and try to create a level playing field.

2. The Current Transfer Pricing Rule Is Inappropriate for Tax Authorities in Developing Countries

Governments need transfer pricing rules[3] to ensure that the taxable profits of MNCs are not artificially shifted out of their jurisdictions.

Following the BEPS project (OECD, 2013a), the G20 endorsed the arm's length principle for determining transfer prices, cementing it as the dominant approach in international taxation standards. More and more countries are introducing the arm's length principle in their transfer pricing rules, including many African countries like Algeria, Angola, Burkina Faso, Cameroon, Egypt, Gabon, Ghana, Madagascar, Malawi, Mauritania, Nigeria, Senegal, Tanzania, Uganda, Zambia, and Zimbabwe.

The arm's length principle is enshrined in the OECD guidelines, however, there are problems in its application. The revised Transfer Pricing Guidelines (OECD, 2017) have become even more complex and unclear, adding to the compliance costs for both MNCs and tax administrations, and will create further growth in conflicts (Collier and Andrus, 2017). The five approved transfer pricing methods are highly subjective. Critics also point to the many drawbacks that application of transfer pricing rules pose for developing countries: it is a very complex, time-consuming, costly process and requires substantial work by skilled staff (Durst, 2015; Picciotto, 2013; Tovony, 2015). It is hard enough for rich countries to devote sufficient resources to this important task, and they are often out-maneuvered by skilled experts that large MNCs have the means to deploy. The problem is obviously even more severe for small and poor countries, which do not have the same resources to challenge the MNCs.

Due to the challenges listed above, this chapter considers short-term and long-term strategies that can be taken in response. The short-term strategies attempt to make transfer pricing rules more workable for developing countries, drawing on the practices of four emerging countries: Brazil, Argentina, India, and Mexico. A longer-term solution should focus on developing better rules for the allocation of profits, with the active involvement of all countries, especially developing countries, in the decision-making process.

3. Short-term Strategies: Selected Approaches to Do More with Less

This section reviews approaches to transfer pricing audits attempted by various emerging countries: Brazil, Argentina, India, and Mexico.[4] The objective is to give clear and predictable transfer pricing rules which will improve and ease the work of the tax administration, including revenue collection, and also enhance predictability for both tax administrations and the taxpayers.

It is worth mentioning that the approaches to transfer pricing audits taken by Brazil, Argentina, and India deviate from the OECD Transfer Pricing Guidelines but do not completely abandon the arm's length principle. Rather, these countries allow for the determination of the arm's length price in unorthodox ways. Whereas the OECD guidelines recommend that MNCs' transactions be examined on a case-by-case analysis, tax administrations in these countries instead use predetermined mathematical formulas set down in the tax law to calculate margins, mark-ups, or thresholds and thereby arrive at an arm's length price. Mexico is an exception from this: they use a conventional case-by-case analysis, but have unique requirements in terms of the kinds of transfer pricing documentation they require, aiming to improve the quality of resources of the tax administration.

3.1 Brazil's[5] Fixed-Margins Method

Brazil enacted its transfer pricing rules in 1996 (Federal Law No. 9,430/96) and they entered into force on January 1, 1997. With these rules, Brazil simplified the traditional methodology to make it more practical. This chapter discusses only the 'fixed-margins' methodology. An exhaustive discussion of Brazil's transfer pricing rules can be found in the UN Manual (2017: Chapter 10.1).

The majority of the methods included in the OECD's guidelines involve identifying a comparable for the profit rate of a related-party transaction. As the name suggests, the fixed-margins approach instead uses pre-established profit margins to indicate the level of profit that can be acceptable in the arm's length price (also called the parameter price). As a result, the tax administration does not need to perform complex comparability analyses. The profit margins are determined by taking into account the economic sector, line of business or, even more specifically, according to the kind of goods or services dealt with (UN Manual, 2017: 372). Current legislation sets forth different fixed margins per economic sector.[6]

Benefits of the Fixed-Margins Approach for Developing Countries

Researchers have noted the benefits of Brazil's fixed-margins approach, which are listed below:

Simplicity: Determining the arm's length price through the fixed-margins approach is a much more manageable task than performing resource-intensive and expensive case-by-case comparability analyses. This approach is easy for both taxpayers and tax authorities to use (Valadao and Lopes, 2013). It requires less technical skill than performing a traditional comparability analysis. It also eliminates the need for the tax authority to access expensive databases, lessening their financial burden.

This does not mean, however, that calculating the transfer price under the fixed-margins method is a straightforward task. The costs to which the fixed margins are applied must still be determined by the tax authorities. This requires data from the other related parties, its providers, third parties, and in some instances from MNCs that may have similar transactions in a public database. However, this process is still simpler than the conventional comparability analysis.

Predictability: Under the fixed-margins method, the rules for determining the transfer price are clear to both taxpayers and the tax authorities, and thus, predictable.

Transparency: The process is also transparent, which is a key element for promoting investment in developing countries. In situations where there is weak tax administration there is a greater need for clear and transparent rules, such as fixed margins, in order to leave no room for corruption. Sundaram has stated that, 'as long as fixed margins are transparent and "scientific" in their formulation and operation, and genuinely seek to determine prevailing market margins, they provide a more flexible, real world response to what constitutes an arm's-length price' (Sundaram, 2015: 17).

Certainty: Evidence has shown that, in sharp contrast with the traditional approach, Brazil's fixed-margins approach results in very few legal disputes between taxpayers and the tax authorities, thereby removing the need for expert staff applying subjective judgments susceptible to corruption (Picciotto, 2017: 11). As a result, this approach provides certainty to both taxpayers and the tax authorities.

Tax collection: Experts believe that Brazil's fixed-margins approach is helping to protect the Brazilian tax base (Schoueri and Galendi Júnior, 2017: 193). Ilarraz has said that it could strengthen the taxing rights of developing countries (Ilarraz, 2014: 218). A criticism of the approach, however, is that it focuses primarily on minimum taxable profit (Lang et al., 2008: 111 spéc. p. 128). This could be considered a disadvantage of the approach since only a minimum of tax revenue would be collected. However, ensuring a guaranteed minimum of tax revenue is a realistic goal for developing countries that have limited capacity and resources with which to perform transfer pricing audits. According to Valadao and Lopes (2013: 40), the approach is also low cost, which is a benefit for tax administrations that cannot afford to run audits under the conventional framework.

Difficulties in Its Application and Other Criticisms of Brazil's Fixed-Margins Approach

Other research has identified certain criticisms of Brazil's fixed-margins approach, which are listed below.

Lack of justification and transparency in setting the margins: Setting the profit margins for prices requires information on how MNCs operate and on market conditions. Brazilian law provides for discussion between the taxpayers and the tax administration on the applicable rates for each specific industry. However, details on the preliminary steps or studies that Brazil undertook in determining their fixed-margin rates are not publicly known. The United Nations Practical Manual can be useful here as it provides general guidance for countries considering adopting the fixed-margins approach, including pricing research from existing public databases (UN Manual 2017: D.1.9. at 543–545).

Rigidity of the fixed margins: Another difficulty may arise in a situation where an MNC engages in activities in more than one of the categories specified by the law. Brazilian legislation emphasizes that the applicable margins are those corresponding to the activity sector in which the imported goods are intended for use. However, an MNC's operations may be complex. This poses a challenge for tax authorities determining the real use of the goods within the structure of the MNC. Use of an incorrect margin may constitute a new means of profit shifting. For example, a company importing pharmaceutical chemicals can charge a 40 percent margin, and another company importing chemical products can charge a 30 percent margin; in such a situation a company may have an incentive to use a lower margin to reduce its tax obligation.

Risk of double taxation: Another criticism of the fixed-margins approach is that it was adopted somewhat unilaterally without adequate consultation with other countries in which Brazilian subsidiaries might have had business activities. As a result, MNC profits could be taxed twice, if, for example, the other country refused to make the correlative adjustment. For this reason, introducing this approach unilaterally may raise issues as it may make the country appear less attractive for foreign investment. Where multiple jurisdictions are concerned, coordination between countries would be judicious in order to balance the need to attract investment and collect tax revenue. Weak tax administrations may consider adopting the fixed-margin approach on a multilateral or bilateral basis if it is feasible.

Brazil's Accession to the OECD and the End of the Fixed-Margins Approach

By way of Decree No. 9,920, of July 18, 2019, the Brazilian government announced its intention to join the OECD. In this respect, the OECD and the Brazilian Tax Administration issued a statement deciding that the Brazilian transfer pricing rules would be fully aligned with the OECD transfer pricing rules (OECD and RFB, 2019). This decision will override some of the positive features of the Brazilian transfer pricing approach (Schoueri, 2019). Going forward, the fixed-margin approach may be less attractive for developing countries that aspire to join the OECD but may still have merit as a methodology.

3.2 Argentina's Sixth Method

In 2003, the Sixth Method was introduced in Argentina by Art. 15 of the Income Tax Act (as amended by Act No. 25,063). Argentina's Sixth Method is essentially a version of the Comparable Uncontrolled Price transfer pricing method, which compares the price charged for property transferred in a controlled transaction (a transaction between related parties) to the price charged for property transferred in a comparable uncontrolled transaction (a transaction between unrelated parties) in comparable circumstances. 'If there is any difference between the two prices, this may indicate that the conditions of the commercial and financial relations of the associated enterprises are not at arm's length, and that the price in the uncontrolled transaction may need to be substituted for the price in the controlled transaction' (IBFD, 2016: 59).

The Sixth Method is targeted specifically at the commodities industry and is also referred to as the 'Commodity Rules'. In Argentina, commodity transactions include grain, oilseed, and other crops, petroleum and their derivatives, and, in general, goods with a known price in transparent markets. The adoption of Argentina's Sixth Method was triggered by the government's perception that the commodities industry was involved in aggressive transfer price manipulation (Baistrocchi, 2017: 102). Argentina's tax authority observed that subsidiaries in Argentina traded raw materials for low prices to their related parties in countries with lower tax rates, which resulted in very low taxes paid in Argentina (Baistrocchi and Roxan, 2012).

The Sixth Method specifies that the transfer price must be determined according to the publicly quoted price in the transparent market, on the date of shipment of the goods traded. To obtain pricing information on goods, the Sixth Method requires the use of public databases.[7] These databases are freely available to the public, so neither taxpayers nor tax authorities have to pay expensive subscription fees for access to private databases. In fact, use of private databases is not allowed under the Sixth Method. The Sixth Method also specifies that the price used must be that on the date of shipment of the goods in question. This makes it difficult to report a fake transfer price as the tax administration can check the date of shipment with the customs administration. If the date of transaction were used instead, for example, the parties could report a date with a more favorable price in order to engage in profit shifting.

Benefits of the Sixth Method for Developing Countries

The Sixth Method is a very popular transfer pricing method, which is especially appropriate for developing countries as many of them are commodity dependent. It has been adopted in numerous countries in Latin America, including Uruguay, Ecuador, Mexico, Peru, Guatemala, Honduras, the Dominican Republic, and Brazil; African countries including Zambia, and Eastern European countries, such as Ukraine. However, each country's domestic legislation may have its own peculiarities. The Sixth Method has been officially recognized as an accepted method by several international organizations including the IMF, the OECD, the UN and the World Bank Group (The Platform for Collaboration on Tax, 2017). As a result, this method is considered compatible with the international transfer pricing rules. Below are additional advantages of the Sixth Method.

Predictability: Transfer prices derived through application of the Sixth Method are predictable, because the list of databases that must be referred to are indicated in the tax law; it is clear for both tax authorities and taxpayers that they should refer to the same databases to obtain the benchmark prices. An additional benefit of having a limited list of databases specified in the tax law is the reduced administrative burden on tax authorities, who do not have unlimited time to search for pricing information in all existing databases. This also reduces the chances of a contested outcome of transfer prices by the tax authority as well as by the taxpayers.

Less likelihood for asymmetry of information: Since the taxpayer and tax authority must use the same databases, this ensures that there is symmetry of information between the MNCs, which are capable of accessing many expensive private databases, and the tax administrations, which are resource constrained.

Reduced financial burden on tax authorities: Publicly available databases eliminate the need for subscription fees required for private databases. This is extremely important for developing country tax authorities, as access to the private databases is costly while access to the public databases is free.

Difficulties in Application and Other Criticisms of the Sixth Method

The Sixth Method also has disadvantages, as described below.

Limited scope: A downside of the Sixth Method is that it is limited to the commodity industry only. In addition to commodities, developing country economies are also composed in large part by services such as insurance, telecommunications, and so on. The Sixth Method would therefore not cover all transfer pricing cases faced by developing country tax authorities but still address quite a few.

Lack of pricing information: Another difficulty may arise if the reference prices of commodities do not exist in the public market. This can happen, for example, if a commodity is very specific to one country. There are two versions of this problem. First, if there is no pricing information in the public databases at all, then the Sixth Method will not be applicable. Alternatively, if there is pricing information in the public databases but it does not match the existing market conditions, then a price adjustment will be required. This in turn makes the process more complex and expensive, as additional information will be needed, undermining the advantages of the Sixth Method. This difficulty arises particularly with respect to the specificity of certain minerals. A study for minerals carried out in 2013 reported that: 'at first glance, one might think that the identification of comparable transactions is easy in the mining sector because some minerals are listed on world markets (such as the London Metal Exchange (LME) or Platts). In reality, the price of ore is not necessarily the determining factor' (Charlet et al., 2013: 527).

Lack of clear guidelines: Although Argentinian law allows for comparability adjustments, there are no formal procedures for how this additional analysis should be conducted. The process can therefore benefit from additional clarity and transparency. Increased transparency regarding the price adjustment process would therefore be an improvement to the Sixth Method as currently implemented in Argentina.

3.3 India's Safe Harbor Rules

According to the Indian government, calculating arm's length prices had led to an increasing number of disputes between MNCs and the Indian Revenue Service (Income Tax Act, 1961).[8] As a result, India introduced safe harbor provisions into its legislation in 2009. These rules specify 'circumstances in which the tax authority shall accept the transfer price declared by the taxpayers' in order to reduce litigation (India Income Tax Act, Section 92CB).[9] When the profits reported by the qualifying taxpayers fall within a certain range or under a certain amount, the taxpayer is not required to engage in any complex transfer pricing analyses (UN, 2017: B.1.7.6).

India's Income Tax Law specifies the eligibility criteria for taxpayers who wish to take advantage of the safe harbor.[10] Eligible taxpayers are those engaged in low-risk operations, in specified sectors. In effect, it applies to taxpayers who do not perform most of the economically significant operations, have no ownership rights on any intangibles, do not supply funds, and actually do not control the underlying activity.

The safe harbor is elective, so that taxpayers must opt-in to the regime by requesting to be certified as eligible by the tax authority. The tax authority must approve the characterization of sectors (Rule 10TC) and verify that the operation does not involve 'significant risk' (Rule 10TB). Once certified, the normal audit process does not apply and eligible taxpayers are entitled to have their declared operating profit margin accepted if it complies with the specified minimum for their sector: 20% for software development, IT enabled services; 25% for knowledge process outsourcing; and 12% for core or 8.5% for non-core auto component manufacturing, etc. (Income Tax Rules, Rule 10TD).

Benefits of Safe Harbors for Developing Countries

Safe harbor rules for transfer pricing have many benefits. There is broad consensus that they bring certainty, predictability, and simplicity to the transfer pricing assessment process (Lang et al. 2008: 128).

Ease of use and administrability: Safe harbor methods can reduce administrative burdens, offer predictability to both MNCs and revenue authorities, reduce litigation and help boost foreign direct investment (Mehta and Siu, 2016: 344). For these reasons, safe harbors should be seen as a practical alternative to conventional transfer pricing assessments (Krishnamurthy, 2014: 47).

Informational advantage: India's safe harbor rules are beneficial for tax authorities for several reasons. Under India's safe harbor rules, taxpayers must continue to provide transfer pricing documentation. This documentation is very valuable for tax administrations as it can help tax administrators gain experience and build capacity in analyzing transfer pricing documentation and in understanding MNCs' tax-related strategies, and finally, can constitute a potential source of information that could be used for risk assessment when undertaking future audits. In this way, the tax authorities will be better able to identify transfer pricing abuses by MNCs.

The OECD agrees that safe harbors reduce the need for comparable data, and they propose use of them in their Transfer Pricing Guidelines (OECD, 2014: para. 26).[11] However, India's safe harbor rules differ from the OECD's proposal in various respects: the OECD recommends implementing safe harbors on a bilateral or multilateral basis whereas India has implemented them unilaterally. In addition, the OECD's safe harbor rules provide for Mutual Agreement Procedure (MAP) proceedings for resolving conflicts under tax treaties, whereas India's safe harbor rules deny access to MAP for taxpayers. Finally, the OECD recommends that the documentation normally required from MNCs be dispensed with when the taxpayer opts for using the safe harbor, whereas India requires that MNCs still maintain and provide their documentation as discussed above.

Difficulties with India's Safe Harbor Rules

Despite the benefits of safe harbors, it should be noted that critics have argued that India's safe harbors have not found favor with all taxpayers (Picciotto, 2018: 36). Below are some of the criticisms from the practitioners in the field.

Unilateral measure: Unilateral implementation of safe harbors may result in unrelieved double taxation of MNCs, which may undermine their attractiveness. Coordination on safe harbor rules between countries, therefore, is recommended. The 'Maquiladoras regime' adopted in Mexico can be cited as the best example of a bilateral safe harbor between the Mexico Tax Administration Service and the US Internal Revenue Service (Picciotto, 2018: 38).

Limited scope: The safe harbors recommended by the OECD and in India are targeted only at low-risk activities. The reason for this was to relieve both taxpayers and tax auditors from focusing on low-risk activities and to re-direct resources to higher-risk activities. However, limiting the application of safe harbors to only low-risk transactions poses two distinct practical problems for developing countries. First, it requires tax administrations to make clear distinctions between high-risk and low-risk activities. Critics have argued that this may be a difficult and confusing task as there are no precise definitions on what constitutes a low or high-risk activity, and making such a distinction would require sound technical understanding of the eligible taxpayers' business activities. Second, in responses to a survey conducted by the European Union, tax administrations in ECOWAS countries[12] have stated that their transfer pricing challenges apply to both high- and low-risk activities, and thus, safe harbors could be useful for both. The study concluded that: 'in view of the particular difficulties faced by ECOWAS

Member Countries, it might be appropriate to consider safe harbour rules that could apply to transactions other than low-risk transactions, provided that such a regime is sufficiently well designed to limit the potential loss of revenue' (Charlet et al., 2017).

Potential for abuse: A downside of safe harbors is the possibility of abuse, which happens when transactions that would otherwise have been concluded at lower prices are priced at the limit of the safe harbor. An example of such abuse is 'breaking down what is in reality a large transaction into several smaller ones' in order to fall within the safe harbor (OECD, 2013b). There may be a distortionary impact in that such a regime may encourage and perpetuate an economy based on small-scale or low-risk transactions rather than higher-risk/higher-reward transactions to which the safe harbors will not apply (UN Manual, 2017: B.8.8.5).

For the practical implementation modalities of safe harbors, the UN Practical Manual on Transfer Pricing for Developing Countries and the Handbook on Transfer Pricing and Developing Economies by the World Bank Group (World Bank Group, 2016) could be very helpful in designing tailor-made solutions.

3.4 *Mexico's Dictamen Fiscal Rule*

Mexico's Dictamen Fiscal Rule is not a transfer pricing methodology, and thus does not replace the arm's length approach. Even so, this rule can help tax authorities with the important task of collecting business data with which it conducts transfer pricing audits. This could be relevant for the tax administrations of developing countries in terms of improving their ability to collect data themselves and may also improve their understanding of MNCs' tax planning strategies.

Mexico's Dictamen Fiscal Rule is part of the tax statutes in the Mexican Federal Tax Code (Mex. Income Tax Law, Article 76-IX). It is a two-level process to help prevent transfer pricing abuses by MNCs. The first level involves the taxpayer, and the second level involves a registered and certified public accountant (Mehta and Siu, 2016: 349).

First, the law requires taxpayers to prepare special transfer pricing documentation called an 'information return', proving that all transactions entered into with foreign-based related parties are at arm's length prices. It stipulates that all corporate taxpayers engaged in business activities must file an information return regarding international related-party transactions. The information return consists of three basic kinds of information confirming that the company (1) meets the arm's length standard on all transfer pricing transactions; (2) has done a transfer pricing study, has documentation on all major transactions, and that it has been verified by outside opinion; (3) has, for all transfer pricing transactions above $1 million, information on who the company is trading with, location of affiliates, why, and so on.

Secondly, the Dictamen Fiscal Rule requires that a registered and certified public accountant attest that the information return satisfies the requirements of the Dictamen (in Article 54 of the Federal Fiscal Code) and that the information provided conforms with the current transfer pricing rules in Mexico. The accountant must issue a report called the Statutory Tax Audited Report, along with a tax certification. Specifically, 'the accountant's report must indicate that the taxpayer's transactions were made at arm's length, include the transfer pricing methods, list any transfer pricing adjustments and advance pricing agreements, and confirm the existence of transfer pricing documentation' (World Bank Group, 2016: 239). Additionally, a specific transfer pricing questionnaire containing general information and knowledge about the MNC's operations must also be completed and filed with the report. In addition, the accountant is required to disclose in their report the failure of the taxpayer to comply with the requirements: 'According to the Dictamen, the certified public accountant shall identify and shall disclose non-compliant taxpayers. In fact, non-compliant taxpayers to the Dictamen requirements should be subject to a transfer pricing audit' (Article 52 of the Federal Fiscal Code).

The Dictamen requirements have been taken very seriously by the Mexican government. They have established tough sanctions for failure to comply with the Dictamen's provisions, for both accountants as well as for the taxpayers. Sanctions against non-compliant taxpayers include fines, a non-allowance on deductibility of payment, or a risk of being audited. This disincentive helps make the rules more effective. Sanctions against non-compliant accountants range from a warrant, a reprimand, a suspension, or even a definitive cancellation of their registration (Article 57 of the Federal Fiscal Code), depending on the severity of the case. These provisions are designed so that the accountant takes responsibility for the MNC's compliance with their transfer pricing obligations, including disclosure of non-compliant taxpayers.

Benefits of the Dictamen Fiscal Rule for Developing Countries

Mexico's Dictamen Fiscal has many benefits. Below are a few identified in the literature.

Risk assessment and compliance: According to Mehta and Siu (2016), 'disclosure rules that require attestation by senior corporate officers and verification by independent public accountants provide an important risk assessment function for tax administrations and also encourage taxpayer compliance'. The public accountant's disclosure therefore helps the tax authorities identify cases that should be subject to audit.

Additional accountability: A public accountant is a professional with the capacity and experience to verify taxpayer compliance with tax obligations. Their work is in effect like a preliminary transfer pricing audit carried out on behalf of the tax administration. López states that it also minimizes the cost of transfer pricing audits (López, 2009). In addition, this specific verification mechanism may improve and incentivize automatic compliance of the taxpayers. The process could therefore enhance the fiscal discipline of MNCs, as well as provide reduced audit-risk as well as confidence for compliant taxpayers.

Informational advantage: Furthermore, the documentation that the tax authorities receive from the taxpayers and the public certified accountant will allow them to gradually enhance data collection and strengthen their knowledge of MNC's business activities. For example, the documentation may reveal the methods used for pricing intra-group transactions. In addition to using this information as a basis for transfer pricing audits, they can develop a deeper understanding of transfer pricing in particular, and MNC transactions in general.

Finally, Mexico's Tax Administration Service reported that the Dictamen Fiscal Rule has had a positive impact in reducing transfer pricing abuses by MNCs in Mexico (García Gálvez and Salazar Díaz, 2014). This approach can be very useful for developing country tax administrations, given their limited resources, especially in comparison with those of the companies that are being audited for potential transfer pricing abuse.

Difficulties in the Application of the Dictamen Fiscal Rule

The major criticism that could be made of the Dictamen Fiscal Rule is that it puts a significant burden upon the tax authorities, since they still have to review all documentation submitted to them and make a judgment on compliance. In this case, the additional administrative costs relating to gathering the requested information should be assessed to evaluate whether this will lead to further benefits for the tax authority.

4. A Long-term Strategy: Unitary Taxation with Formulary Apportionment

In the preceding sections, several innovations by developing country governments have been presented as short-term strategies to ameliorate the challenges of applying transfer pricing rules. What follows is a brief discussion on a longer-term approach to allocating profits and tax rights among jurisdictions.

4.1 *Unitary Taxation*

The unitary approach, which groups MNC affiliates together as a single firm, has been proposed since the 1980s as an alternative to the separate entity approach for determining tax liabilities within a MNC (Langbein, 1986; Picciotto, 2013). It uses a formula to divide up profits among jurisdictions where the MNC operates, based on factors of economic activity, such as sales, assets, or employees in each jurisdiction. The challenge for this approach is to identify the most relevant factors and their respective weights in determining economic activity.

This approach has been gaining increased support from stakeholders, which would hopefully have significant impact for the reform of the corporate taxation system (Government of India, Central Board of Direct Taxes, 2019; Faccio et al., 2018; Ocampo et al., 2015). Moreover, existing regional adoptions of a unitary approach and/or fractional apportionment among various US states, Canadian provinces, and Swiss cantons demonstrate that it can provide effective protection against base erosion (Siu et al., 2014). The European Union has proposed a unitary approach with formulary apportionment in the Common Consolidated Corporate Tax Base (CCCTB) based on formulary apportionment (European Commission, 2011 updated in 2016). Negotiations have again stalled, but the OECD has now taken up the discussion in its work on the digitalization of the economy (OECD, 2019). The government of India has recently proposed a worldwide unitary taxation to attribution of profits to 'permanent establishments' (Government of India, Central Board of Direct Taxes, 2019). The proposal supports formulary apportionment on a model similar to the EU's CCCTB. But it suggests that an immediate shift is possible to 'fractional apportionment', using local revenues as the starting point rather than global consolidated accounts, and adding a fourth apportionment factor to reflect users/data for highly digitalized business models. Developing countries also could explore a formulary apportionment approach in a progressive way, beginning with implementation within a regional organization (for example, within the ECOWAS region, etc.).

Unitary taxation is the right solution for tax administrations in developing countries for various reasons. Unitary taxation is superior to the arm's length principle because it recognizes that the multinational enterprise is a single entity. The first advantage is that there is no fiction. This fiction potentially can be very problematic in developing countries because 'pretending' related entities are independent enterprises leads to many technical complexities. The implementation of this fiction is expensive. Furthermore, transfer prices obtained by the tax authorities can be countered by multinationals that are well equipped, and have access to the advice of well-trained and well-paid lawyers.

Unitary taxation is an improvement over the current transfer pricing policies for the tax authorities who want to tax a subsidiary operating in their jurisdiction. For an auditor within the tax administration, it is often preferable to have a consolidated global account that provides visibility of the overall profitability of the multinational corporation. The system of unitary taxation meets this objective, since as a first step it requires global consolidation of the group's profit. In a second step, unitary taxation provides for the distribution of the profits among the stakeholders on the basis of a predefined formula. This allocation of the taxable base between jurisdictions uses objective and verifiable factors of production such as sales, payroll, and assets.

5. Conclusion

This chapter has argued that developing countries are disadvantaged in their ability to perform transfer pricing audits to make sure they are receiving the right amount of tax due to them. This chapter has proposed several short-term strategies that developing countries can use to make the arm's length approach more workable: Argentina's Sixth Method, Brazil's fixed-margins method, India's safe harbor rules, and Mexico's Dictamen Fiscal Rules. These are all attractive alternatives for developing country tax administrations, which are constrained in terms of resources and capacity.

For all methods, it is advised that their interpretation and application be clearly specified in domestic tax legislation to ease implementation and ensure legal certainty. It is also important to remember that for the tax administration, the objective should be to strike the right balance between maintaining the attractiveness of investments and protecting the tax base against transfer pricing abuse. These are opposing objectives that can best be reconciled through a process that is deemed fair and equitable by both sides.

Beyond the general recommendations made in this chapter, it is also necessary to underline that more in-depth analysis might be required to take into account the specific economic context of each country. For example, for the fixed-margin or safe harbor approaches, the margins threshold must be designed with the interests of both the taxpayers and the tax administration in mind. Finally, it should also be noted that taking any of the approaches outlined above must be considered as a short-term strategy. The benefits of these simplified approaches are clear and evident: they are easier and less expensive for the tax authorities to implement, while at the same time increase certainty for the taxpayer. However, these measures have their own limitations too. First, while they result in a guaranteed minimum of tax revenue, they may also result in forgone tax revenue. Second, they cannot capture all potential instances of transfer pricing abuses. Further, in many of the cases discussed, they are often imposed unilaterally, without coordination between countries, and without satisfactory exchange of information. In such cases, these measures cannot overcome the asymmetry of information between MNCs and tax administrations for which we need a longer-term solution.

For these reasons, it is important that developed and developing countries work within the OECD and the United Nations to seek a fairer mechanism for the longer term. In this respect, unitary taxation with formulary apportionment persists as the best way forward as a long-term solution. Both developed and developing countries should be treated equitably, and profits should be properly taxed where economic activity occurs. This is the fundamental basis of taxation and an objective that should be pursued.

Notes

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2 For fuller discussions of transfer pricing challenges faced by tax administrations in developing countries and the imbalance of forces and capacities, see Lennard (2014) and Hofmann and Riedel (2018).
3 For a comprehensive history on the origins of transfer pricing rules, see Picciotto (2016).
4 Very recent studies proposing some ways to simplify transfer pricing methodologies for tax administrations in developing countries are Picciotto (2018) and Faccio et al. (2018).
5 At the time of writing (August 2019), Brazil is not yet a member of the OECD and is not bound by the OECD's transfer pricing guidelines until its accession to the OECD (see Schoueri, 2019).
6 It may seem as if using different margins across industries is unfair. However, the different profit margins reflect the ability of different activities to generate varying levels of profit. For example, the profit margins for services are higher than the profit margins for the distribution of goods. In line with this, the UN Manual on Transfer Pricing asserts that, 'countries may establish different profit margins per economic sector, line of business or even more specifically according to the kind of goods or services' (see UN 2017, D.1.9).
7 Argentinian law provides an exhaustive list of the international public databases that taxpayers and tax authorities should refer to in order to determine the arm's length price. The World Economic Outlook (WEO) database reported by the International Monetary Fund is a well-known and online public database, which contains average monthly/annual data on commodity prices around the world. See: www.imf.org/.
8 In 2012, India had the third largest stock of transfer pricing disputes (E&Y, 2014). A digest of tax court decisions published by an Indian advocate contained 2,000 cases for the year 2017 alone, 1,200 of which concerned transfer pricing (Lala, 2018).
9 Finance Bill, 2001 introduced TP regulations to the income Tax Act, 1961, in section 92A to 92F. The law was operationalized using Rules 10A to 10E of the income tax rules, 1962. Section 92CB of the Income Tax Act as introduced with effect from April 1, 2009, has introduced the provisions of safe harbor rules. No rules have been notified as yet until 2012 (S92CB of Income Tax Act, 1961 and Rules 10TA to Rules 10TG).
10 Income Tax Rules, Rule 10TB, 10TC provide details on these criteria.
11 For details, see OECD (2013b), OECD's Revised Section E on Safe Harbours in Chapter IV of the Transfer Pricing Guidelines. This is a newer position for the OECD, who in their 1979 Report made no recommendations for safe harbors and claimed that they may be arbitrary.
12 ECOWAS countries: Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone, and Togo.

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3 | INTERNATIONAL TAX COMPETITION, HARMFUL TAX PRACTICES AND THE 'RACE TO THE BOTTOM': A SPECIAL FOCUS ON UNSTRATEGIC TAX INCENTIVES IN AFRICA

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Executive Summary

Countries often adopt competitive tax policies to encourage foreign investment or discourage the exodus of investments. However, the tax policies that countries adopt may result in harmful tax competition if they affect another country's tax polices, by forcing them to adopt lower tax rates to remain competitive. This 'race to the bottom' can ultimately drive applicable tax rates to zero for all countries. In addressing this problem, the OECD BEPS Project concentrated on harmful tax practices by preferential tax regimes. In Africa, the harmful tax practice that leads to the race to the bottom is the granting of unstrategic tax incentives to foreign investors in the hopes of encouraging foreign direct investment. This chapter discusses the fiscal challenges of granting unstrategic tax incentives at the domestic level and their harmful internal and external implications. Recommendations are offered to ensure the efficiency and effectiveness of domestic tax incentives by improving their design, transparency, and administration. Recommendations are also offered to prevent the race to the bottom at international level by encouraging tax coordination at the regional level.

1. Introduction

Countries compete with one another in a number of ways. They can for instance compete for economic activities by offering different mixes of security of ownership, access to resources, regulatory climates, and demands on investors (Morriss and Moberg, 2012: 5).

Tax competition is one form of state competition (G20 Development Working Group, 2015: 29). Since states are sovereign jurisdictions that have a right to determine their own tax policy, they can adopt competitive tax policies by which they lure economic activity away from other countries, for example by lowering fiscal burdens (through tax cuts, tax breaks, or tax subsidies) to either encourage the inflow of productive resources or discourage the exodus of those resources (Morriss and Moberg, 2012: 9).

Tax competition might not be bad if, for example, it counters a political bias towards excessive public expenditure or where it counters governments' tendency to overtax and ensures that tax rates are kept at optimum levels (G20 Development Working Group, 2015: 29). However, the tax policies and tax choices a country adopts can result in harmful tax competition if they affect another country's ability to choose how to tax and expend resources on behalf of its citizens. This is especially so when governments engage in 'tax wars' by competing with one another to offer the lowest tax rates so as to attract economic activity to their country. The resultant harmful tax practices undermine the sovereignty of all countries involved by forcing them to adopt lower tax rates to remain competitive. The underlying policy concern is that such harmful tax practices can lead to a 'race to the bottom', which can ultimately drive applicable tax rates to zero for all countries, whether or not this is the tax policy any country wished to pursue (OECD/G20, 2015 Action 5: 23). This ultimately impacts the fiscal economic development of all the countries in the region (Herzfeld, 2017: 284).

Concerns about harmful tax practices were brought to the forefront in 1998 when the OECD issued a Report on 'Harmful Tax Competition' (OECD, 1998b), in which it pointed out that harmful tax practices are encouraged, firstly, by jurisdictions that actively market themselves as secretive tax havens for the avoidance of taxes that would have been due in other countries (OECD, 1987: 20; Ginsberg, 1997: 5–6; Roper and Ware, 2000: 5). Secondly, harmful tax practices occur when governments form preferential tax regimes to encourage investments to their country by levying no or low effective tax rates on income, even if this leads to the depletion of other countries' tax bases (OECD, 1998b: para. 75).

When the OECD issued its 2013 Action Plan to curtail 'base erosion and profit shifting' (BEPS), it reiterated that harmful tax practices by preferential tax regimes are among the causes of BEPS which stimulate a race to the bottom and deplete other countries' tax bases.

However, in Africa, the pertinent harmful tax practice that leads to the race to the bottom and self-imposed tax base erosion, is the granting of unstrategic tax incentives that are not well designed or planned to suit the economic needs of the country, but instead are granted to foreign investors in the hopes of encouraging foreign direct investment (FDI). This matter is not addressed in the BEPS Project, but is the main focus of this chapter.

The focus of this chapter is on investment tax incentives that relate to corporate income tax. This excludes tax incentives related to indirect taxes such as sales taxes, value added taxes or other trade tariffs; and grants, in-kind benefits, or loan guarantees, which could mimic the effects of tax incentives, but are usually designed differently and subject to different governance procedures. The chapter also includes a discussion of tax exemptions (whereby a taxpayer is excluded from tax or where certain types of income are excluded from tax subject to certain conditions), which also undermine revenue collection and tax fairness in African countries, complicate tax systems, and open the door to political interference and corruption (Culpeper and Bhushan, 2010).

This chapter explains the fiscal impact of granting unstrategic tax incentives at the domestic level and their harmful internal and external implications. Recommendations are offered to ensure the efficiency and effectiveness of domestic tax incentives by improving their design, transparency, and administration. At the international level, the chapter provides recommendations to prevent the race to the bottom by encouraging tax coordination among countries in the same region.

2. Historical Background: The OECD Work on Curtailing Harmful Tax Practices

As noted above, the OECD 1998 Report on harmful tax competition pointed out that harmful tax practices can be encouraged by tax haven jurisdictions and harmful preferential tax regimes (OECD, 1998b: para. 75). The Report noted that tax haven jurisdictions are characterized by: high levels of secrecy in the banking and commercial sectors and lack of effective exchange of information with other governments (OECD, 1998b: para. 79). The Report further noted that preferential tax regimes, which often occur in (otherwise) high-tax jurisdictions, are characterized by: imposition of low or no taxes on corporate income; the presence of *ring-fencing*[1] from the domestic economy; lack of transparency; and no effective exchange of information (OECD, 1998b: para. 75). Over the years, the OECD's initiative has been successful in promoting transparency and exchange of information by tax haven jurisdictions, but it has generally failed to address harmful tax practices by preferential tax regimes (Herzfeld, 2014). In its 1998 Report the OECD highlighted eight factors to determine whether a preferential tax regime is harmful. These are cases where a regime: has an artificial tax base, in that the level of commercial activities in the country is not commensurate with the revenue raised; fails to adhere to international transfer pricing principles; exempts foreign source income from taxation; permits negotiation with individual taxpayers on the tax rate that would be applicable to them; has high levels of secrecy in the banking and commercial sectors; has a wide network of tax treaties which encourages abuse of tax treaties negotiated with other countries; promotes tax minimization schemes; and encourages business operations or arrangements that are purely tax driven and involve no substantial commercial activities (OECD, 1998b: para. 89).

In addressing preferential tax regimes, the OECD excluded countries with holding company regimes, which encourage setting up 'holding companies' to own the controlling shares in one or more related companies located in other jurisdictions. Although the OECD's review of holding company regimes in its member countries in 2000 concluded that holding company regimes may create harmful tax competition, it reached no conclusions on their status as potentially harmful preferential regimes (OECD, 2000: para. 12). This finding encouraged many OECD member countries to adopt holding company regimes that have over the years encouraged harmful tax competition. Meanwhile multinational companies (MNCs) exploited the situation by engaging in tax avoidance schemes to shift profits out of their subsidiary companies in other jurisdictions to the holding companies in the preferential tax regimes where little or no substantive economic activity was performed (Olivier and Honiball, 2011: 689). The OECD contends that these harmful tax practices contribute to what it refers to as 'base erosion and profit shifting' (BEPS) (OECD, 2013: 5). For a long time, countries' tax authorities have known about the harmful tax practices encouraged by these regimes but there was no political will to address the problem. Faced with budgetary deficits after the 2007/2008 global financial crisis, the G20 at their 2012 Summit called upon the OECD to address the matter (G20 Leaders' Declaration, 2012). Thus in 2013 the OECD issued an Action Plan to address BEPS, and in 2015 it sought to curtail BEPS through a consensus package of 15 Actions to better align the location of taxable profits with the location of economic activities and value creation (OECD, 2013: 7).

In Action 5 the OECD recognizes the continued relevance of the underlying policy concerns that the 1998 Report expressed regarding the race to the bottom by preferential tax regimes and acknowledges overlooking one important criterion for identifying preferential tax regimes that was pointed out in the 1998 Harmful Tax Competition Report, namely 'lack of economic substance' by preferential tax regimes. BEPS Action 5 requires countries with preferential tax regimes (for example, intellectual property regimes, holding company regimes, shipping company regimes, financing and leasing regimes, headquarter company regimes, fund management regimes, banking and insurance regimes) to ensure that investors in such regimes carry out substantial business activities (core income-generating activities) (OECD/G20, 2015: 37–39) and that such countries improve transparency, including compulsory and spontaneous exchange of tax rulings related to preferential tax regimes (OECD/G20, 2015: 45).

Concerns about the harmful tax practices of preferential tax regimes exist not only in OECD countries, or in developed countries at large. Some African countries, such as Botswana, Liberia, Mauritius, and South Africa also feature such regimes that encourage harmful tax practices and impact other countries' tax bases. Since 2010, the OECD Global Forum has been reviewing these preferential regimes (OECD/G20, 2015: 64), but the reviews do not address the preferential tax regimes as these regimes were assessed by the Global Forum before the substantial activity requirement in Action 5 of the BEPS Report was developed. Thus, they may need to undergo additional review and possible amendment of certain regime features. However African countries with regimes such as the above are very hesitant to adopt the OECD recommendations because doing so would reduce the competiveness of their economies in attracting badly needed FDI.

For example Mauritius has a headquarter company regime under which foreign investors can set up Global Business corporations with Global Business Licenses (GBL), which are very popular as headquarter companies (Oleynic, 2006: 43). South Africa has a headquarter company regime which is intended to make South Africa a gateway for foreign investment into Africa (section 9I of Income Tax 59 of 1962; Olivier and Honiball, 2011: 844). Botswana has a holding company regime intended to foster the creation of intermediary holding companies and establish Botswana as 'a world class hub for cross border financial and business services into the rest of Africa' (Botswana International Financial Services Centre, 2009/10: 3). Liberia also has a Shipping Registry regime that is recognized globally as the most tax-effective offshore corporate registry in the world (Doggart, 1990: 53; The Africa Report, 2016; OGSY, 2017). Since 2010, OECD has been reviewing these regimes.[2]

3. The Pertinent Harmful Tax Practice in Africa: Granting Unstrategic Tax Incentives

In most African countries, preferential tax regimes are less of a problem since most are high-tax countries. Instead, the most important concern for African countries is the granting of unstrategic tax incentives. In this race to the bottom, governments compete with one another to adopt tax incentives that will attract foreign investors to their country rather than to other countries in the region (Easson, 2004: 1–2; Hines, 2001: 40). Often, the pressure to offer incentives stems from an awareness of those offered by other countries. Many tax incentives granted by African countries are unstrategic as they are not well designed or planned to suit the economic needs of the country. This results in spillover effects that impact other countries' tax bases and pose base erosion risks (Easson, 2004: 1–2; Hines, 2001: 40). Despite these tax base erosion risks, such tax incentives are not part of the OECD BEPS Project. Instead, this matter was dealt with by the G20 Development Working Group in conjunction with the OECD, the IMF, and the World Bank in the form of 'toolkits', which are essentially a side project intended to assist low-capacity developing economies in addressing BEPS concerns that are of priority to them (G20 Development Working Group, 2015: 6).

Tax incentives have been defined as 'any tax provision granted to a qualified investment project that represents a favorable deviation from the provisions applicable to investment projects in general' (G20 Development Working Group, 2015: 7). A tax incentive can be present in a country's tax code if there are provisions that result in tax not being levied or tax being levied at a reduced tax rate. Tax incentives take several forms, including, for example: tax free zones (designated areas in which specified businesses are exempt from customs duties and other indirect taxes); tax holidays (complete exemption from tax for a limited duration); and preferential tax rates (reduced tax rates or tax credits for certain investment expenditures) (G20 Development Working Group, 2015: 8). Provisions granting tax incentives are prevalent in the tax codes of most countries all over the world. They differ in regard to the type of tax incentives used. High-income countries tend to rely more on granting tax credits for investment and favorable tax treatment of research and development; middle-income countries rely more on offering preferential tax zones (where favorable treatment applies to investments in the zones); and low-income countries rely more on offering tax holidays and reduced tax rates (G20 Development Working Group, 2015: 8). Ultimately, the choice of incentives depends on the economic development needs of the countries concerned.

The primary motivation for granting tax incentives is to stimulate investment by attracting FDI, which often contributes to a country's overall economic development. Indeed, some empirical studies have found positive correlations between inward FDI and economic growth, even though conclusions about causality remain contentious (Adams, 2009: 939–949). Tax incentives have been noted to promote specific economic sectors or certain types of activities as part of an industrial development strategy or to address regional development needs (G20 Development Working Group, 2015: 6). The resultant FDI inflows can yield various social benefits, such as capital injection, job creation, knowledge and technology transfer, new management practices, and increase in the efficiency of domestic markets (Bwala, 2006). Studies have found, for instance, significant knowledge transfers from foreign to local firms as well as other positive spillovers on domestic firms that supply or purchase products from the foreign entity (G20 Development Working Group, 2015: 14–15; Harrison and Rodríguez-Clare, 2010; Javorcik, 2004).

The granting of tax incentives is a sovereign right of nations, which are free to determine their own economic and fiscal policies.

Even though a country may want to raise taxes to invest in infrastructure and to fund the provision of government services, it may also want to design its fiscal policies to attract FDI that would ensure economic development and thereby create jobs, increase know-how, and improve access to its natural resources. A country may therefore use its tax code to attract FDI in designated development areas by strategically granting tax incentives to foreign investors to develop certain development projects in specific sectors of the economy, thus giving up tax revenue maximization for the sake of achieving those developmental objectives.

The granting of tax incentives must, however, be done strategically, because tax incentives can narrow a country's tax base and result in corporate income tax revenue losses (IMF, 2008; Redonda, 2016: 2). Thus, a strategic tax incentive is one that is effective in contributing to a country's economic development and in improving living conditions for its citizens (G20 Development Working Group, 2015: 9). This is the case if the tax incentive results in new job creation and boosts productivity that spills over in the domestic economy (IMF, 2008: 8). In addition, a tax incentive is considered strategic if its governance is efficient in ensuring that the revenue forgone is commensurate with the developmental objectives envisaged. When granting tax incentives, countries should understand that the public revenue forgone as a consequence of the tax incentives is in fact an implied tax expenditure.

On the other hand, tax incentives are unstrategic when they are inefficient and counterproductive, that is, when their costs exceed the social benefits or the benefit is simply not worth the cost (G20 Development Working Group, 2015: 9). This is the case when a nation gives up more revenue than is necessary for achieving some development objectives or when the same development objectives could have been achieved with a smaller revenue sacrifice. The following are some of the indicators that a tax incentive is unstrategic and inefficient:

Tax incentives that do not result in sufficient FDI: Tax incentives are not worthwhile when the incentive attracts little investment. Even though some empirical studies on the relationship between effective tax burdens and FDI generally conclude that host country taxation significantly affects investment (De Mooij and Ederveen, 2008), these studies refer mainly to investments in developed countries.

In developing countries, the effect of tax on investment is generally smaller (James and Van Parys, 2009; Abbas and Klemm, 2013). This is because, when making investment decisions, investors not only place emphasis on a country's tax system, but they also consider a country's economic and institutional situation, such as infrastructure, policy uncertainty, and political stability, before large-scale investments are made (OECD, 1995: 19). Tax incentives on their own cannot overcome these negative factors in some developing countries. In addition, general features of the tax system (e.g., the tax base and tax rates) are more important than tax incentives (Holland and Vann, 1998: 986; Brooks, 2008–2009: 508).

Redundant tax incentives: Granting tax incentives can be unstrategic if the investor would have invested without the offer of the tax incentive, which makes such a tax incentive redundant (G20 Development Working Group, 2015: Executive Summary). A tax incentive can also be rendered unstrategic when it is targeted at new investors, but is sought by businesses outside the target group (OECD Tax and Development, 2013: 2).

Tax incentives that distort resource allocation: Although tax incentives act as a tool for encouraging FDI, a tax incentive can be unstrategic if it creates a competitive disadvantage for non-incentivized sectors. Where labor and capital are diverted to incentivized firms in response to discriminatory tax treatment, this can distort the allocation of resources and can hurt economic growth (G20 Development Working Group, 2015: 19; UN, 2018: 4).

Where the costs of administering the tax incentive outweigh the advantages: If a country grants a tax incentive, resources are required to ensure that businesses comply with the requirements of granting that tax incentive (IMF, 2008: para. 15). Where labor and various expenses become costly compared to the advantages the tax incentive was expected to provide, the tax incentive may be quite unstrategic considering the revenue already forgone. These administrative costs are especially pertinent in developing countries where administrative capacity is often limited and scarce resources might be diverted away from core aspects of a country's tax administration (G20 Development Working Group, 2015: 16).

Tax incentives that discourage domestic investment: A tax incentive can be unstrategic if is granted to foreign investors in a certain field, but not domestic investors in a similar field. This gives foreign investors competitive advantages over small and medium enterprises that operate at the domestic level (Klemm and Parys, 2012). In response, domestic investors may resort to abusing the tax incentive regime. For example, local firms may use foreign entities to route their local investments in order to qualify.

Tax incentives can encourage tax abuse: A tax incentive is unstrategic if it creates unintended tax planning opportunities leading to further revenue leakages. This could be the case where the tax incentive enables opportunities for profits and deductions to be artificially shifted across entities with different tax treatment either domestically or internationally (OECD Tax and Development, 2013: 2). Similarly, a tax incentive is unstrategic if it results in rent-seeking, corruption, and other undesirable abusive activities (Klemm and Parys, 2012).

From the above, it can be concluded that a tax incentive is unstrategic if:

(i) the tax incentive is poorly designed (so that its benefits could be gained at lower cost or more benefits at the same cost); or
(ii) the tax incentive results in tax loss beyond that which was intended (for example, it provides tax planning opportunities); or
(iii) the tax incentive is unnecessary (for example, redundant tax incentives).

4. Factors Leading to Unstrategic Tax Incentives

Unstrategic tax incentives result from numerous factors that can impact their effectiveness. Those factors include the following:

Lack of basic information on current tax incentives in place: In some cases, there is no readily available information on the lists of tax incentives or the identity of the beneficiaries (OECD Tax and Development, 2013: 2).

Lack of cost–benefit analysis of tax incentives: Unstrategic tax incentives are often granted based on inadequate analysis of their costs and benefits in a national context to support government decision making (OECD Tax and Development, 2013: 2).

Governance issues: Tax incentives may be unstrategic if they are granted outside of a country's tax laws, if they are administered under multiple pieces of legislation, or if they are administered by different ministries that do not coordinate their incentive measures with one another or with the national revenue authority. This may result in governance overlap, inconsistency in administrative measures, and even ministries working at cross-purposes (OECD Tax and Development, 2013: 2).

The assumption that foreign investors can only get relief from taxes through tax incentives: Host country tax incentives are not the only way to give foreign investors relief from tax as MNCs are still able to get tax relief by avoiding host country taxes (G20 Development Working Group, 2015: 14). Investment can also be encouraged through other means, such as direct subsidies (for example, to support research and development) which provide a financial benefit rather than relief from tax (Busom et al., 2013).

Tax sparing provisions in tax treaties: Because most African countries employ the territorial system of taxation, in that only income derived within their territory is taxable, the benefit of the tax incentives they offer to foreign investors may be limited; for example, if such countries have entered into double taxation treaties with developed countries that employ the worldwide system of taxation to tax their residents. To prevent double taxation, most developed countries grant their residents a tax credit for foreign taxes paid. If no foreign taxes were paid because of a tax incentive granted by the country in which the investment is made, the investor loses the benefit of the tax credit and may have to pay the tax that would have been paid to the host country but for the incentive to the home country. This implies that the incentive-granting country essentially donates some of its potential tax revenues to the investor's home country. To prevent this, developing countries often insist on tax sparing provisions in their treaties (UN, 2013: 35) which require the investor's country of residence to allow residents to retain the advantages of tax incentives provided by those countries, by essentially sparing the taxation of foreign source income of such resident (Oguttu, 2011; Hines, 2001: 40).

The push to include tax sparing provisions in tax treaties can, however, intensify the granting of unstrategic tax incentives by developing countries as they position themselves to attract FDI (G20 Development Working Group, 2015: 32). Tax sparing can also provide significant scope for transfer pricing, round tripping,[3] and treaty shopping,[4] both in the country of the investor and in the country of the investment (Arnold and McIntyre, 2002: 53). Tax sparing inevitably results in the direct loss of revenue from the forgone tax. In practice, developing countries often have to make concessions to obtain tax sparing. They are, for instance, forced to grant developed countries favorable withholding taxes in the source country (OECD, 1998a: 21–30; Owens and Fensby, 1998). To prevent this kind of tax abuse, the 1998 OECD Report on Tax Sparing sets out several recommendations that have been included in the OECD Model Tax Convention on Income and on Capital (OECD, 1998a: 35–36).

Tax incentives in bilateral investment agreements: A bilateral investment treaty (BIT) is a treaty between two states that protects investments by investors of one state in the other state (Vandevelde, 2000). Tax incentives in BITs vary widely in form and there is no standard template for them. Although BITs often exclude tax matters, the 'most favored nation clause'[5] (Dolzer and Schreuer, 2008) in BITs might unintentionally accord benefits to other taxpayers not originally intended to benefit from the tax incentive. Moreover, protections under the BIT, such as stabilization clauses, which insulate the investment project from adverse changes to the legal and fiscal environment (Mann, 2011), may make it hard to withdraw the tax incentive when it no longer serves the original purpose, or may require compensation not otherwise payable. The other concern is that BITs can open up opportunities to shop for forums to resolve tax-related disputes. This was a cause of concern in the Uganda case of *Heritage and Gas Limited v Uganda Revenue Authority* (Tax Appeals Tribunal Tax Application No 26/2010) which was based on double taxation issues. After losing the case, the taxpayer decided to seek resolution of the tax dispute under the BIT which has an arbitration clause (unlike the case in the double tax treaty). The case was taken for arbitration to London under the United Nations Commission on International Trade Law, which deals with investment disputes and was decided in favor of Uganda (*Tullow Uganda Ltd v Heritage Oil and Gas Ltd, Heritage Oil plc* [2013] EWHC 1656 (Comm)). These issues are best considered in collaboration with those responsible for negotiating the investment treaties (G20 Development Working Group, 2015: 32).

5. Addressing Unstrategic Tax Incentives at the Domestic Level

A number of academic papers have been written about the ineffectiveness and inefficiency of tax incentives and the associated abuse and corruption (Zee et al., 2002). They have recommended reform of tax incentive regimes by removing unstrategic tax incentives or improving their design, transparency, and administration. Yet there has been reluctance to scale back incentives. Instead there has been a tendency for them to proliferate, as there are usually various vested interests, political inertia, and tax competition with other countries involved (G20 Development Working Group, 2015: 6). The granting of tax incentives is not driven by tax considerations alone or by well-articulated economic concerns aimed at improving the wellbeing of citizens. They are also driven by political motivations (G20 Development Working Group, 2015: 28). For instance, politicians may find it attractive to introduce new tax incentives to reveal their proactive stance in addressing weak economic performance, or to favor particular regions. Vested interests in certain tax incentives by businesses and some government officials may also make it difficult to have such incentives repealed, even if they may be ineffective (G20 Development Working Group, 2015: 28). Businesses often influence the governance and design of tax incentives to suit their objectives, and they often become powerful lobbyists who can capture the political process to resist change (Moe, 2005). It is also much easier for corrupt officials to steal government funds through tax incentives 'under the radar' rather than through excessive government expenditures that can be easily detected.

In 2011, the IMF, OECD, UN, and World Bank stated in their joint report to the G20 that there was a need to support effective tax systems in developing countries to ensure efficient and effective use of tax incentives for investment (IMF et al., 2011). Consequently, in 2015, the G20 Development Working Group in conjunction with the OECD, the IMF, and the World Bank, published a 'Toolkit for

Tax incentives' (G20 Development Working Group, 2015: 6) which can prevent the granting of unstrategic tax incentives. The toolkit sets out the following guidance for the design and governance of tax incentives and recommendations to prevent the spillover effects of tax incentives that lead to a race to the bottom in an international context (G20 Development Working Group, 2015: 6).

5.1 Guidance on the Design of Tax Incentives

The design of tax incentives is critical to their effectiveness and efficiency. The G20 Development Working Group recommends that policies relating to tax incentives should involve four core design issues:

The choice of tax instrument to incentivize investment: There are various tax instruments that can be used to grant a tax incentive. This can include the use of a wide range of taxes, such as corporate income tax, VAT, tariffs, property taxes, personal income taxes, and social contributions (IMF, 2008: para. 3).

A country may also have to choose between cost-based and profit-based tax incentives. Cost-based tax incentives involve specific allowances linked to investment expenses, such as accelerated depreciation schemes and special tax deductions and credits. They are targeted at lowering the cost of capital, thus ensuring that investment projects are more profitable at the margin thereby encouraging investments that would not otherwise have been made. Profit-based tax incentives, in contrast, generally reduce the tax rate applicable to taxable income. Examples include tax holidays, preferential tax rates, or income exemptions. In general, profit-based tax incentives are less effective at encouraging investment as compared to cost-based tax incentives. With a profit-based incentive, the investor will benefit only if it makes a profit, whereas with a cost-based incentive, the investor will benefit no matter what. A cost-based incentive provides important downside protection by reducing the amount of money the investor needs to put at risk.

Depending on the context, each type of incentive can be highly effective or redundant. Investments that are highly mobile, for example, intangible assets such as patents or trademarks, may be sensitive to both cost-based and profit-based tax incentives (G20 Development Working Group, 2015: 20). On the other hand, profit-based tax incentives offered for investments based on the presence of location-specific factors, such as natural resources, tend to be associated with high redundancy rates. In this case, government revenue is forgone in order to increase the profitability of investment projects that, in many cases, would have been undertaken even without the incentive.

Eligibility criteria used in the selection of qualified investments: Developing criteria to select investments helps identify the types of investment that a government seeks to attract and reduce the fiscal cost of incentives. The selection can be based on the size of the investment, the sector of investment or the region, or special zone in which the investment takes place (G20 Development Working Group, 2015: 23).

Provisions to monitor life-cycle of investments: After their approval, the tax administration should continue monitoring investments throughout their life-cycle stages. This matter is often neglected in many countries (G20 Development Working Group, 2015: 23). It is important that taxpayers be required to file a tax return so that the authorities can assess the revenue cost of the incentive. Tax authorities should periodically carry out audits to ensure that tax incentives are not abused and that the conditions attached to them are actually fulfilled (G20 Development Working Group, 2015: 23).

Sunset provisions: Making tax incentives temporary rather than permanent provides for a natural point of evaluation, ensuring a periodic reconsideration of whether the incentive should be continued, reformed, or repealed (US Department of the Treasury, 2010).

5.2 *Guidance on the Governance of Tax Incentives*

Governments' decisions about tax incentives, their policies, and administration must be transparent and subject to scrutiny and evaluation to ensure accountability for actions taken. This would limit the scope for corruption, strengthen the trust of investors in government, and enhance the confidence of the public in the tax system (G20 Development Working Group, 2015: 23). The G20 Development Working Group recommends the following key requirements for good governance of tax incentives:

The awarding and monitoring of incentives should be guided by the rule of law: Two general approaches are applied in the administration of tax incentives: a rules-based system and a discretionary system. Under a rules-based system, the decisions about whom, under what conditions, and in what form to provide incentives are based on statutory provisions. Under a discretionary system, the incentives are granted on an ad hoc basis by government agencies and officials. It is recommended that a rules-based system be adopted, as this limits the room for misuse and corruption (IMF, 2008: para. 34). This implies that tax incentives must be approved by the legislature with appropriate parliamentary and public scrutiny. To ensure transparency and accountability, tax incentives must be consolidated into the main body of the tax law and not spread out in multiple pieces of legislation that are outside the tax laws. The law should specify the criteria and conditions that the taxpayer must satisfy to qualify for a tax incentive.

Transparency of tax incentives: Transparency is fundamental to empowering all stakeholders (the legislature, businesses, civil society, and the public at large) with information about tax incentive policies, so they can hold government accountable for its decisions (Neubig and Rodenda, 2017). It is important that transparency be created along the following three dimensions. Firstly, there should be legal transparency, in that tax incentives should have a statutory basis in relevant tax laws (Nierum, 2011). Secondly, there should be economic transparency, in that the rationale for tax incentives should be clearly spelled out to enable a public debate on the country's policy priorities. Thirdly, there should be administrative transparency, so that the criteria for qualifying for incentives are clear, simple, and specific, so as to reduce the discretion of officials that grant the incentives (G20 Development Working Group, 2015: 24).

Coordination of agencies granting tax incentives: It is critical that the ministries and agencies involved in the granting of tax incentives coordinate their activities. Such ministries include the Ministry of Finance, Agriculture, Tourism, or Mining, as well as investment promotion agencies. These different stakeholders often bring specific expertise that can be useful in the design of tax incentives, but they usually have different objectives. For instance, investment promotion agencies often support tax incentives in order to attract investors but they have little direct concern for the revenue consequences (Amegashie, 2011). The Ministry of Finance, in contrast, ensures that the revenue needs of the country are taken into consideration. The ultimate and sole authority to enact tax incentives at the national level should therefore be with the Minister of Finance as they are best placed to weigh the different priorities while also keeping an eye on the cost of the incentives (G20 Development Working Group, 2015: 27).

The administration of tax incentives: The G20 Development Working Group recommends that revenue administrations should be in charge of the implementation and enforcement of tax incentive schemes as they have the unique authority, expertise, and experience necessary for the execution of the tax law of which incentives should be part (G20 Development Working Group, 2015: 28).

5.3 Examples of Measures Taken in Some African Countries to Reform Unstrategic Tax Incentives

Efforts to reform unstrategic tax incentives typically come up against political economy arguments in favor of free-market economies and the convenience of tax breaks as a policy lever. There are, however, a few examples of African countries that have successfully reformed unstrategic tax incentives over the years.

In 2005, Egypt enacted a provision in its income tax law to phase out tax holidays while grandfathering current beneficiaries (Keen and Mansour, 2010: 578).

In 2006, Mauritius unified the tax rules relating to its export processing zone companies with the rules relating to other sectors; by removing all provisions relating to tax credits and tax holidays but it retained a four-year income tax holiday for small business. Alongside these changes, the corporate tax rate was gradually reduced from 25 to 15 percent in 2008 (Keen and Mansour, 2010: 560).

In 2012, Senegal adopted a comprehensive tax reform with tighter administrative measures that streamlined the tax system and led to a significant rollback of unstrategic tax incentives and exemptions. Senegal either abolished or consolidated the tax incentives it had in about 17 laws in its General Tax Code. This significantly improved transparency of the tax system (G20 Development Working Group, 2015: 26).

In 2013, Algeria modified its tax incentives relating to natural resources, introducing some and abolishing others. 'It introduced tax incentives to encourage investments in unconventional oil and gas activities and in the exploration of offshore oil fields, complex geological deposits, small deposits and fields situated in less explored areas. At the same time, it abolished the 50% income tax rate reduction which mining companies established in the cities of Illizi, Tindouf, Adrar and Tamanghasset were entitled to' (IBFD, 2014: 6).

In 2013, although Senegal introduced a concession of 50 percent reduction in the taxable base for enterprises that export at least 80 percent of their production or services, this incentive is not available to the extractive industry sector. This measure was taken to prevent the reduction of the revenue base from this sector (IBFD, 2014: 6).

The above examples show that if there is political will, it is possible for countries to roll back their unstrategic tax incentives.

6. Addressing the Impact of All Tax Incentives at the International Level: Harmful Tax Competition and the Race to the Bottom

Unstrategic tax incentives create negative fiscal implications at the domestic level, as we have seen. But even strategic tax incentives, as well as unstrategic ones, have harmful implications at the international level that can lead to a race to the bottom and cause spillover effects in other counties. Often this translates into governments perceiving that investors would choose neighboring countries in which to invest, thus triggering strategic reactions to offer similar policies. Given the competitive reaction of other countries and the disposition of investors to invest in countries that offer such incentives, providing a tax incentive may appear to be the optimal strategy for a country to follow. But, as in the 'prisoner's dilemma', such apparently optimal conduct may be collectively self-defeating by fueling a 'race to the bottom', in which all countries forgo tax revenues without any meaningful gain in investment (OECD, 2014). The race to the bottom is evident among special regimes in Africa, where effective tax rates have fallen to almost zero in industries where special regimes are in place (Abbas and Klemm, 2013).

Even though a strategic tax incentive may be successful at the domestic level, the tax incentive may cause more overall loss than gain. Thus, even if one country could be better off if it alone provided certain strategic tax incentives, all relevant countries would be better off if none of them provides tax incentives than if all of them do. The ideal solution to ensure economic development for all countries in the region is for them to think collectively in the way they shape their tax codes and the design of their tax incentives. This collective approach will ensure that countries in the region do not introduce tax incentives whose costs for the whole region exceed the benefits for the country providing them. The collective approach would ensure that if the countries in the region chose to introduce tax incentives, these would be designed to ensure the attraction of capital, the creation of jobs, gaining know-how, accessing natural resources, and the development of infrastructure in the region as a whole.

It is important to note that the adverse effects of tax incentives are not only limited to countries in a given region but they can have broader global effects that can have negative effects on developing countries in general. The IMF has for long warned about the pervasiveness of tax incentives in developing countries due to the spillover reaction to tax policies of other countries outside their given region (IMF, 2008: 7). At the UN Third International Conference on Financing for Development in Addis Ababa in July 2015, national leaders noted that although tax incentives can be an appropriate policy tool, ameliorating their negative impact requires multilateral dialogue in regional and international forums to prevent resultant harmful tax competition (UN, 2015: para. 27).

6.1 Tax Coordination

To resolve the collective action problems that emanate from tax incentives at the domestic level and their harmful impact at international level, tax coordination and cooperation among states is needed so that they reach agreement not to engage in a 'race to the bottom'. The G20 Development Working Group asserts that tax coordination offers opportunities to address the harmful spillover effects that tax competition is likely to cause under uncoordinated tax design (G20 Development Working Group, 2015: 2). Tax coordination can take the form of countries agreeing on a non-binding code of conduct not to use certain tax incentives, such as tax holidays. Tax coordination can also take the form of a common legislative framework regarding certain tax incentives (G20 Development Working Group, 2015: 31) or the form of cooperation among producers of specific natural resources (G20 Development Working Group, 2015: 30).

Regional tax cooperation and coordination occurs in Africa through several economic communities. A discussion of these groups follows.

East African Community (EAC): In 1999, the EAC, comprising Kenya, Tanzania, and Uganda, was formed by treaty, followed in February 2005 by the EAC Customs Union (IMF, 2008). Since then, EAC members have made gradual progress in harmonizing their corporate tax rates, though there has not been much progress in the harmonization of investment incentives.

Over the years, the EAC countries have expanded their investment incentives. Tanzania has been increasing its number of special economic zones (IMF, 2008: para. 22) and Kenya continues to provide tax holidays to companies operating in its export processing zones (secured territories in which a special tax regime and other conditions are applied to companies operating there) (IMF, 2008: para. 14). Even though Uganda eliminated tax holidays in 1997 (IMF, 2008: 6), it is under pressure to establish its own export processing zones and to provide more generous incentives to investors to match the investment incentives provided by Kenya and Tanzania (IMF, 2008: 8). There is also increased pressure for tax holidays in EAC countries in response to competition for foreign investment from non-EAC countries. The increased competition over FDI and growing pressure to provide tax holidays and other investment incentives to attract investors could result in a race to the bottom that would eventually hurt all three EAC members (IMF, 2008: 8).

In 2008, the IMF recommended that a coordinated approach to providing tax incentives should become a priority in the EAC (IMF, 2008: para. 32). To facilitate closer regional economic integration and to prevent the damaging uncoordinated contest to attract foreign investors, the EAC members should seek closer coordination of investment and tax policies. The IMF also recommended that the EAC countries agree on a Code of Conduct for Investment Incentives and Company Income Taxation. Such a Code could provide a framework for consultation and coordination, it could place limits on what kinds of investment incentives could be offered, and it could incorporate standard guarantees to investors, including the freedom to invest, nondiscrimination, repatriation, and limited expropriation (IMF, 2008: para. 34).

A Code of Conduct Against Harmful Tax Competition for the EAC was subsequently drafted but has not yet been adopted as the signatures required for the code to enter into force have been pending for years, possibly for political reasons. In 2016 the Tax Justice Network (Tax Justice Network, 2016) called on the EAC to accelerate the harmonization of its tax legislation by ratifying the East African Code of Conduct on Harmful Tax Competition.

West African Economic and Monetary Union (WEAMU): In the WEAMU, considerable effort has been made to set up a structure to tackle tax competition by issuing directives that limit the applicable tax rates that countries can use. Coordination of investment incentives has also been pursued in the WEAMU (IMF, 2008: para. 26). The coordination framework has led to some convergence of countries' tax systems, and in turn to positive revenue effects in WAEMU Member States.

However, there are large gaps between *de jure* and *de facto* coordination, as WAEMU has failed to provide its Member States with the necessary resources to undertake effective surveillance, which has led to ineffective enforcement and has undermined the credibility of coordination. In fact, the framework allows for unfettered tax competition so long as this is done outside the countries' main tax laws. This has made their tax systems opaque, has increased complexity and has contributed to a culture of tax negotiation (Mansour and Rota-Graziosi, 2013).

South African Development Community (SADC): The SADC aims to reduce and ultimately to eliminate tax competition that damages the region's revenue mobilization efforts. The SADC Protocol on Finance and Investment provides for cooperation and coordination of legislation pertaining to tax incentives so that the economic policies of Member States are not prejudiced (SADC, 2002).

In terms of the SADC 'Memorandum of Understanding on Cooperation in Taxation and Related Matters' (the MOU), which was entered into in 2002 (SADC, 2002), Member States committed themselves to preventing harmful tax competition in the region. They came up with measures to ensure coordination and cooperation so that tax incentives would not encourage harmful tax competition in the region and to address the negative consequences of tax incentives. In terms of Article 4(3) of the MOU, Member States committed to ensuring that in the treatment and application of tax incentives, they will avoid harmful tax competition as may be evidenced by the following: zero or low effective rates of tax; lack of transparency; lack of effective exchange of information; restricting tax incentives to particular tax payers such as non-residents; promotion of tax incentives as vehicles for tax minimization; or tax incentives in the absence of substantial activity in the jurisdiction. Member States also committed not to introduce tax legislation that prejudices another Member State's economic policies, activities, or the regional mobility of goods, services, capital, or labor.

Under Article 4(1) of the MOU, Member States are committed to endeavor to achieve a common approach to the treatment and application of tax incentives and will, among other things, ensure that tax incentives are provided for only in tax legislation. Many Member States have passed similar Investment Acts that offer specific tax incentives and have signed mutually beneficial agreements that lighten taxation on businesses (SADC, 2017). This has encouraged cooperation among these states which allows the SADC region to promote the integrated region (not specific countries) as attractive for investment. This in turn provides investors with confidence in the SADC region as a whole.

However, with increasing international trade, many SADC Member States have bilateral tax agreements with other nations inside and outside the SADC region which may create situations where one Member State unknowingly creates a tax regime that could be to the detriment of development in another state. For this reason, the SADC MOU advises all SADC member countries to agree collectively on a Model Tax Agreement that acts as a common policy for dealing with international partners. Member States have also agreed to ensure that information is widely available on the SADC Database and Information Portal in order to avoid unintended tax inequities (SADC Database, 2017).

6.2 Challenges that Tax Coordination in Regional Agreements May Present

It is acknowledged that tax coordination has proven difficult in practice for many regional groupings. Negotiating and implementing an agreement on tax coordination takes a lot of effort and time. And it requires an effective supranational monitoring framework as well as strong enforcement institutions, both of which are lacking in many African regional groupings.

Since the international race to the bottom results from granting both strategic and unstrategic domestic tax incentives, to ensure effective tax coordination, the G20 Development Working Group recommends that countries could first start with modest forms of coordination; for instance, by learning from each other on best national policies for distinguishing been strategic and unstrategic tax incentives, by agreeing on a common framework for reporting tax incentives, and information exchange to encourage mutual learning. This could enhance transparency and governance practices, and enable future assessment of tax incentives (G20 Development Working Group, 2015: 32).

Where regional tax coordination is limited in scope and scale, it may induce tax competition in other respects (G20 Development Working Group, 2015: 30). Tax coordination among countries in a region can intensify tax competition with outsiders who become the beneficiaries. If coordination is too limited in regional scope, the tax base of the participating countries can become more vulnerable to pressures from outside jurisdictions with lower taxes (Keen, 2001).

It also needs to be recognized that harmonization of tax and investment incentives is not a panacea and that other conditions – such as adequate infrastructure and a good business climate – must be in place to promote strong investment and economic growth (IMF, 2008: 6).

7. Conclusions and Recommendations

Although the granting of national tax incentives is often a matter of political decision pursuant to each country's sovereign right to determine its fiscal policy, it is important to ensure that fiscal policy in Africa does not promote unstrategic tax incentives that result in eroding a country's own tax base. There is considerable scope at the domestic level to improve the effectiveness and efficiency of tax incentives, to improve the design of tax incentives, and to strengthen their governance. There is a need to undertake more systematic evaluations of tax incentives by carrying out an analysis of their costs and benefits and by publishing an annual tax expenditure review of tax incentives as part of the budgetary process (G20 Development Working Group, 2015: 33).

At the international level, granting tax incentives can result in a race to the bottom, but this can be curtailed if countries coordinate their tax incentive policies regionally, so as to mitigate the negative spillovers from tax competition. Africa's relatively low intra-regional trade integration remains an important obstacle to faster growth. Therefore, regional bodies need to make sure that the potential benefits of a closer regional integration are not undermined by lack of cooperation on tax incentive policies (IMF, 2008: para. 38).

Notes

1 The term 'ring-fencing' refers to the use of artificial demarcations that restrict or ignore the application of tax rules to certain transactions (which are inside the ring fence). See Olivier and Honiball (2011: 579).

2 In 2011, Mauritius' headquater company was subject to the OECD Global Forum Peer Review process on transparency and exchange of information in tax matters. See OECD *Peer Review Report of Mauritius – Combined Phase 1 + Phase 2* (2011). The Second Supplementary Peer Review conducted in 2014 concluded that Mauritius was largely compliant with the standard of exchange of information on request. See OECD *Second Supplementary Peer Review Report Combined Phase 1 + Phase 2: Mauritius* (2014). In 2012, South Africa's headquater company regime was subject to the OECD's Global Forum Peer Review process and was cited as a reliable and cooperative partner with respect to exchange of information in tax matters. See OECD *Peer Review Report: Combined Phase 1 +Phase 2 – South Africa* (2012) para. 10. In 2010, Botswana holding company regime was subject to the OECD Global Forum Peer Review process. See OECD *Peer Review Report of Botswana – Phase 1: Legal and Regulatory Framework* (2010). The 2016 review found Botswana to be largely compliant with the international standard exchange of information. See OECD *Global Forum on Transparency and Exchange of Information for Tax Purposes Peer Reviews: Botswana* (2016). In 2012, Liberia's Shipping Registry was subject to the OECD's Global Forum Peer Review, in which it was required to address concerns regarding ownership and identity information as well as its accounting records. Since then, Liberia has signed tax information exchange agreements with a number of jurisdictions. See OECD *Supplementary Peer Review Report – Phase 1 Liberia* (2016).

3 This is a tax avoidance scheme which involves the transfer of funds between or among parties, which directly or indirectly results in a tax benefit and significantly reduces, offsets, or eliminates any business risk incurred by any party.

4 The use of double tax treaties by the residents of a non-treaty country in order to obtain treaty benefits that are not supposed to be available to them.

5 Under a 'most favored nation' clause, one contracting state (the state receiving investments) is obliged to give investors or investments from the other contracting state (the sending state) no less favorable treatment than it grants to investors or investment from third countries.

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4 | TAXING DIGITALIZED COMPANIES: OPTIONS FOR AFRICAN COUNTRIES

Mustapha Ndajiwo[1]

Executive Summary

Digitalization of businesses is happening very rapidly in Africa, but the current international tax rules are not adequate to ensure that they are taxed in a fair way that is fit for the modern economy and the digital age. Africa needs to participate more actively in the design of the policies that will govern taxation and not leave it to the OECD and G20 countries to mandate the guidelines.

African countries can also learn from other country approaches to taxing digitalized businesses. India has introduced a new nexus rule in the form of significant economic presence, a fractional apportionment model, and an equalization levy, all in an attempt to tax the income made by digitalized companies with activities in India. This model can be explored by African countries while taking into consideration their own context. The important thing is that African countries not wait for the OECD and the Inclusive Framework to reach a consensus on how to tax the digitalized economy.

This chapter proposes that African countries chart their own course by considering three options. African countries can explore adopting treaty provisions based on Article 5.3.b, Article 7, and Article 12A of the UN Model Convention, using the fractional apportionment method for allocation of taxable profits, and interpreting the nexus rules without the requirement of physical presence. African countries also have the option of strengthening their source rules by adopting nexus and profit allocation provisions that are not limited by physical presence and are based on fractional apportionment. Lastly, African countries can continue the discussion under the Inclusive Framework work while exploring the aforementioned options.

JEL CODES: O3, O17, H5 & F5

KEYWORDS: Taxation, Digitalized Business, Africa, Digitalized Economy, Nexus, Permanent Establishment, Source Rules and Profit Allocation

1. Introduction

African countries often find it difficult to raise corporate income tax revenues due to challenges such as a largely cash-based economy and weak legal and tax administration capacity. The advent of digitalization has worsened this problem, making it more difficult for African countries to effectively and efficiently mobilize enough revenues to fund development. Digitalization, which can be described as the use of the internet and online means to conduct transactions and business, has brought about increased efficiency, fewer barriers to entry into markets, and room for innovation to thrive in the way trade and investment is conducted. These improvements, however, also come with new tax challenges for African countries because the rules governing cross-border taxation were designed before the advent of digitalization.

The two central challenges facing taxation of the digitalized economy are the issues of nexus and profit allocation (OECD, 2015). Nexus refers to the connection that a taxable legal person (business or individual) has to a country, which gives that country the right to tax it. Profit allocation rules refer to those rules that give a country the right to tax a portion of the profits made by a multinational company, which conducts business in that country, and often these companies may belong to a larger multinational group. Digitalized companies such as Google, Amazon, Uber and Facebook[2] conduct business and supply services to African countries (without necessarily having a physical office or personnel there), raise substantial revenue and profits there, and yet, do not have to pay taxes on the profits because the current nexus and permanent establishment rules contained in the OECD and UN model tax conventions require a 'fixed base', or physical presence in the country before the profits generated there can be taxed.[3]

Secondly, the current rules regarding profit allocation treat multinational companies of the same group as separate entities although they may share common ownership, interest, and control. These rules, in the form of Transfer Pricing[4] Guidelines (OECD, 2017c) have made it possible for multinational companies to move taxable profits from high-tax to low- or no-tax countries, which has led to what is known as base erosion and profit shifting[5] and other harmful tax practices.

There has been a lot of discussion, some unilateral measures, and new proposals on how to overcome these two central challenges, but there has not been a significant response from African countries, even though they experience the same challenges. In fact, the challenge is much more pronounced for African countries, since they rely more heavily on corporate taxation, and raise much less revenue overall relative to more developed countries (Crivelli et al., 2016).

The Challenge Facing Africa

African economies are in need of adequate revenues for development. However, weak tax laws, illicit financial flows,[6] and aggressive tax planning have made it difficult for them to attain their full potential in raising revenue. Furthermore, the advent of technology in the form of digitalized businesses, although having brought tremendous improvement to trade in Africa (International Trade Centre, 2015), comes along with disruptive elements to tax policy. These developments will further hinder the drive to attain sustainable revenue mobilization in Africa. This is attributable, among other things, to the sophistication of information systems, to the lesser need for bricks-and-mortar facilities to conduct business, and to the possibility of doing business in a country even without a physical presence, and hence without a tax presence, in it (OECD, 2015). The challenge of raising corporate taxes becomes even more complicated when digitalized companies operate as multinational groups,[7] spreading structures across different countries through branches and subsidiaries for purposes of profit shifting and tax minimization. It does not help when the countries concerned face the challenges of weak tax administration and the clear asymmetry of information and imbalance of sophistication between the multinational companies and the tax authorities in Africa.

The conundrum birthed by the challenges of taxing the digitalized economy adds to the list of tax-related issues affecting sub-Saharan African countries. For example, the High-Level Panel report on Illicit Financial Flows (IFF) in Africa revealed that 65 percent of illicit financial flows in Africa result from tax evasion, aggressive tax planning, and abusive transfer pricing carried out by multinational companies (AU/ECA, 2014). The implications of these harmful practices can be best understood through the prism of their opportunity cost. For example, according to the African Development Bank (2010), Africa needs an additional $US 50 billion annually to close infrastructure deficits.[8]

In light of the above background, this chapter attempts to address the two central direct tax challenges of digitalization from an African perspective. It proposes that African countries should chart their own course. The chapter explores immediate steps that African countries can take and longer-term measures that would require a global consensus. Consequently, three options are discussed in this chapter: African countries can explore existing treaty provisions under the UN Model, strengthen source rules,[9] or wait for a global consensus at the end of 2020 while exploring the first two options and championing the concept of significant economic presence and fractional apportionment for profit allocation through the OECD/G20 Inclusive Framework.

The second section of this chapter presents the efforts of the OECD/G20 and the Inclusive Framework on the corporate taxation of digitalized businesses. The third section describes unilateral measures and proposals by India, France, and the European Union (EU). The fourth section explores the way forward for African countries and concludes with recommendations.

2. The OECD/G20 and the Inclusive Framework on Base Erosion and Profit Shifting

The Base Erosion and Profit Shifting (BEPS) project was started after the St. Petersburg Declaration (OECD, 2013) and three years later, the OECD/G20 issued its final BEPS report, with the underlying objective that taxes should be paid where income is generated and value is created. The Action 1 Report of the OECD (2015), focused on addressing the tax challenges of the digitalized economy, and analyzed the direct and indirect tax[10] challenges the digital economy poses. The main direct tax challenges identified by the report are the nexus and profit allocation issues. Although a few suggestions on the way forward were discussed, there were no lasting solutions offered. The suggested solutions included a withholding tax on transactions and the concept of significant economic presence. The report concluded that it would be difficult to pursue these options at that stage as it would be difficult to achieve consensus (OECD, 2018).

Nexus and the Permanent Establishment (PE) Problem

The advent of digitalization means that companies participate in the markets of jurisdictions without necessarily having a physical presence there. This is a problem given the current international taxation rules, particularly Article 5 of the OECD Model Tax Convention on Income and Capital (OECD, 2017a, 2017b) and the United Nations Model Double Taxation Convention between Developed and Developing Countries (UN, 2011),[11] because both Conventions provide that there has to be a fixed base in the jurisdiction before it qualifies as a permanent establishment. For this reason, digitalized businesses such as Facebook, Google, and Amazon, which operate in African countries may not have a taxable presence based on the current rules, because their business model does not require being physically present in a country before it can operate. Although there are indications that some plans are on the way, currently, no evidence suggests that African countries have taken any significant measures to address these two central tax challenges arising from digitalization.[12]

Profit Allocation Rules

The current OECD rules on profit allocation, the Transfer Pricing Guidelines, are underpinned by the separate entity principle, which means that companies which are under the same ownership and control within a multinational group will be treated separately from a legal and tax standpoint. Instead of treating the group as one, each subsidiary or related company is treated individually, and this may lead to harmful tax practices which result in base erosion and profit shifting (Picciotto, 2017).

Additionally, companies operating within the same group are expected to transact based on the arm's length principle, which means that even though companies may be related, they should operate as though they are not and transact under real market conditions. Due to conflict of interests and the overall aim of the multinational group to maximize profits, it is wishful thinking that they would ordinarily adhere to the arm's length principle. Based on the experience of many African countries, the Transfer Pricing Guidelines are insufficient to address many harmful tax challenges given that the underlying principle of these rules is unrealistic (Picciotto, 2017).

Comparability analysis is at the core of transfer pricing audits. This analysis is to ensure that transactions carried out between related parties are similar to those under real market conditions. This is often difficult to achieve as data is not easily available to compare the transactions, and in some cases they do not exist. African countries are sometimes forced to source comparable data from developed country databases even though the market conditions may differ significantly (McNair et al., 2010).

Although many African countries have introduced transfer pricing regulations, challenges still exist in the implementation of these rules. To ensure that multinationals are reporting their incomes appropriately, tax authorities carry out analyses of the functions performed, assets employed, and risks undertaken. This requires a significant deployment of resources – both in monetary terms and personnel. This is a particular challenge for African revenue authorities due to the capacity constraints and paucity of resources relative to the big audit firms (Shongwe, 2019). Multinational firms have the resources to employ a plethora of transfer pricing specialists relative to African Revenue Authorities that have very few. Although there has been some help from the Tax Inspectors Without Borders (TIWB) (OECD, 2019e) Initiative,[13] there is still a lot more to be done.

The aforementioned challenges have been exacerbated by the advent of digitalization due to a number of factors. First, Article 7 of both the OECD and UN models, which both concern the attribution of profits rely on Article 5 of both models. However, Article 5 is flawed because it does not capture the digitalized businesses due to its reliance on physical presence as mentioned earlier. Secondly, highly digitalized businesses rely significantly on intangibles to operate their businesses and have used this to their advantage by minimizing taxes through complex structures. For example, Uber has a presence in over 60 countries. Initially, Uber placed its intellectual property in Bermuda, a zero corporate income tax rate country through a scheme termed *Double Dutch* which involves Dutch entities that serve as conduits for profits routed to lower-tax countries, in this case, Bermuda. In Bermuda, Uber receives royalty payments from the countries in which Uber operates at a price largely determined by Uber and pays no taxes on them, whereas in those countries where Uber pays the royalties, the royalties are allowable expenses used to reduce the overall tax liability of the Uber multinational group. In 2019, Uber moved its intellectual property from Bermuda to the Netherlands due to an EU crackdown on tax havens. However, this did not stop Uber from inventing another strategy. In the Netherlands, corporate income tax rate is 25 percent, but taxes on royalty payments are taxed at 7.5 percent. Furthermore, by moving its intellectual property to the Netherlands, Uber created a tax deductible cost of $6.1 billion, which will be used to reduce its tax liability going forward (Bloomberg, 2019).

Another major tax challenge that makes profit allocation difficult due to digitalization is that the concept of value creation has become more complex. The value generated through user participation is not captured and taxed because it focuses only on physical activities. The main challenge with the user contribution is that ascertaining its contribution relies on the location of the user, which can be easily manipulated through the use of virtual private networks.

An alternative to the current transfer pricing guidelines that has been proposed is unitary taxation with formulary apportionment, because it treats the multinational group as a single entity and eliminates the incentive for shifting profits to other related companies in low-tax jurisdictions (Picciotto, 2017). Unitary taxation with a formulary apportionment is not a new concept – it has been practiced at the national level in the US and Swiss Cantons. In fact it has been considered in the EU, as the Common Consolidated Corporate Tax Base (CCCTB) which is restricted to the EU and is voluntary (Picciotto, 2012).

Unitary taxation with formulary apportionment offers a fairer method of profit allocation as it is based on a formula on the economic activities that take place in the jurisdictions where a multinational operates while disregarding tax havens. It requires the filing of a consolidated return in all the countries where the company operates which will increase transparency and reduce the administrative burden due to the availability of information from other jurisdictions. Based on the popular Massachusetts formula, unitary taxation with formulary apportionment considers quantifiable and location-specific factors in the form of sales, tangible assets, and labor (payroll).

Under a unitary tax system, African countries will not need to spend fortunes getting comparable data that may not be necessarily useful. The difficulty experienced by the tax officials of the African revenue authorities will be largely diminished. Unitary taxation with formulary apportionment offers a long-term solution to the challenges facing global taxation. One of the challenges identified with the unitary taxation with formulary apportionment is the global agreement that is required before it can be implemented. For this reason, countries such as India and the EU that have recognized that a formulaic approach to profit allocation is a simpler and fairer method have opted for a fractional apportionment method which is also based on a formula.

The OECD/G20 and Inclusive Framework Efforts to Tax the Digitalized Economy

The Interim Report

After the 2015 Final report on Addressing the Tax Challenges of the Digital Economy the work by the OECD/G20 continued through the Task Force on the Digital Economy (TFDE), and in 2018 the Inclusive Framework released the Interim Report (OECD, 2018). In the report, a detailed analysis of the different business models of digitalization was carried out. However, no lasting solutions were recommended.

Due to the lack of direction from the OECD, many countries, including countries of the G20 and Inclusive Framework, either proposed or went ahead with unilateral measures in an attempt to safeguard their tax base. These jurisdictions include the EU, France, and India. As pressure continued to mount on the Inclusive Framework to produce lasting solutions and the fear that there would be increased lack of coordination internationally, the Inclusive Framework released a technical note in January 2019 to chart a way to the Programme of Work. The technical note acknowledged the deficiency in the arm's length principle[14] and suggested that it may be time to go beyond it (OECD, 2019a). In the past, the OECD had never shown interest in pursuing this approach. This is unprecedented and marks a very significant point in the international tax transformation, but there is still a lot of work to be done. Although the OECD has acknowledged the deficiency of the arm's length principle, it continues to support its usage.

The OECD/Inclusive Framework Public Consultation

Following the OECD/Inclusive Framework Technical Note of February 2019, the Inclusive Framework released a public consultation document to receive inputs from experts and other relevant stakeholders including businesses, civil society, and academia. The consultation received about 200 submissions, which is one of the highest ever received by the OECD and Inclusive Framework. The consultation document put forward three different proposals on how to tax non-resident digitalized businesses. The proposals have the same objective: to identify the value created by economic activity or participation in a jurisdiction that is not recognized under the current transfer pricing rules. The three proposals discussed in the public consultation document are user participation, marketing intangibles, and significant economic presence. The three proposals prioritize allocating taxing rights to market jurisdictions (OECD, 2019b).

The User Participation Proposal is targeted at certain highly digitalized businesses, and the idea behind it is that the continuous engagement and active participation of users is a critical factor for value creation to those businesses. Hence profit will be allocated to the market jurisdiction based on the value created therein as a result of user contributions. (OECD, 2019b). The Marketing Intangibles Proposal is similar to the user participation proposal, and it also involves changing the nexus and profit allocation rules. But whereas the user participation proposal is focused on certain highly digitalized businesses, this proposal is meant to have a wider scope with the aim of responding to the broader impact of digitalization on the economy. 'Marketing intangibles' here means the same thing as an intangible in the transfer pricing guidelines.[15] (OECD, 2019b). Both the User Participation and Marketing Intangibles Proposals envisaged a bifurcation of routine and non-routine profits where the non-routine profits will be allocated to the market jurisdictions.

The Significant Economic Presence Proposal is not new and has been discussed in the Action 1 Report. According to the proposal, a non-resident enterprise is considered to have a taxable presence in any jurisdiction if it has 'significant economic presence on the basis of factors that evidence a purposeful and sustained interaction with the jurisdiction via digital technology and other automated means' (OECD, 2019b: 16). The revenue generated in a sustained manner from a jurisdiction will be the basic factor to determine nexus;

however, it may not achieve nexus if other factors are not considered alongside it. The following factors may, therefore, be considered: user base and user data; the volume of digital content; billing and payment in local currency together with local payment options; maintenance of a website of a local language; delivery responsibility; and marketing, sales, and promotional activities to entice customers.

In terms of profit allocation, the proposal considered a fractional apportionment method for allocating all profits to a significant economic presence. Under this proposal there is no division between residual and routine profits. All three approaches involve (at least in part) a global approach to profit allocation starting from the total profits of a business. Nevertheless, the new rights would work alongside the existing transfer pricing rules (OECD, 2019b).

The Programme of Work

In May 2019, the OECD/G20 and the Inclusive Framework published a Programme of Work to Develop a Consensus Solution to the Tax Challenges Arising from Digitalisation of the Economy, a working document that was aimed at finding a global solution by the end of 2020 (OECD, 2019c). The Programme of Work was developed after receiving comments on the public consultation from over 200 submissions. The Inclusive Framework split the work into two pillars. Pillar One addressing the issue of new taxing rights which focused on new principles to determine profit allocation and nexus rules, while Pillar Two focused on the remaining BEPS issues, particularly the 'race to the bottom'.[16] The main aim of Pillar Two was to devise rules that would allow the resident jurisdiction of a parent company to tax the profits of a subsidiary in any other jurisdictions where they either fail to tax the profits generated therein or where the payment is below a certain threshold.

Three approaches were considered under the new profit allocation rules under Pillar One: a modified residual profit split method, fractional apportionment method,[17] and distribution-based approaches (OECD, 2019c).

New Nexus Rules

Due to the realization that the current nexus and permanent establishment rules have become outdated, the Programme of Work considered basing the new taxing right on the concept of a 'remote taxable presence' which does not require a physical presence. Under the approach, two methods were considered: 'amendments to the definition of a "permanent establishment" in Article 5 of the OECD Model Convention, and potential ensuing changes to Article 7 of the OECD Model Convention; development of a standalone rule establishing a new and separate nexus, either through a new taxable presence or a concept of source' (OECD, 2019c: 18). To achieve this, some factors need to be considered, including a sustained monetary and temporal revenue threshold in the jurisdiction, and other factors alongside the sustained revenue generation that indicate a linkage between the digitalized business and the jurisdiction. These factors should ordinarily go beyond selling in the jurisdiction (OECD, 2019c).

Unified Approach

As a follow up to the public consultation on the Programme of Work, in September 2019, the OECD secretariat released another consultation document called the Secretariat Proposal for a 'Unified Approach' under Pillar One. Unlike the previous proposals, this proposal came from the OECD secretariat and not the Inclusive Framework. According to the OECD secretariat, the Unified Approach takes into consideration the commonalities identified in the three approaches under Pillar One of the Programme of Work. The approach, although it covers highly digitalized businesses, will focus on *consumer-facing* businesses. It offers a new nexus rule without a physical presence requirement, and it considers new profit allocation rules, but retains the arm's length principle.

The approach considers a three tier profit allocation mechanism: the first tier of the mechanism allocates a portion of the deemed residual profit to market jurisdictions based on a formula; the second tier allocates a fixed baseline portion of profit for marketing and distribution activities that are carried on in the market jurisdiction; and finally, the third tier includes a binding and effective dispute prevention and resolution mechanism under the new proposals.

A Global Anti-Base Erosion (Globe) Proposal

The proposal under Pillar Two emerged because some members of the Inclusive Framework believe that there are lingering issues beyond those addressed by Pillar One. For that reason, this proposal was designed to address the challenges not captured by Pillar One, particularly profit shifting and the 'race to the bottom', through the development of four rules. The proposal gives countries the choice to set their tax rates, however, it should be done in a manner that does not negatively affect other jurisdictions by way of ensuring a global effective minimum tax rate is adhered to. There are four approaches considered under this proposal. The first is the income inclusion approach, which suggests taxing the income of a foreign branch, subsidiary, or a controlled entity if the effective tax rate falls below a minimum rate set. The second is an undertaxed payments rule, which would deny any deduction or imposition of source-based taxation (including withholding tax), alongside any changes to tax treaties for certain payments, unless the payment is taxed at or above a minimum rate. Thirdly, the proposal also considers a switch-over rule which would allow a jurisdiction to switch from an exemption method to a credit method if the profits that are attributable to a permanent establishment or immovable property are taxed below the agreed effective minimum tax rate. Lastly, it also considers a subject to tax rule that would subject the undertaxed payments to withholding tax or other source taxes and amend the treaty benefits of certain incomes that are taxed below the effective minimum tax rate (OECD, 2019d).

Takeaways from the Current OECD and Inclusive Framework Proposals

The current OECD proposals categorize African countries as market jurisdictions and claim to enhance their taxing rights. Another development is that it is willing to embrace the concept of a taxable nexus that does not require a physical presence, new profit allocation rules beyond the separate entity principle, and a method that addresses the race to the bottom.

However, notwithstanding the work on new profit allocation rules, the Unified Approach and the Programme of Work strongly indicate that the existing transfer pricing rules will remain, despite their acknowledged challenges. The issue with the Unified Approach is that, first, the proposal emanates from the OECD secretariat and not the Inclusive Framework. Secondly, it drops the fractional apportionment proposal which came from the G24[18] countries led by India – even though their approach is simpler since it is a formulaic approach that considers sales, assets, and payroll and does not require the complexity of separating the routine from non-routine profits.

The proposal retains the arm's length principle alongside the new approach which is a recipe for complexity because of the bifurcation of routine and non-routine profits. Practically, this is very difficult to achieve and in the end may bring about unfair allocation. This will not only complicate the current rules, but it will also make it difficult for African countries to implement them due to the paucity of resources and capacity constraints.

Furthermore, although the Globe proposal appears to curb the problem of ineffective tax incentives granted by African countries and the use of tax havens, it hinges on an effective minimum tax rate. Calculating an effective minimum tax rate will be difficult as it requires the use of expenses to ascertain the rate, which may differ from jurisdiction to jurisdiction. This among other things should be reflected upon before considering the implementation of this proposal.

African countries have some opportunities to be heard through the Inclusive Framework,[19] however, it is unclear if they can truly influence the work to consider their own peculiarities. Two things are certain, though: the current proposal requires a lot of technical work to achieve its goals, and it is highly uncertain if consensus will be achieved by the end of 2020.

3. Unilateral Measures Proposed and Taken by Other Countries

In the meantime, other countries have proposed and taken unilateral measures to tax profits of digitalized businesses, which is earned from their countries. For example, the EU has proposed a measure, while France and India have enacted unilateral actions, which are discussed below.

EU

The EU conducted an analysis in 2017, which revealed that the effective tax rate of digitalized businesses (8.5–10.1 percent) was much lower than that of traditional businesses in the EU (20.9–23.2 percent).[20] Moreover, many of the digitalized businesses are mainly US-owned and based. Another motivation behind the EU proposal is the realization that lasting solutions may require time and compromise because consensus is unlikely to happen in the short-term. Hence it is designed as an interim measure to ensure that EU countries tax a share of the income generated in their jurisdiction.

The proposal attempts to address the two central issues – nexus and profit allocation. To ensure the EU countries establish their taxing rights regardless of whether the digitalized businesses have a physical presence in the country or not, the following provisions were proposed:

> A digital platform will be deemed to have a taxable 'digital presence' or a virtual permanent establishment in a Member State if it fulfills one of the following criteria: It exceeds a threshold of €7 million in annual revenues in a Member State; It has more than 100,000 users in a Member State in a taxable year; Over 3000 business contracts for digital services are created between the company and business users in a taxable year. (European Commission, 2018)

The proposal is comprehensive in capturing the non-resident digitalized businesses operating in the EU. Instead of meeting all three criteria to qualify as a taxable resident, the EU chose to accept either of the three, which is likely to cut across the different models of digitalized businesses. Digitalized businesses such as social media platforms and search engines rely largely on user participation although they make income from advertisements (sales). On the other hand, digitalized businesses such as Amazon and Jumia, which focus more on online retail, rely mostly on sales of goods. However, they also rely on user participation for brand promotion and growth. All digitalized businesses complete a form of contract with customers electronically. Some are done automatically as one completes an order online, while others are done by signing end-user agreements.

For this proposal, there are a number of things to be concerned about, particularly if African countries were to consider adopting it. First, although the idea of creating a nexus based on the proportion of sales revenue obtained from a jurisdiction sounds fair, the challenge may be in the definition of what constitutes a supply of digital services and the mechanism to use in measuring the threshold. Secondly, it is clear that users add value to digitalized businesses and should be a factor in determining nexus and profit allocation.

However, the issue with user participation or contribution is that it is difficult to identify users and their location, due to the fact that they may make use of virtual private networks to mask their identity and disguise their location. For example, Country A may think that user A is doing business in their country based on the users Internet Protocol (IP) address[21] situated there but the virtual private network can make it look like the user is in Country B. Studies have shown that a growing number of internet users in the world use virtual private networks, which would make this part of the proposal largely ineffective given the capacity constraints of revenue administrations. There are countries such as China that are closing down virtual private networks (Reuters, 2018a) but this may be stifling human rights because people may have legitimate reasons for using a virtual private network due to privacy or security reasons.

Another aspect of the EU proposal is the 3 percent equalization levy, which would be a tax on the turnover of the non-resident digitalized business. As of August 2019, there is no agreement within the EU on any of the proposals. This has led a few EU countries to take unilateral measures. In Africa, there are no such proposals, and the administrability of such a tax would be difficult due to issues such as information, inability to enforce companies that are not physically present, and the possibility of the tax burden being shifted to the customers. For this proposal to be effective, a lot of work would be required, and perhaps this is one of the reasons why some EU member countries refuse to agree with it.

France

France is one of the EU countries advocating for a digital tax, and it made it clear that it would take unilateral measures if nothing is agreed at the EU level. In July 2017, a French court ruled in favor of Alphabet, Google's parent company, in a tax case (*Alphabet Inc vs. France*). The tax administration argued that Google had a liability of 1.11 billion euros to pay back taxes for the years 2005 to 2010. The argument was that Google, a California company, and its subsidiary Google Limited in Ireland, have been selling online advertisement services to customers in France through their search engine. The court ruling was premised on the fact that Google Ireland, through which the sales were carried out, did not have a permanent establishment (Tribunal Administratif de Paris, 2017). However, in April

2019, the district court of Paris approved an agreement to settle between Google and France for amounts up to 500 million euros and an agreement between Google and the French Tax authority amounting to 465 million euros. Based on the agreement Google does not have to admit to tax evasion (TP Cases, 2019). In an administrative action, Amazon reached an agreement with the tax authority to pay an undisclosed fee (Reuters, 2018b).

After the EU failed to reach an agreement on its tax proposal, in 2019, France passed into law a 3 percent turnover tax on the revenues that companies earn from providing digital services to French customers. The tax applies to digital businesses that earn a global revenue of more than 750 million euros and make sales of at least 25 million euros in France. By design, the tax largely applies to companies such as Google, Amazon, Facebook, and Apple, and is thus referred to as the GAFA tax (BBC, 2019). The announcement of this law has drawn strong condemnation from the United States (US) President, who claims that the tax is targeted at US companies, and threatened France with retaliatory tariffs on French wine (*Financial Times*, 2019). The French government responded by saying although they do not look forward to having disputes with the US, with whom they have enjoyed good partnership, they will preserve their sovereignty and the right to tax any income generated in their jurisdiction (*The Guardian*, 2019). This type of dispute and exchange is what the OECD has always claimed to try to avoid. And while coordination is very important, it is equally important that countries get a fair share of taxes from economic activities that take place and create value in their jurisdictions.

Another concern of the turnover tax is whether this burden will be transferred to the customers in the source or market jurisdiction. Amazon recently stated that the 3 percent turnover tax will be borne by French users (France 24, 2019), which means that the tax will effectively be an indirect tax such as a sales or value added tax.[22] This type of tax would likely be regressive and would increase the cost for customers and at the same time harm small and medium enterprises that leverage online market places such as Google. Although more research is needed to fully understand how the burden of the turnover tax is shared, the fact that the main digitalized businesses are mainly US companies, which are somewhat like monopolies, means that careful consideration must be made before adopting this tax. This is especially true for African countries where incomes are low, inequality is high, and where there is high demand for foreign products.

India

India's unilateral measures are also due to the unsatisfactory progress made globally, despite being a member of the G20 and the Inclusive Framework. India is thus a good example of what African countries should consider since it is also a developing country and has a large market for highly digitalized businesses. In 2016, India enacted an equalization levy of 6 percent through the Indian Finance Act 2016 (Indian Government, 2019). The levy is imposed mainly on digital advertisements and it is in the form of withholding taxes deducted from payments made by Indian resident businesses or an Indian permanent establishment to foreign digitalized businesses. However, the finance minister has indicated that although the tax is on e-commerce, it may be extended to other areas of digitalization (Ernst & Young, 2016a).

The 2018 Finance Act (Indian Government, 2019) introduced the concept of significant economic presence into the domestic law of India. This means that any income realized by non-residents is deemed to arise in India if characterized by the criteria. According to Section 4 of the Act, the term 'significant economic presence' means:

> any transaction in respect of any goods, services, or property carried out by a non-resident in India, including the provision of download of data or software in India, if the aggregate of payments arising from such transaction or transactions during the previous year exceeds the amount as may be prescribed; or systematic and continuous soliciting of its business activities or engaging in interaction with such number of users as may be prescribed, in India, through digital means … the Act provides that the transactions or activities shall constitute significant economic presence in India whether or not the agreement is entered into in India, the non-resident has a residence or place of business in India, or services are rendered in India. (Indian Government, 2019: 7)

Due to the continued direct tax challenges posed by the digitalized economy and the unsatisfactory progress achieved for a global solution, in April 2019, the Indian government, through the Central Board of Direct Taxes sent out an invitation for public comments on the proposal to amend rules on profit attribution to permanent establishment. The proposal considered both the demand and supply sides that contribute to income and value creation which is why it rejected the OECD approach to profit attribution and permanent establishment, which only considers functions, assets, and risks. In India's view, the OECD approach favors capital-exporting countries (that is, investor countries) and not capital-importing countries (that is, host countries) such as India (Ernst & Young, 2019).

The Indian model is one for African countries to emulate for a number of reasons. India is a developing country with a significant need for revenue to fund development, so any taxable income that is generated in its jurisdiction should be collected for the benefit of the country. As a country that imports goods and services from the foreign-based digitalized businesses, India is also characterized as a so-called market jurisdiction. India, through its actions, has also shown that a solution based on consensus may not be reached anytime soon, hence they have strengthened their source rules and initiated some unilateral measures to forestall the loss of revenue due to deficiencies in the current international tax rules. African countries can benefit

4. Options for African Countries

There are three main options available to African countries to take in response to the tax challenges arising from the digitalization of the economy. African countries can explore Articles 5.3(b), 7 para. 4, 12 and 12A of the UN Model and determine to what extent they can increase their taxing rights and allocate profits to their jurisdiction. This approach is low-hanging fruit for African countries. It will afford them the right to tax corporate income of digitalized businesses that operate in their jurisdictions where economic activities take place and where value is created. The second approach is to strengthen the source rules by domesticating the Articles mentioned above, and also ensure that there is a general source rule that makes it clear that any income derived from the African country should be taxed in that country. Thirdly, African countries can wait and coordinate with the

Inclusive Framework to reach a global consensus by the end of 2020. A mix of these options can also be applied. However, each option has its pros and cons.

Treaties Provisions

The UN Model Tax Convention, which was designed to cater to the peculiarities of developing countries including African countries, has some provisions that can address both issues of nexus and profit allocation to a considerable extent.

Article 5.3(b) of the UN Model states:

> The term 'permanent establishment' also encompasses ... The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned.

The current treaties offer some options to African countries. Article 5.3.b, in particular, may prove to be significant because of its scope and also because of the dematerialized nature of digitalization in the form of service provision. Most digitalized businesses provide services, although they may also supply goods. Another advantage of Article 5.3.b is that the 183-day threshold will be likely met by the personnel or agents of most digitalized companies because they provide services day in and day out. Additionally, application of treaty provisions will not be considered a unilateral measure, therefore, this action poses little risk to international tax coordination. Another significant advantage of this provision is that it may be applied to services in the extractives sector in African countries.

The success of applying this provision is reliant on the treaty networks of African countries. Currently, the home country of the major digitalized businesses is the US, which has tax treaties with only four African countries: Egypt, Morocco, Tunisia, and South Africa (IRS, 2019).

Another challenge to the Article is the interpretation problem. The different views on whether there is a need for a fixed base in the source country or not could be a challenge during negotiations and application. Although this can be mutually agreed upon, it is conceivable that resident countries of the digitalized business will favor one that requires a fixed base. During the 11th session of UN Committee of Experts on International Cooperation in Tax Matters in 2015 (UN, 2015), a majority of countries opted against interpreting the Article without the fixed base requirement while the minority chose to interpret the provision with the fixed base requirement. The UN Committee suggested that countries that wish to explore the Article without the restriction of the physical presence criterion should do so through the Mutual Agreement Procedure (Article 25 of the UN Model) if the contracting country does not agree.

Saudi Arabia is already applying this without the physical presence requirement and focuses only on the furnishing of services (Ernst & Young, 2016b). For a country like Saudi Arabia, with a large oil sector that relies on the provision of services by foreign companies that may or may not have personnel resident in the country for more than 183 days, this provision is not only significant for the digitalized economy, but perhaps also to the more significant sector of their economy, oil. This also applies to many developing countries that have natural resources because of the large extractive sector services business.

Other Articles under the UN Model that can be explored in ensuring the taxing rights of African countries are Articles 12 and 12A. Article 12 concerns withholding taxes on royalties paid to the resident country. For example, if Uber grants licenses to Nigerian operators and the Nigerian operators were to pay a fee for the royalties, the Nigerian tax authority will collect a withholding tax from the Nigerian operators. Application of this provision has similar advantages and disadvantages as the services permanent establishment clause in Article 5.3 of the UN Model. However, these Articles under the UN Model can make significant headway in addressing the challenges of nexus under digitalization.

On the profit allocation question, Article 7 paragraph 4[23] of the UN Model serves as an opportunity for African countries as they are largely subscribed to the UN Model:

> In so far as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total

> profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article. (UN, 2011: 17)

This means that the allocation of profits will be based on the economic activities occurring in a jurisdiction and the value created there. However, careful consideration must be given to the allocation factors. The Massachusetts formula is the most popular formula that takes into account both the demand and supply side, but with the digitalization of the economy, the user threshold/contribution is also important to capture the real value-driving activities. More work needs to be carried out on the user contribution because, as it is now, the issue of identifying user location is challenging due to the use of virtual private networks.

Strengthen Source Rules

The second option available to African countries to explore is to go back to the basics and strengthen their source rules by adopting the UN Articles discussed above into national law. This would ensure that there is a provision for the taxation of services at the source without a physical presence requirement. This would also ensure that African countries have more rights to tax both highly digitalized companies and the services in the extractive sector. A fractional apportionment provision such as India's under the domestic law will also ensure that beyond the taxing rights, profits are allocated to African jurisdictions based on the economic activities carried out there. Domesticating services taxation and fractional apportionment would ensure that African countries can raise additional revenues from economic activities of multinational companies in their jurisdictions.

The weaknesses of this approach, however, include the challenges that may be encountered in trying to enforce non-resident companies with no physical presence in the jurisdictions; the increased risk of lack of coordination; and possible conflict with provisions in existing treaties of African countries. To address this challenge, African countries should consider working under a regional body such as the

East African Community or the African Union to have a stronger voice and authority to negotiate and address possible conflicts with the home countries of the highly digitalized businesses, and to ensure that their treaties are not in contradiction with domestic rules.

Wait for a Global Consensus

The third option that African countries have is to wait for the global consensus planned to be achieved in 2020 by the Inclusive Framework. During this period of waiting and participation in the Inclusive Framework, African countries can consider exploring the OECD and Inclusive Framework proposals discussed earlier as interim measures while championing a comprehensive rule such as the significant economic presence nexus rule and fractional apportionment profit allocation rule. African countries can also explore another unilateral measure in the form of turnover taxes such as the one employed in France, bearing in mind the challenges associated with it. Or finally, they can simply wait for the global consensus in 2020 while making no efforts before then.

The merits of exploring treaties and strengthening source rules are that it gives African countries their tax sovereignty. It also has the potential to raise substantial revenues from both highly digitalized businesses and the extractives sector between now and 2020, particularly from the perspective of services. The possible downside to fully relying on the OECD and the Inclusive Framework process is that any reforms are highly likely to be complex and thus difficult for African countries to implement, similar to the measures adopted through the first round of OECD/G20 reforms. Lastly, because there will be winners and losers from the proposals under the unified approach[24] it is highly unlikely that a global consensus will be achieved by the end of 2020.

5. Conclusion

The two central challenges regarding corporate taxation from the perspective of digitalization are the difficulty in finding a suitable nexus and the allocation of profits. As argued in this chapter, the significant economic presence proposal and fractional apportionment for profit allocation can offer a balanced long-term solution to the two central problems discussed. If these rules are adopted globally, it is possible that developing countries as a whole, and African countries in particular, will have greater rights to tax income. Since digitalization is expanding at a fast pace in Africa, it is imperative that the countries concerned put a stake in the ground as to what is acceptable to them in terms of a fairer form of taxation.

In terms of immediate options, the countries in Africa could either follow the route of treaties or strengthen their source rules as argued in the chapter. In either scenario, African countries need to take their tax destiny into their own hands, and not wait for uncertain solutions that are handed down to them by the OECD/G20 and the Inclusive Framework in 2020 as is currently proposed. It is clear that not even the OECD and G20 countries have confidence that a consensus-based solution will be reached soon, hence the reason behind the interim and unilateral measures of some of their member countries. African countries need to be willing to take bold action now so that their need for tax revenue from this rapidly expanding phenomenon can be fairly addressed.

Although multilateral conventions are very important, particularly from the perspective of exchange of information, African countries should realize that they already have taxing rights as sovereign jurisdictions. Signing bilateral treaties does not give taxing rights; it is rather a way of limiting rights as the jurisdiction may be confined to the provisions of the treaty. Hence, in exploring treaties, African countries should bear this in mind and only sign treaties if and when necessary after a cost–benefit analysis has been carried out.

Experience has shown that international tax rules require some form of consensus to be effective. From the perspective of African countries, it is important that they consider championing these options under a regional body such as the African Union and the African Tax Administration Forum. In the post-pandemic world, it is important that the taxation of digital companies be done in a fair and equitable manner.

Notes

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2 According to Internet World Stats, there are currently over 200 million Facebook subscribers in Africa. These subscribers are very key to the advertisement business

of Facebook, as they supply data and help Facebook create a mass of users that adds value to its brand.

3 'For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on' (OECD, 2017b: 8).

4 Transfer Pricing refers to how related companies, companies under the same multinational group price transactions. The transactions could be purchases, loans, royalties etc. Transfer pricing guidelines were set up by the OECD to ensure that transactions between related companies are fair and are not used to undermine the tax system. Related companies can use loans to reduce tax liability in a high-tax jurisdiction by paying interest to the related company in a low-tax jurisdiction where the interest received as income will not be taxed.

5 Base erosion and profit shifting refer to tax avoidance strategies adopted by multinational companies to shift profits from high-tax jurisdictions to low-tax jurisdictions, thus eroding the tax base of the high-tax jurisdictions.

6 Illegal capital flight or the illegal transfer of huge sums of money meant to vanish from any records in the country of origin.

7 Jumia Group, formerly Africa Internet Group, operates in several African countries through branches and subsidiaries.

8 Some $50 billion has been reported to be lost to IFF annually, which exerts a negative impact on the development of Africa.

9 Source rules or source-based rules means a jurisdiction has rules that allows it to tax the income generated by a legal person in the country regardless of whether they are resident in the country or not. It is different from resident-based rules that only ensure the taxing of residents of a jurisdiction.

10 Tax levied on goods and services, not income or profits.

11 These Conventions are used as a basis for negotiating and signing agreements between countries. The OECD Model mainly favors OECD countries, while the UN Model was specifically designed to improve upon the OECD Model and give more taxing rights to developing countries.

12 Some efforts have been made with respect to VAT (South Africa) and also taxing social media access, although these are targeted at citizens and not the big foreign digitalized businesses.

13 This is an initiative developed by the OECD which provides audit assistance to tax administrations in developing countries through knowledge and skill transfer.

14 This is a transfer pricing principle which states that the amount charged by or between related parties for a product must be the same as if the parties were not related.

15 'an intangible ... that relates to marketing activities, aids in the commercial exploitation of a product or service and/or has an important promotional value for the product concerned. Depending on the context, marketing intangibles may include, for example, trademarks, trade names, customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers' (OECD, 2017c).

16 This refers to a situation where countries lower their tax rates in order to attract investment, which leads to more countries lowering their rates to attract investment.

17 The fractional apportionment method was previously in the OECD Model before it was removed.

18 This is a group of developing countries on international monetary affairs and development.
19 There are now 24 African countries in the OECD/G20 Inclusive Framework.
20 The EU countries had an effective average tax rate for traditional businesses at 20.9 percent while for traditional businesses that engage in cross-border business, it was 23.2 percent. Comparing this to the digitalized economy, the effective tax rates for the digitalized domestic business model is 8.5 percent, the digital international Business to Customer model is 10.1 percent, and the digital International Business to Business model is 8.9 percent (PWC, 2017).
21 This identifies a computer on a network and allows for communication. It can be used to identify the location of a computer, hence the location of the user of the computer. This is applicable to any device that uses the internet.
22 This is a tax on consumption that does not take into consideration the income of the consumer. In the United States and other countries, it is termed 'sales tax' and the difference is that the VAT is collected in different stages of transactions between producer and consumer, while the sales tax is collected at the final retail level.
23 This Article was in the OECD Model Conventions before it was deleted. However, it still exists in some of the treaties of the OECD member countries to date.
24 For example not all African countries are considered significant market jurisdictions.

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5 | TAX ASPECTS OF BILATERAL INVESTMENT TREATIES AND FREE TRADE AGREEMENTS

Victoria Lee[1]

Executive Summary

Private investment, especially foreign direct investment, can produce significant revenue flows for the state. While the potential is enormous, poor tax governance and trade disputes with foreign investors can significantly undermine these revenue flows.

This chapter examines revenue losses linked to the terms of Bilateral Investment Treaties and Free Trade Agreements, and their adjudication before arbitration tribunals. Using examples from Africa, South America, and Europe this chapter examines how well that system of arbitration works. In particular, it looks at how well the tribunals balance investor protection with the right of states to regulate to achieve legitimate policy objectives where such measures have an adverse effect on the economic value of an investment. It asks whether an investment tribunal is the best place to resolve highly technical tax issues. The chapter considers a solution proposed by the European Union: a multilateral investment court, and, also how treaties could be renegotiated to improve revenue mobilization, while also ensuring investor protection and guaranteeing the state's right to regulate in the public interest.

Introduction

When Ghana appointed Nana Akufo-Addo as the new president in January 2017 he was in for a surprise: 'a $1.6 billion hole in the budget and a deficit twice as high as expected'.[2] It is reminiscent of events following the United Kingdom general election of May 2010, when the incoming chief secretary to the Treasury, David Laws, arrived at work expecting to find a handover note from the outgoing minister but instead, found a letter which said simply 'Dear chief secretary, I'm afraid to tell you there's no money left'.[3]

How can Mr. Akufo-Addo fund his election promises to ensure every village has access to safe drinking water and make secondary school education free? His plan is to boost economic growth by encouraging private sector investment. Private investment, especially foreign direct investment in the extractive industries, can produce significant revenue flows for the state and healthy profits for the investor. The potential is enormous but when it goes wrong, it can spell disaster for both sides.

Recent events in Tanzania prove the point. In March 2017 Tanzania banned exports of gold and copper concentrates after it accused Acacia Mining, a company with a Canadian majority shareholder, for under-reporting the amounts of gold and copper in those concentrates.[4] In July 2017 the Tanzania Revenue Authority served Notices of Adjusted Assessment for both corporate income tax, and interest and penalties in the sums of, respectively, approximately US$ 40 billion and US$ 150 billion. Acacia served Notices of Arbitration on the Government of Tanzania.[5] As a result of the dispute Acacia's share price has fallen 67 percent since February 2017[6] and talks with Endeavour Mining Corp, a Canadian gold mining company, about a proposed merger have collapsed.[7]

Foreign direct investment is a potential source of revenue to fund the Sustainable Development Goals, but those revenues can be reduced by tax incentives, tax stabilization clauses, and adverse decisions by privately constituted investment arbitration tribunals. This chapter looks at how revenue is lost and suggests ways to minimize those losses.

The main part of the chapter addresses the terms of bilateral investment treaties (BITs) and free trade agreements (FTAs), and investment arbitration tribunals. When an investor has a grievance with a state in which it has invested about the functioning of that investment, and the investor belongs to a state with whom the first state has an investment agreement, the resolution of that grievance will be under the terms of the agreement rather than in the national courts. Although the method of resolution can differ from agreement to agreement, the main rules of procedure used are the Convention on the Settlement of Investment Disputes between States and Nationals of Other States ('the ICSID Convention') and the Arbitration Rules of the United Nations Commission on International Trade Law ('the UNCITRAL Arbitration Rules'). This section examines how well that system of arbitration works. The case of *Burlington v. Ecuador* is outlined to demonstrate how tax issues can form the basis of a dispute and how a dispute is resolved. The chapter then addresses criticisms of the current system, particularly around the balance between the sometimes competing principles of state sovereignty and investor protection, and the predictability and transparency of decisions.

The European Union is concerned about the current system and has proposed, as a solution, a multilateral investment court. As the proposal of a group of 27 countries and the world's largest trading bloc, it deserves some attention. Although it is designed as a global court, as the idea has yet to come to fruition, the EU is seeking to establish the principles of such a court in its new trade agreements. Most recently there has been the Comprehensive Economic and Trade Agreement (CETA) with Canada and the EU–Vietnam Free Trade Agreement. We set out the principles in CETA to demonstrate what a multilateral investment court could look like. States could consider supporting the EU in its proposal to establish a multilateral investment court. States could also consider terminating their agreements with individual European Union partners, and negotiating a FTA with the EU to enshrine the dispute resolution principles and procedures replicated in CETA.

An alternative solution is to cancel the bilateral trade agreements that are not working. We consider the examples of South Africa and Ecuador, which have recently undertaken reviews and terminated a number of agreements. Even if treaties are terminated, if a state wishes to attract foreign direct investment it will need to provide a level of investment protection. The section addresses some of the issues to be considered in negotiating new relationships to improve the balance between investor protection and revenue mobilization.

The revenue losses incurred as a result of an adverse tribunal decision are made up of both damages and interest. Given that interest payments can dwarf the amount awarded in damages, it is an issue that needs to be considered. The section describes examples of disputes where compound interest was awarded, and argues that it was wrong in principle, and recommends amending BITs to clarify that only simple interest can be awarded as per the proposed text in the model BIT of the South African Development Community to limit interest to simple interest.

Many the reforms suggested will require diplomacy at an international level. Though some may argue these issues are for business or the private sphere, the author holds that these are as much public law issues as they are private, and thus are properly an issue for the international community. The chapter concludes with arguments on why the international community should support the proposed reforms and from where the political will needed to make the changes will come.

Taxes: An Exercise in State Sovereignty

In a fluid policy environment, a government may wish to modify or withdraw tax incentives. It may wish to amend tax legislation to increase tax rates. Taxes can be raised on so-called 'windfall profits': bonus profits from, for example, a sharp rise in a commodity price. This exercise of state sovereignty has been met with protest by private investors. Before turning to the example of *Burlington v. Ecuador*, it is worth noting that windfall taxes are nothing new and although a developing economy may be more likely to be the respondent before an arbitration tribunal, such taxes are also used by G7 countries.

For example, in the United Kingdom, Harold Wilson's labor government introduced a petroleum revenue tax on profits at 45 percent, in addition to corporation tax, under the Oil Taxation Act 1975.[8] Introducing the Bill to the House of Commons on November 27, 1974, Mr. Edmund Dell, the Paymaster-General neatly summarized the policy issue:

> The second priority, of course, is to increase the nation's revenues and to secure for the community a reasonable share of the profits of North Sea oil … In arriving at the total proportion of North Sea revenues which should accrue to the public – what has come to be called the 'Government take' – there is a delicate balance to be struck. Besides securing for the community a reasonable share of the profits, we need to ensure a fair rate of return to the oil companies whose risk capital and skill and experience are crucial to the development of these resources.[9]

Ecuador was extracting hydrocarbons at a time when the price of crude oil soared. Its efforts to secure for the nation a fair share for of the windfall profits led to conflict with the investor.

The Case of Burlington v. Ecuador

In September 2001 an American subsidiary of Burlington Resources Inc. acquired interests in production-sharing contracts with Ecuador for the exploration and exploitation of hydrocarbons at Blocks 7 and 21 in the Ecuadorian Amazon Region.[10] The contracts set out a formula for the allocation of oil between the state and the contractors. The contracts included a clause providing that the contract was governed by Ecuadorian law. Certain tax clauses regulated the tax treatment that would apply to the contractor. A tax modification clause called for the application of a 'correction factor' whenever tax changes had an impact on the economy of the contract. Burlington argued that this was a stabilization clause whereas Ecuador argued it was an opportunity to renegotiate the tax liability.

In September 2001 the price of Oriente crude oil from Block 7 stood at US$ 20.15 per barrel. By 2006 it reached over US$ 60/bbl. By 2008 it was at US$ 121.66/bbl. The Napo crude oil at Block 21 was of a lower quality but was not yet in production at the time Burlington acquired its interest. By 2006 it was over US$ 50/bbl. Although oil prices fell in 2008, they stabilized at around US$ 60–70/bbl for most of 2009 and 2010.

The parties became embroiled in a dispute over how to share the economic benefit of this spike in the oil price. On April 19, 2006 Ecuador's Congress passed Law 42 imposing a 50 percent tax on windfall profits; the excess represented by the monthly average selling price minus the monthly average selling price at the date the production-sharing contract was agreed. On October 18, 2007, that law was amended to increase the percentage from 50 to 99, in favor of the government. Burlington paid the tax under protest but asked for the tax modification clause to be applied to apply a correction factor that would, in effect, rescind the law so that no tax increase would be charged. Ecuador failed to respond to the request to renegotiate. A request for arbitration was made by Burlington when Ecuador announced a decision to move to service contracts, from which Burlington considered Ecuador would benefit. Non-payment of the tax led to the seizure of crude exports. Burlington suspended its operations, the government moved in to operate the fields, and negotiations to restore Burlington failed.

The dispute went before an investment arbitration tribunal established under the Bilateral Investment Treaty (BIT) between the

United States and Ecuador. The Tribunal was charged with considering whether Ecuador's actions amounted to expropriation in breach of the BIT. It considered the effect of the tax modification clause and held that the application of the correction factor for both Blocks 7 and 21 was mandatory in order to absorb the impact of any tax increase or decrease.[11]

The Tribunal held that the implementation of Law 42 at either the 50 or 99 percent rates was not expropriation. The Tribunal noted: 'Taxation is an essential prerogative of State sovereignty'.[12] The Tribunal held that confiscatory taxation which would amount to the loss of the economic value or economic viability of the investment, looked at as a whole, would be an indirect expropriation. 'The inquiry under the test of loss of economic use or viability goes beyond the issue of whether the challenged measure caused a reduction or loss of profits'.[13] The Tribunal observed

> The Law 42 tax is a so-called windfall profits tax, i.e. a tax applying to oil revenues exceeding the ones prevailing at the time the [contracts] were executed. By definition, such a tax would appear not to have an impact upon the investment as a whole, but only on a portion of the profits. On the assumption that its effects are in line with its name, a windfall profits tax is thus unlikely to result in the expropriation of an investment.[14]

The Tribunal found that although the failure to absorb the impact of Law 42 was a breach of the production-sharing contracts, it was not an expropriation because the evidence of the profitability of the Blocks showed there was no substantial deprivation of the value of those investments. Even at 99 percent, the Tribunal accepted that although profits were considerably diminished there was no substantial deprivation because the investment still generated a commercial return. In other words, the investment was neither unprofitable nor worthless.[15]

The Tribunal went on to hold that the act of seizing oil shipments to cover the cost of the unpaid tax equally did not amount to expropriation because the seizures did no more, in terms of economic effect, than the impact of Law 42 at 99 percent. What the Tribunal did consider amounted to expropriation was the decision by Ecuador to take possession of Blocks 7 and 21, after Burlington announced its intention to suspend operations, in order to guarantee the continuation of operations. That was not permitted under the contract as 30 days of suspension had not yet passed. The Tribunal went on to hold that even if that period had passed, Ecuador would still not have been entitled to take possession because Burlington had just cause to suspend operations given that Ecuador had breached the contracts by failing to absorb the tax increases implemented by Law 42. On the facts the Tribunal found that Ecuador was not justified in taking possession of the Blocks in order to prevent serious and permanent damage to them. Ecuador retained possession after Burlington refused the request to resume operations, as it was entitled to do given the breach of contract. Ecuador neither paid nor offered compensation to Burlington. As such the expropriation was unlawful.

One is left with the sense that, with skilled negotiators, the two sides could have reached an agreement for Burlington to continue production and pay the tax under Law 42 at the rate of 50 percent. Burlington did pay the tax at this rate, albeit under protest, and although the financial evidence was disputed, it appears they were making a handsome profit at this rate. They were certainly invested in the project as even after Law 42 was introduced, their consortium submitted a US$ 100 million investment plan for another area, the Oso field. It is also noteworthy that the effect of the law at 50 percent was equal to a price adjustment clause included in a different contract Ecuador had entered into with City Investing Company for the exploitation of the Tarapoa Block. The 99 percent rate seems to have been a bargaining tool used by the new president to settle on a rate of 70 percent.

Criticisms of the Current System

A criticism of the current investment arbitration system is that the balance between state sovereignty and investor protection has been lost, with the investor being accorded a certainty of investor landscape that, in effect, protects the investment from regulatory changes. Taxes are raised; tax incentives are withdrawn; a national minimum wage is introduced; standards in environmental waste management or health and safety are raised. These can all add to the cost of doing business and so reduce the expected rate of return. However, not every reduction in profit should be treated as expropriation. This is problematic for a number of reasons. It curtails the state's legitimate right to regulate in the public interest. It makes it more difficult to mobilize revenue. Where that protection is only provided to foreign investors, it discriminates against domestic investors and makes it more difficult for them to compete.

Another criticism is about the predictability of proceedings. In *Burlington v. Ecuador* the Tribunal may have affirmed a state's right to raise taxes, but the outcome of any litigation is uncertain and international investment arbitration is arguably more so because of this concern. Stephan Schill wrote

> Unsurprisingly, the decentralized structure of arbitration has resulted in a significant number of inconsistent and incoherent decisions as regards the interpretation of not only similar provisions across different IIAs, but also provisions of the same agreement in relation to virtually identical facts. These inconsistencies have fueled concern about the lack of predictability of international investment law, adding to the sense of a legitimacy crisis of the field.[16]

The risk alone of an 'unfair' decision is enough to make states change course.

Related to this is the concern about the lack of transparency in proceedings. Consistency in decision making is aided by the publication and dissemination of decisions.

A further related concern is the lack of an adequate right of appeal. Section 5 of Chapter IV Arbitration of the ICSID Convention[17] provides for the revision or annulment of an award only in limited circumstances. Article 51 provides for revision where a new fact is discovered that could decisively affect an award. Article 52 provides for annulment of an award on the basis of limited grounds: that the Tribunal was not properly constituted; that it had manifestly exceeded its powers; that there was corruption by a member of the Tribunal; that there was a serious departure from a fundamental rule of procedure; or that the award failed to state the reasons on which it was based.

Another criticism, particular to the European Union, relates to a state's right to legislate on public policy when the dispute resolution system does not give due deference to State Aid rules. The State Aid rules are a cornerstone of the single market and ensure that businesses compete on a level playing field. States cannot give financial assistance, whether through tax breaks or otherwise, to businesses outside of prescribed public policy goals.

The European Commission clashed with an investment arbitration panel over the case of *Micula*. The influence of this 2015 decision can be seen in the EU proposals for reform. *Micula* concerns tax and duty incentives provided by Romania which had to be withdrawn to comply with State Aid rules in the context of its accession negotiations to the EU. An investment arbitration tribunal held that the claimant had a legitimate expectation that the incentives would continue until a certain date. A State Aid investigation was initiated by the European Commission. The Commission however, held that the increased costs faced by Micula were ordinary operating expenses. Not to have to bear them was an economic advantage, and a selective one at that, as it was only available to those who could take advantage of the Investment Treaty. Their repeal was necessary to re-establish the normal conditions of competition.[18]

The Commission determined there could be no legitimate expectation because the aid was in breach of the law. Essentially the Commission placed an obligation on the claimant to know the law and that this would be unlawful aid: 'A diligent economic operator must be assumed to be able to determine whether that procedure has been followed'.

EU Proposal for Reform

The solution put forward by the European Commission is the establishment of a permanent body to decide investment disputes: a Multilateral Investment Court with an Appellate Body.[19] The Commission considers that the principles of transparency and legitimacy require publicly appointed judges and public hearings. Furthermore, the Commission concludes that an appellate court is needed to ensure consistency of decisions.

This is a relatively new proposal from the EU and, at the moment, remains a proposal. The EU has however taken concrete steps to advance their agenda as can be seen in two recently concluded investment agreements, the Comprehensive Economic and Trade Agreement (CETA) with Canada[20] and the EU–Vietnam Free Trade Agreement. The terms of CETA can therefore offer some insight into what a multilateral investment court system might look like. For those states who are host to European investors and who have unsatisfactory BITs with individual EU members, CETA can also offer a template on what the investment and dispute settlement provisions of a new treaty negotiated with the EU might look like.

CETA: The Right to Regulate on Tax

Article 8.9 reaffirms the right of the Parties to regulate to achieve legitimate policy objectives and confirms that the fact that regulation may negatively affect an investor's expectation of profits does not of itself amount to a breach of a Treaty obligation. This principle is confirmed in the definition of 'Expropriation' at Annex 8-A, paragraph 2(a) which makes clear that the fact that a measure or series of measures has an adverse effect on the economic value of an investment does not of itself mean that the measure amounts to indirect expropriation.

CETA: Dispute Settlement

CETA does not set out a completely new method of resolving disputes as it provides for a claim to be submitted under the ICSID Convention, the ICSID Additional Facility Rules, or the UNCITRAL Arbitration Rules.[21] What is new is the constitution of the Tribunal. Made up of 15 members, five nationals from member states of the EU, five from Canada, and five from other states, they must be qualified in their home country for judicial office or jurists of recognized competence. Signaling a shift that takes arbitration disputes from the private to the public sphere, Members are required to hold demonstrated expertise in public international law while expertise in international investment law, international trade law, and the resolution of disputes arising under international investment or international trade agreements is only 'desirable'.[22] Rather than being able to agree on their own arbiters, the President of the Tribunal allocates, randomly, three Members to a Tribunal, one from each pool. The only exception to this is where the parties may agree to a sole Member (from the third-party national pool) to hear the dispute. This is envisaged in cases where 'the claimant is a small or medium-sized enterprise or the compensation or damages claimed are relatively low'.[23]

A departure from the ICSID Convention is the powers of the Appellate Tribunal. In addition to the power to annul a decision, the

Appellate Tribunal may 'uphold, modify or reverse the Tribunal's award based on: (a) errors in the application or interpretation of applicable law; [or] (b) manifest errors in the appreciation of the facts, including the appreciation of relevant domestic law'.[24]

Critique of EU Proposals

There has been some criticism of the EU proposals[25] that essentially the impetus for reform is political rather than as a result of in-depth analysis of the current system. These criticisms are either overstated or can be resolved with amendments to the current system. For example, charges that there is a lack of consistency and predictability in decisions can be dealt with by better publicity of decisions.

In addition, there is particular criticism of the proposed appeal system: finality of awards is preferred over accuracy because this allows for the speedier and cheaper resolution of disputes. A limited scope of review supports this policy objective. However, the formal differences between courts and tribunals have become blurred as each borrows from the other rules and procedures that suit it. When an employee is dismissed and his or her wages are stopped, time is of the essence in deciding whether or not the dismissal is fair and awarding damages. An employment tribunal is designed to be used without lawyers, with simple rules of procedure and much discretion left to the Tribunal on issues like the weight to be attached to evidence. Costs are kept low. This suits the parties who are usually of limited means. By contrast, international investment disputes often involve sums of money so large that they can have an impact on the cost of borrowing or the level of services a state can deliver. Both sides can access legal advice and multinationals, the primary claimants of BITs, have contingency funds and insurance plans to support them. For those reasons, certainty is preferable to speed and the balance between finality and accuracy should shift to the latter.

What is also of merit in the EU's proposal is the prerequisite for judges to have public international law experience. It is a welcome development that public law issues have permeated what were previously private commercial matters. If the Sustainable Development Goals and their accompanying Financing for Development Agenda are to make gains, the judges need to be mindful of these issues.

Unilateral Action and Renegotiation

The establishment of a multilateral investment court will take time and its mandate could be undermined by the absence of key investor countries such as the United States. Some countries such as South Africa and Ecuador as outlined below have taken matters into their own hands and have withdrawn from a number of BITs. To a certain extent this is a unilateral response. Indeed, Ecuador intends not to enter into new BITs with countries with whom it has little trade but to allow the national courts to resolve disputes. However, for a country wishing to attract foreign direct investment, withdrawal is only the first step and needs to be followed with new investment treaties or a domestic legislative framework that inspires investor confidence. It is also worth noting that withdrawal usually requires a notice period and the BIT can have temporary, transitional effect for investments made under it.[26]

South Africa

South Africa launched a review of its bilateral investment treaties after claims[27] were made against it under investment treaties with Italy, and the Belgo-Luxembourg Economic Union in respect of public policy proposals to 'encourage greater ownership of mining industry assets by historically disadvantaged South Africans'.[28] The Black Economic Empowerment equity divestiture requirements established by the Mining Charter required the sale of 26 percent of shares in relevant companies to such persons, and the payment of compensation at fair market value. The claim was settled so the Tribunal was not required to rule on the issues but clearly the threat was enough to make the South African government review its position.[29]

The review examined the extent to which BITs were necessary to attract foreign direct investment, and the extent to which the treaties were consistent with the South African Constitution and law, particularly the right to regulate in the public interest. Nine European Investment Treaties were terminated between March 2013 and October 2014.[30] In 2015 the government published the Protection of Investment Act,[31] designed to 'protect investment in accordance with and subject to the Constitution, in a manner which balances the public interest and the rights and obligations of investors'.[32] The Preamble acknowledges that investments must be protected but also recognizes the obligation to take measures to protect or advance persons historically disadvantaged because of discrimination. Existing investments made under BITs continue to be protected under the terms of those treaties.

Ecuador

Ecuador has also taken the step of terminating a number of BITs that are not seen as working for them. The government launched a Commission for the Comprehensive Audit of Investment Protection Treaties and of the International Arbitration System on Investments (CAITISA) to audit the treaties and make recommendations.[33] The Commission was composed of government officials, academics, lawyers, and civil society groups. The report, published in May 2017, found that Ecuador had faced claims of US$ 21.2 billion in investment disputes, with US$ 1.498 billion paid out so far. The Commission puts the liability to claims from current cases as US$ 13.4 billion. It recommended the termination of current treaties and the negotiation of new investment treaties. It also recommended excluding the ISDS and using the national courts instead. Interestingly the report noted that most foreign direct investment comes from countries with whom they do not have BITs: Brazil, Mexico, and Panama.[34] The president adopted the recommendations and on May 16, 2017 terminated 16 BITs, including those with the United States and several members of the European Union.

Renegotiating BITs: Rights and Responsibilities and Legitimate Expectations

In seeking to rebalance the relationship between investor and state, South Africa has emphasized the state's right to pursue legitimate public policy objectives (remedying prolonged discrimination and economic exclusion). The EU has emphasized the state's right to raise taxes, enshrining in CETA the principle that a reduction in anticipated returns does not of itself amount to expropriation. They also set out what standards an investor may expect; standards of fairness and non-discrimination etc. What is absent, and what a state may wish to consider in renegotiating a BIT, is a statement about the investor's responsibilities. This issue can manifest itself in disputes in relation to claims of legitimate expectation. An investor may be induced to invest because of, and later seek to rely on, a promise of favorable tax treatment. That promise may have been offered outside of ministerial governance or parliamentary procedures. There arises an issue of whether the state should be required to honor it.

In *EDF v. Romania*[35] the Tribunal held that

> Except where specific promises or representation are made by the State to the investor, the latter may not rely on a bilateral investment treaty as a kind of insurance policy against the risk of any changes in the host State's legal and economic framework. Such expectation would be neither legitimate nor reasonable.

This begs the question of whether it is legitimate to expect every representation by the state to be enforceable. This question is not just about the apportionment of risk but what due diligence the investor can be expected to make. In determining the answer to this question, it may be helpful to look beyond the case law of investment arbitration to public administrative law.

This question was considered in the United Kingdom in *Al Fayed v. Advocate General of Scotland*.[36] The Court considered the legitimacy of a 'forward tax agreement' entered into between the then Commissioners of Inland Revenue (a government department) and the claimant tax payers, an agreement as to the specific sums the tax payer would pay in future years in order to satisfy its tax obligations. Inland Revenue ended the agreement when it became clear that it did not have a complete picture of the taxpayer's financial affairs. The taxpayer sought to rely on the agreement, but the Court held that it was ultra vires as Inland Revenue had no power to enter into such an agreement.

The Court noted that the frustration of a legitimate expectation could be so unfair as to constitute an abuse of power. However, it went on to rule:

> [U]nder our domestic law a legitimate expectation can only arise on the basis of a lawful promise, representation or practice. There can be no legitimate expectation that a public body will continue to implement an agreement when it has no power to do so … While the [taxpayers] may well have had an expectation, it was not, in the particular circumstances of this case and according to our common law, a legitimate expectation.[37]

To ensure the investor can meet its due diligence responsibilities, it is essential that legislation and regulations are properly published and disseminated.

Renegotiating BITs: Forum Shopping

A state considering cancelling and renegotiating a BIT may wish to consider the impact on other BITs. One of the challenges faced by a state party is it cannot predict who can bring a dispute under a BIT. It is common for multinational corporations to establish subsidiaries in multiple jurisdictions. If a particular BIT is withdrawn but another inadequate (as far as the state is concerned) BIT exists, there may be some scope for a multinational to use a subsidiary in the jurisdiction of that second BIT to bring a dispute. Forum shopping is the practice of an investor choosing the most favorable regime under which to pursue a claim against a state party.

A state can request a claim be struck out where, at a time when a dispute looks foreseeable, a claimant establishes a subsidiary in a country for the purpose of taking advantage of treaty provisions. However, an allegation of abuse can be very difficult to prove. It may therefore be preferable for cancellations (and renegotiations) to be done en bloc to deter this practice.

Renegotiating BITs: Scope of 'Investor' Status

An issue related to this is the potential pool of claimants who can bring a dispute. The larger the pool, the multiplication of jurisdictions. The term 'investor' is defined very broadly under a treaty such as CETA. Article 8.1 of CETA includes in the definition a party who owns or controls, directly or indirectly, not just an enterprise but stocks or shares or other equity participation in that enterprise, or a debt instrument in or loan made to that enterprise.

It is not just the broad scope of potential claimants that this provision allows but, in the absence of requirement for control, opens up the possibility of a claim being brought by a non-functioning subsidiary. It is difficult to see the rationale for giving those without control of the investment claimant status. A person who purchases shares makes a calculated risk that the investment could go up or down. Public policy allows limited circumstances in which a shareholder can sue an enterprise, for example where the enterprise provides misleading promotion material to induce share purchases.

However, there also has to be a limit to that relationship of proximity or the chain of causation. Control should be an essential element of giving someone claimant status.[38] Underlying a claim for damages based on lost profits is an assumption that the claimant has both the authority and competence to make a return on investment at a certain rate. That is not the case with these sub-categories of investor. In any renegotiation, a state may therefore consider limiting the scope of investor status to those with control.

Compensation and Compound Interest

Tribunals can award both damages and interest to compensate an investor whose rights under a treaty have been breached. Compound interest is routinely awarded. It may be an obscure and uninspiring topic, but it is not for nothing that compound interest was described by Albert Einstein as 'the eighth wonder of the world' for its ability to grow money exponentially. As interest can dwarf the amount ordered to be paid in damages by tribunals, it needs to be considered. This section argues that compound interest is not required to effect adequate compensation and states could seek to amend their BITs accordingly.

In a claim under the United Kingdom–Egypt Investment Agreement of 1975,[39] Wena Hotels Ltd[40] sought damages for an act by the Egyptian government equivalent to the expropriation of two hotels Wena was operating in Cairo and Luxor. The Tribunal found for the claimant and awarded approximately $8 million in damages. These represented the sums actually invested in the hotels rather than lost profits on the grounds that those were considered too speculative. Interest was awarded at a rate of 9 percent, compounded quarterly, which amounted to approximately $11 million.

Interest is not specifically dealt with in the United Kingdom–Egypt Agreement. Article 5(1) provides that compensation shall be 'prompt, adequate and effective'. It continues 'Such compensation shall amount to the market value of the investment expropriated immediately before the expropriation itself'. The ICSID Convention is also silent. Article 42(1) on the powers and functions of the Tribunal provides that 'The Tribunal shall decide a dispute in accordance with such rules of law as may be agreed by the parties. In the absence of such agreement, the Tribunal shall apply the law of the Contracting State party to the dispute (including its rules on the conflict of laws) and such rules of international law as may be applicable'.

In justifying its award of compound interest, the Tribunal approved the decision in *Metalclad* that this would best 'restore the Claimant to a reasonable approximation of the position in which it would have been if the wrongful act had not taken place'.[41] The Tribunal explained:

> [A]n award of compound (as opposed to simple) interest is generally appropriate in most modern, commercial arbitrations. As Professor Gotanda has observed 'almost all financing and investment vehicles involve compound interest … If the claimant could have received compound interest merely by placing its money in a readily available and commonly used investment vehicle, it is neither logical nor equitable to award the claimant only simple interest'.[42]

In *Copper Mesa Mining Corporation v The Republic of Ecuador*[43] the state cancelled mining licenses and the investor initiated a claim under the Canada–Ecuador Bilateral Investment Treaty.[44] The Tribunal awarded damages calculated by reference to proven expenditure, holding that a claim for loss of profits was too uncertain and subjective, depending too much on contingencies which could not be assessed by the Tribunal.[45] Despite this, the Tribunal interpreted the Treaty provision to award interest 'at a normal commercial rate' to mean compound interest.[46]

In both of these cases, the flaw in the reasoning is that the effect of awarding compound interest is to award the claimant the profit it would have made, had it invested the money elsewhere. In both cases, however, the claims to lost profits were dismissed as too speculative. There is therefore an internal inconsistency to the Tribunals' reasoning. More broadly though, to award compound interest is to remove all investment risk from the claimant, at the cost of the state. It assumes the claimant would have made a risk-free investment at, say, 9 percent compounded quarterly. By providing this safety net, the claimant has all of the opportunity to make a greater return on its investment but with none of the risks. There is a respectable argument that this goes beyond the 'adequate' compensation required in many treaties; 'adequate' is not equivalent to 'restitution'.

In awarding compound interest, the Tribunal in *Wena Hotels Ltd* relied on current commercial practice. However, this cannot be the source of a norm of customary international law. There is no common state practice that could support a norm of compound interest. Compound interest is prohibited under Ecuadorian law for public policy reasons. The United Kingdom would also not support such a norm; it successfully defended an appeal in the Supreme Court to avoid paying compound interest on repayments of mistakenly overpaid VAT by arguing that the statutory remedy of simple interest was adequate under both domestic and European Union law.[47]

States could seek agreement to amend their BITs to provide only for simple interest. The South African Development Community (SADC) has published a model BIT to assist countries in their negotiations and in Article 6 'Expropriation' provides at 6.3 for two alternatives of simple interest: 'Payment shall include simple interest at the [LIBOR rate] [current commercial rate of the Host State] from the date of expropriation until the date of actual payment'.[48]

Public Law Issues in Private Law Matters: Financing for Development

Whether states adopt a multilateral investment court or renegotiate BITs, there is an argument for greater deference to public law issues in investment disputes. The rights and obligations provided for under the UN Conventions have permeated norms of commercial practice, whether in labor rights, health and safety requirements, or environmental impact assessments. The international community has undertaken public policy measures at the interface of private commercial matters such as the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) to enable countries to protect public health through access to affordable medicines, the Heavily Indebted Poor Countries Initiative, or the Kimberley Process to reduce the trade in so-called conflict diamonds which could be used to finance conflict.

The most important of these, in terms of norm setting, is the UN's Addis Ababa Action Agenda of the Third International Conference on Financing for Development, at which the international community committed to finding ways to finance the Sustainable Development Goals.[49] Heads of state and government and high representatives committed to promoting inclusive economic growth and an equitable global economic system.

> We will respect each country's policy space and leadership to implement policies for poverty eradication and sustainable development, while remaining consistent with relevant international rules and commitments. At the same time, national development efforts need to be supported by an enabling international economic environment, including coherent and mutually supporting world trade, monetary and financial systems and strengthened and enhanced global economic governance.[50]

On investment treaties they observed:

> The goal of protecting and encouraging investment should not affect our ability to pursue public policy objectives. We will endeavour to craft trade and investment agreements with appropriate safeguards so as not to constrain domestic policies and regulation in the public interest.[51]

Decisions made under investment arbitration tribunals have to be cognizant of these international commitments as part of their understanding of what constitutes current commercial realities or practices.

A move to a public international law framework would be invaluable in implementing these commitments. Returning to *Burlington v. Ecuador*, it appears from the decision that there was no consideration as to whether the tax stabilization clause in the agreement was, like the forward tax agreement in *Al Fayed*, ultra vires. Perhaps a tribunal member with experience more in public international law than private investment law, like those to be appointed under CETA, would have approached the case differently.

Political Will

From where will the political will come to effect changes? The Addis Ababa Actions Agenda is a good place to start. The declarations to commit to the policy responses required to promote inclusive economic growth were reaffirmed by the G7 in May 2017 in the Bari Policy Agenda on Growth and Inequalities.[52] Although the focus of the tax aspects of the Bari Agenda was on tax avoidance, this political commitment needs to be leveraged to revise international investment treaties that are not working for developing economies. Tax and inclusive development remains an item on the international agenda but focus is uneven. The G20 Osaka Leaders' Declaration, published after the G20 met in June 2019, prioritized reform of the dispute resolution system of WTO rules rather than investor treaty dispute resolution.[53] However, before the G7 Biarritz Summit in August 2019, finance ministers and central bank governors met to discuss rules to ensure fair taxation of corporations regardless of their physical presence. They also agreed to ensure 'a minimum level of effective taxation of business profits, in order to address aggressive tax planning schemes'.[54]

That other states are suffering similar challenges of their own can also be employed to create the awareness and empathy needed to make change. The United Kingdom, for example, is facing a GBP 1.2 billion claim from Littlewoods in its compound interest appeal. If they lose, HM Revenue and Customs has estimated its liability to similar claims as up to GBP 55 billion.[55] In addition, following its exit from the European Union, the United Kingdom has a political need to enter new trade agreements to demonstrate that Brexit is a success. The British government has spoken of the potential of reinvigorating the Commonwealth to achieve this end. This then could provide an opening to those member states to negotiate better terms. Similarly, the EU's recent reflections on its trade dispute resolution mechanism with the US, which prompted the decision to promote a multilateral investment court, can also be drawn on.

Conclusion

Providing an attractive investment environment while raising sufficient revenue to fund development is a delicate balance. States need to consider whether financial incentives are necessary and what level of investment protection is required. Each state will approach this from its own unique economic and political setting, and so there is no one prescribed solution. The following is therefore not a list of best practices but options that a state may consider adopting.

- Consider having one body or minister in charge of incentives, and put them on a legislative footing to ensure transparency, accountability, and effective parliamentary oversight. Use incentives rather than tax stabilization clauses for these reasons. A clear legislative framework will also help to protect against claims of legitimate expectation in respect of unauthorized concessions.

- Undertake a review of BITs and FTAs and terminate the ones that do not support the state's development strategy. Seek to renegotiate those that are deficient, to reset an investor's expectations of the level of investment protection provided, for example to assert the state's right to advance public policy objectives, and to clarify that a reduction in profits due to tax increases does not of itself amount to indirect expropriation. As leverage, evaluate what improvements to the investment environment have taken place since the BIT was entered into.
- In terms of investment arbitration, consider agreeing rules under the BIT to appoint arbitrators with public international law expertise, consider whether the level of information and documents available to the public is appropriate or needs to be improved, consider changes in the rules to allow amicus curiae to make representations to the tribunal. Consider supporting the EU's proposal for a multilateral investment court.
- To increase public engagement and facilitate civil society's involvement in supporting reform, consider the efficacy of Freedom of Information legislation.

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6 | MULTINATIONAL ENTITY FINANCE SCHEMES: FORMULARY APPORTIONMENT AS THE WAY FORWARD[1]

Kerrie Sadiq[2]

Executive Summary

One of the most effective but least reported ways multinational corporations (MNCs) shift profits between jurisdictions to lower their tax liability is by using intra-group loans and interest deductions. Profit shifting by MNCs through excessive debt loading and transfer mispricing is facilitated by the currently adopted fiction endorsed by the OECD and adopted in domestic tax regimes that a MNC is a group of separate and independent entities whose transactions with one another are to be recognized for tax purposes. This chapter argues that the undesirable practices of excessive debt loading and transfer mispricing of financial transactions, both of which adopt the separate entity approach, may be addressed with a limited formulary apportionment rule for debt. This approach applies a tax model of the global firm operating as a single entity and allows for profits to be taxed in the location of the economic activity. This chapter uses the specific and detailed facts of *Chevron Australia Holdings Pty Ltd (CAHPL) v Commissioner of Taxation* [2017] FCAFC 62, to demonstrate the economic unreality of the current system. It then suggests that the allocation of worldwide interest expense using a method that is in line with the true nature of the MNC group and akin to formulary apportionment may offer a solution that, while not a panacea, at least removes the fiction of the separate entity approach and allows a deduction for a portion of the group's net external interest expense based on a formula determined by reference to economic activity. The chapter concludes by offering some insights into the likely implications of the global adoption of such a model.

1. Introduction

One of the most effective but least reported ways multinational corporations (MNCs) shift profits between jurisdictions to lower their tax liability is by using intra-group loans and interest deductions. Profits, and therefore tax liabilities, are reduced by shifting earnings away from the location of economic activities. This is done through excessive deductions for interest paid to affiliates that are principally established for tax related purposes. This type of profit shifting mainly affects investment recipient countries, the locations of a MNC's actual operations, which are often developing countries (UNCTAD, 2015). These countries lose tax revenues through the size of, and typically excessive interest rate charged on, such intra-group loans. The first strategy is known as excessive debt loading or thin capitalization, while the second strategy is known as transfer mispricing. In this chapter, the practice of mispricing a loan between related parties by charging a price that is higher than would be agreed to by similar but unrelated parties is termed 'loan mispricing'.

Profit shifting by MNCs through excessive debt loading and loan mispricing is facilitated by the currently adopted fiction that for tax purposes, the subsidiaries of a MNC are separate and independent entities (Picciotto, 2016). Currently, rules that attempt to address excessive debt loading and loan mispricing practices are based on this separate entity approach, thereby relying on a foundation that is, in reality, an economic fiction. Establishment of a single firm across national boundaries reduces transaction costs of acquiring information, bargaining, and protecting trade secrets, as explained in Coase's 1937 article 'The Nature of the Firm'. For MNCs it is more cost effective to operate as a global entity than it is to transact with independent parties. MNCs not only operate on a global scale but they then also profit-maximize by operating as a single global entity for business purposes, on the one hand, but as separate entities for tax purposes, on the other. While the international tax regime applies the separate entity principle in the hope that each jurisdiction is able to accurately tax the economic activity occurring in that jurisdiction, the reality is that MNCs use the economic arrangement to their advantage to shift profits from high-tax jurisdictions to low- or no-tax jurisdictions or to engage in tax arbitrage. The consequence is what is known as tax base erosion.

Surprisingly, given the significance of the use of debt loading and loan mispricing by MNCs, there have been few court cases worldwide initiated by revenue authorities challenging the tax and revenue loss implications of such arrangements. As such, this chapter uses the specific and detailed facts of *Chevron Australia Holdings Pty Ltd (CAHPL) v Commissioner of Taxation* [2017] FCAFC 62 (*Chevron*), to demonstrate the economic fiction of the current system – a system which has historically been accepted and recommended by the OECD. Following a discussion of *Chevron*, the broad current profit shifting practices and recent developments in reform are analyzed. The chapter then proposes a solution that the allocation of worldwide interest expense use a method which is in line with business reality, and also somewhat akin to formulary apportionment. This solution, while not a panacea, avoids the separate entity approach and allows a deduction for a portion of the MNC's net external interest expense based on an equitable formula determined by reference to economic activity. The chapter subsequently analyses recent developments in reform and concludes by offering some commentary into the likely implications of the global adoption of such a model.

2. The *Chevron* Case Study

Despite what is known to be a common practice by MNCs, there have been very few court cases initiated by revenue authorities, which have specifically considered the use of debt deductions as a means of profit shifting. Consequently, *Chevron Australia Holdings Pty Ltd (CAHPL) v Commissioner of Taxation* [2017] FCAFC 62, an Australian Tax Office (ATO) case against Chevron which has significant ramifications and a likely global ripple effect, has been watched closely by an interested audience. The case of *Chevron* is long running and involves tax years dating back as far as 2003, with the initial court decision handed down on October 23, 2015, the appeal decision on April 21, 2017, and a subsequent application for special leave to appeal to the High Court lodged but finally withdrawn on August 15, 2017. The case itself proved to be complex with a total of 11 barristers, 12 witnesses for the taxpayer and 7 witnesses for the ATO, all attempting to prove what constituted an arm's length price (interest rate) for the internally generated debt. However, when the complexities of structures and contracts are removed, the facts of the case are simple: Chevron loaned itself money via an internal transaction at a rate of 9 percent when it had borrowed the money from an external source at an interest rate of approximately 1.2 percent. These facts cannot be (easily) discerned from their financial statements and, in general, would not be revealed in the consolidated financial statements of any MNC, as intra-group debts are not recognized under generally accepted accounting standards. It was only through the court action that the facts were revealed.

2.1 *The Facts of* Chevron

The central issue in the *Chevron* case was whether the interest rate on a loan from Chevron Texaco Funding Corporate (CFC), a wholly owned United States (US)-based subsidiary, to Chevron Australia Holdings Pty Ltd (CAHPL), the Australian parent company, exceeded the arm's length interest rate (the price that might reasonably have been expected in an agreement between independent parties acting at arm's length). The interest was paid under an agreement between the parties dated June 6, 2003, called a 'Credit Facility Agreement'. The purpose of this agreement was to affect an internal refinancing of an Australian currency debt of Chevron Australia and to fund the purchase of Texaco Australia Pty Ltd by CAHPL. CFC was established in the US to lend funds in the amount of US$ 2.5 billion to CAHPL with interest rate payable at AUD-LIBOR plus 4.14 percent after raising that money from the commercial paper market at approximately 1.2 percent. No security was provided by CAHPL and the advance to CAHPL was not guaranteed by the US parent company. For each income year in question, CAHPL claimed a tax deduction in Australia for the interest it paid to CFC. There was no withholding tax imposed on the interest payments as Australian tax law provided an exemption to the type of arrangement in place.

CFC then paid dividends to CAHPL out of its profits, which were non-assessable non-exempt income under the Australian income tax regime. Non-assessable non-exempt income is income which is expressly excluded from being subject to tax under Australia's taxation laws and, as such, is completely tax free. In this case, the dividends were exempt because non-portfolio dividends paid to a company are not assessable when received by an Australian resident company. Further, evidence provided to the court, which it accepted, was that no tax was payable in the US on the profits earned by CFC. While not revealed in the case, this was no doubt due to the US 'check the box' rules which allowed CFC to be a disregarded entity and treated as part of CAHPL with the internal transactions subsequently ignored. The arrangement effectively provided a 'round robin' of money with Chevron relying on tax arbitrage to reduce its tax liability and maximize its profits.

Australia has what are known as thin capitalization rules, which contain a separate entity level debt to equity ratio rule and are designed to limit the amount of debt which can be used to generate an interest deduction. However, these were ineffective against such an arrangement. This is because, despite a default objective debt to equity ratio of 1.5 to 1, there is an overriding provision which allows a deduction to be the arm's length debt amount, which is what was claimed in this case. Instead, relying on what are known as transfer pricing provisions, contained in Australia's domestic legislation,

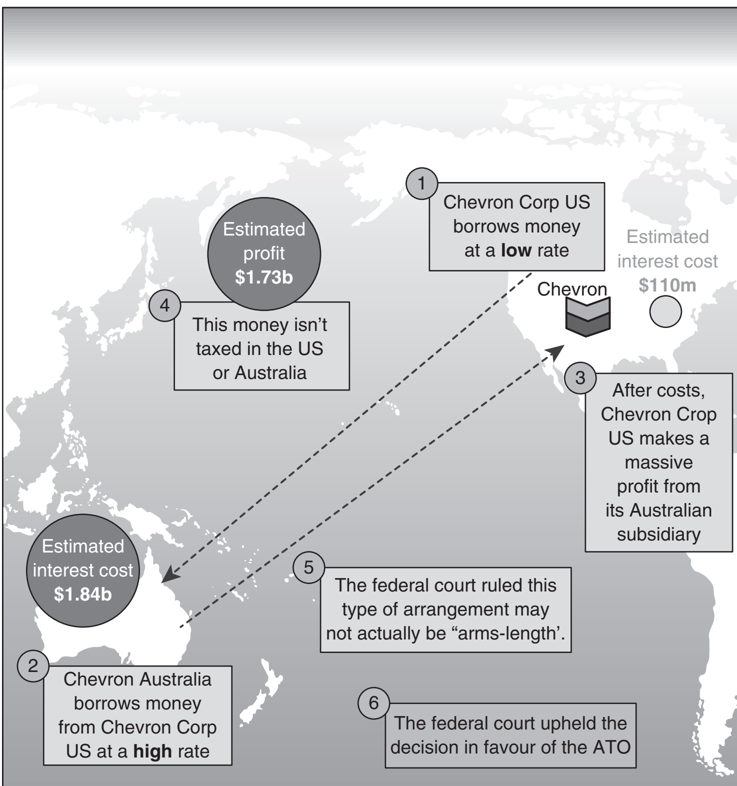

Figure 6.1 How the off-shore structure worked

Source: Mather (2017).

rather than general anti-avoidance provisions, the Commissioner of Taxation (the Commissioner) issued amended income tax assessments on the basis that the consideration paid by CAHPL to CFC exceeded the arm's length price that might reasonably have been expected in an agreement between independent parties acting at arm's length. CAHPL appealed the amended assessments, which were based on an interest rate of approximately 5 percent (Preshaw, 2016). Attention around *Chevron* was significant, with many of the media depicting both the simplicity of the arrangement and the tax benefits which resulted. For example, the *Australian Financial Review* published Figure 6.1, which clearly explains the structure adopted.

A more technical version of the structure, explaining the legal arrangements in place, along with the fiscal significance, is depicted in Figure 6.2.

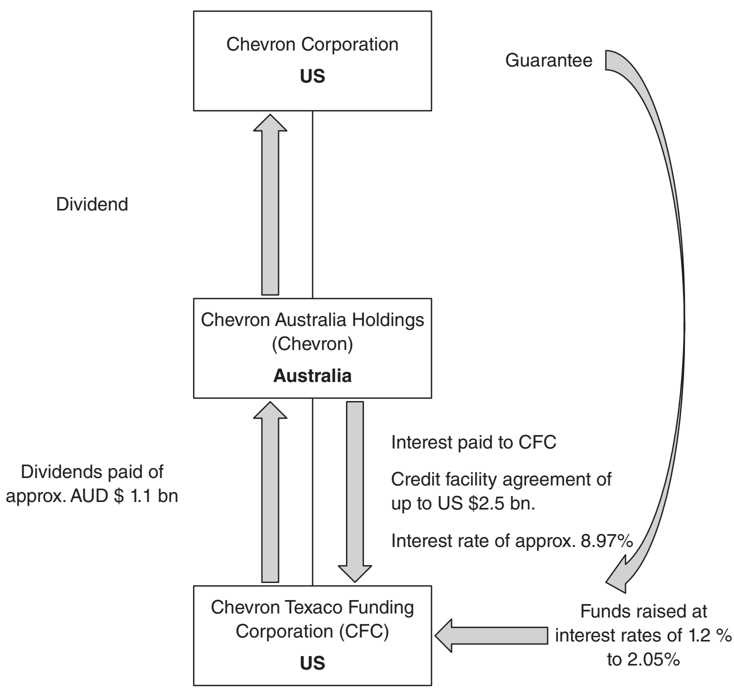

FIGURE 6.2 Chevron arrangement

At first instance, Federal Court Judge, Robertson J, upheld the transfer pricing (amended) assessments finding for the Commissioner on the basis that Chevron was not able to demonstrate that 'the consideration in the Credit Facility Agreement was the arm's length consideration or less than the arm's length consideration nor proved that the amended assessments were excessive' (*Chevron*, 2015: para. 525). In reaching this decision, Robertson J found that no reasonably accurate independent third-party agreement could be identified for comparison purposes. As such, it was necessary for His Honour to determine what one might look like and to take a broad view of what was to be taken into account to determine an arm's length price. This resulted in not only price being relevant but also other factors such as security over assets and loan covenants that a borrower would have provided to a lender.

In April 2017, Chevron lost its appeal to the Full Federal Court against the decision of Robertson J. The predicted special leave to appeal to the High Court was lodged but, on August 15, 2017, Chevron withdrew its application. While the case may bring to a close one of the largest tax disputes ever seen in Australia, it is unlikely to be the end of transfer pricing disagreements on the issue of intra-company debt and the effects are likely to be felt across other jurisdictions. More importantly, the case of *Chevron* reveals the unquestionable problems of excessive debt loading and loan mispricing of financial arrangements and the economic fictions contained in current tax regimes to deal with these kinds of tax arrangements. The case specifically dealt with transfer pricing provisions but also reveals the difficulties that arise in the tax system as a result of debt loading and how the thin capitalization rules are not adequate to deal with them.

2.2 *The Fiction of* Chevron

A tax system which allows a MNC to borrow funds externally for 1.2 percent and then on-loan those funds internally at 9 percent, is arguably flawed. The question then is how the current international tax regime deals with this type of transaction to prevent the profit shifting and tax arbitrage which occurred in a case like *Chevron* and many others around the world. The answer lies in the current arm's length requirement of transfer pricing rules found both in bilateral tax treaties based on the OECD Model Tax Convention and domestic legislation adopted almost universally. It is these principles that the court had to apply in *Chevron*. Applying the arm's length requirement of the transfer pricing rules to the facts in *Chevron* reveal numerous fictions which can be broadly divided into two categories: first, determining what an arm's length loan would look like, and second, determining what a separate entity looks like.

First and foremost, the fiction of the separate entity model meant that the court had to determine what an arm's length loan between two independent parties would look like. All expert witnesses on both sides acknowledged that no loans between independent parties would be entered into on the terms in the agreement, principally due to a lack of formal guarantee. There was no directly comparable loan even under the most basic of fictions. Consequently, the court broadened its deliberations to determine what was an arm's length 'consideration' to find that 'consideration' not only included the price of the loan but broader factors such as the security that came with being part of the Chevron group. The result was that the determinations centered on not only the interest rate but also the terms of the loan and the role of third parties to the transaction, in particular the parent company and any guarantees, insurance, or credit default swaps associated with that relationship. The Court also considered the currency of the loan and whether the taxpayer's decision to borrow in AUD should be respected or whether the arm's length determination should be in USD.

Perhaps the greatest fiction in the case, however, centered on whether CAHPL should be treated as what was labeled an 'orphan', that is, as if it were a truly independent party dealing at arm's length. Such an approach would remove any implicit parent company support and allowed Chevron to argue that the interest rate of 9 percent was due to a lack of any guarantee. The Full Federal Court rejected this argument stating that

> the independence hypothesis does not necessarily require the detachment of the taxpayer, as one of the independent parties, from the group which it inhabits or the elimination of all the commercial and financial attributes of the taxpayer being part of the circumstances that gave the commercial shape to the property the subject of the acquisition and that may be relevant to the consideration for the property. (*Chevron*, 2017: para. 43)

The Full Federal Court held that the question to be asked is:

> What is the consideration that CAHPL or a borrower in its position might reasonably be expected to have given to an independent lender if it had sought to borrow AUD 2.5 billion for five years? The answer to this question is to be found in the evidence. Here the borrower in the independence hypothesis is a company in the position of CAHPL. It is part of a group the policy of the parent of which was to borrow externally at the lowest rate possible. Further, it was usual commercial policy of the parent of the group for a parent company guarantee to be provided by it (the parent) for external borrowings by subsidiaries. In those circumstances, the consideration that might reasonably be expected to be given by a company in the position of the taxpayer CAHPL would be an interest rate hypothesised on the giving of a guarantee of CAHPL's obligations to the lender by a parent such as Chevron. (*Chevron*, 2017: para. 62)

The result was that the fiction created was not that of a truly independent entity, rather it was one which did have connections with the parent company but only in so far as the parent company might give a guarantee for the loan. This is a reality that simply does not exist. To reach its decision the court effectively had to imagine the 'property' that was part of the transaction, whether the simple loan or the bundle of rights, the fictional borrower, and whether they were a stand-alone entity, the fictional lender and the fictional price that the parties would pay (Frost et al., 2017).

Ultimately, the court did not have to decide whether the Commissioner's amended assessments resulted in an arm's length price being applied, as the onus was on Chevron to prove the assessments were excessive. While the Full Federal Court found in favor of the revenue authority and the decision was declared a win in the fight against profit shifting, both the facts of the case and judgments reveal the fiction that the current laws impose. This case not only highlights the transfer pricing issues around the use of intra-group debt, but also excessive debt loading or thin capitalization (Ting, 2017). As Ting's (2017) investigation reveals, an analysis of the Chevron group's financial position in 2014 suggests that the group as a whole had no external interest expense despite intra-group debt between

Australia and the US of $35 billion, amounting to AUD 1.84 billion in interest tax deductions in Australia. There is little doubt therefore, that the transactions were entered into for tax related purposes and even an interest deduction of 5 percent is a fiction as the money could have been easily provided through equity which, absent tax benefits, is a less expensive, and therefore more profitable, option.

3. The Practice of MNCs Shifting Debt Deductions

MNCs take advantage of the separate entity approach of the tax system and engage in the practice of both excessive debt loading and loan mispricing to shift profits between different tax jurisdictions to minimize their tax liabilities. As demonstrated in *Chevron*, the current international tax system attempts to address this via bilateral tax treaties and domestic rules.

The first practice – excessive debt loading or thin capitalization – relies on the fact that MNCs can easily transfer money among related parties. Money is both mobile and fungible which makes it possible for MNCs to achieve favorable tax results by adjusting the amount of debt within the group and is often cited as one of the simplest ways to shift profits (Burnett, 2015; OECD, 2016; Ting, 2017). This practice is exacerbated by the fact that jurisdictions generally treat debt and equity differently for tax purposes. The cost of debt is deductible for tax purposes whereas the cost of equity is not, and as a result, there is a skewing of financing decisions towards borrowing. In its simplest form, a MNC can lend itself money through a transaction that is internal to the group. Where the separate parts of the entity are treated as stand-alone, debt is transferred from a low-tax jurisdiction to a high-tax jurisdiction via a loan that, in turn, provides an interest deduction that reduces taxable profits in the high-tax jurisdiction and provides income in the form of interest earnings in the low-tax jurisdiction. There are numerous variations on this type of arrangement, of differing sophistication, but the result is the same – profits are shifted from a high-tax jurisdiction to a low- or no-tax jurisdiction. To date, developing and developed countries alike have adopted a variety of rules to combat this type of tax avoidance, including arm's length tests, withholding taxes, rules that limit the level of interest expense or debt in an entity with reference to a fixed ratio, rules that limit the level of interest expense or debt with reference to the group's overall position, and specific anti-avoidance rules that disallow certain interest expenses (OECD, 2016). However, most of these rules adopt a separate entity approach and stem from the traditional OECD view of the MNC where transactions internal to the group are recognized and form the basis for determining the deductibility of the interest amount for tax purposes.

The second practice – transfer mispricing – relies on the fact that subsidiaries of the MNC can easily price internal transactions to benefit the global MNC group. A transfer price is simply the price at which separate parts of the MNC transact with each other. Under the current transfer pricing rules, internally booked transactions are recognized for tax purposes, providing a deduction in one country and income in another, despite the global entity owning and/or creating the goods and services transacted. While transfer pricing is not of itself tax avoidance, transfer mispricing, or charging for those goods or services at a price different to an arm's length price, is. For example, on a loan between related parties, a higher interest rate may be charged in the high-tax jurisdiction to increase the tax-deductible expense, thereby reducing profits in that location while transferring those profits via an interest payment to a low- or no-tax jurisdiction. Again, this problem arises because the different parts of the MNC are treated as stand-alone entities. For tax purposes, current transfer pricing regimes recognize the transactions between the different parts of the MNC and adopt the arm's length pricing requirement (what independent parties would pay) to counteract these types of transfer mispricing practices. However, this necessarily assumes that an arm's length price exists.

A determination of the arm's length price generally requires a comparison between related party transactions and comparable transactions with an independent third party. Several methods, grouped into 'traditional transaction methods' and 'transactional profit methods', are considered appropriate for determining an arm's length price. The traditional transaction methods, consisting of the comparable uncontrolled price method, the resale price method and the cost plus method, all rely on the notion that transactions internal to the MNC should be recognized for tax purposes and that a substitute price can be determined according to the market. The comparable uncontrolled price method 'compares the price for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances' (OECD, 2017). The resale price method is based on the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise, with the resale price reduced by the resale price margin leaving an arm's length price (OECD, 2017). The cost plus method, also relying on independent comparisons, starts with the costs incurred by a supplier and then determines an appropriate cost plus margin to ascertain an appropriate arm's length price (OECD, 2017). The transactional profit methods, consisting of the transactional net margin method and the transactional profit split method, examine the profits that arise from particular transactions among associated enterprises, but still determine the price of the dealings according to an arm's length standard. The common factor in applying all of these methods is that the fiction of the separate entity approach is adopted.

Excessive debt loading and debt mispricing of financial transactions is not a new phenomenon and has been proven to be a significant global issue, with prior research findings indicating that both methods of profit shifting are used by MNCs operating not only in developed countries but also in developing countries (ActionAid, 2013). It has been established in academic studies that tax rules do influence the location of debt within MNCs and that levels of debt are multiplied via intra-group financing arrangements (Møen et al., 2011; Huizinga et al., 2008; Mintz and Weichenrieder, 2005; Desai et al., 2004). Studies also indicate that developing countries are even more prone to these risks (Fuest et al., 2011), principally due to their greater reliance on revenue from corporate income taxation compared to developed countries (Durst, 2015). Developing countries, therefore, should be concerned about this type of behavior by MNCs, which results in both increases in internal debt as well as locating debt in high-tax jurisdictions. To date, the success of measures to limit tax base erosion and profit shifting by MNCs using these methods has been limited.

4. A Limited Formulary Apportionment Model

This chapter suggests that a limited formulary apportionment model for debt may provide a solution to the problems outlined above. Calls for a general formulary apportionment regime are not new but have gained little traction within the OECD's program for international tax reform. In 2012, the Base Erosion and Profit Shifting (BEPS) program was initiated by the G20 and, since that date, has been headed by the OECD. This program was designed to address MNC tax practices that result in tax base erosion and profit shifting with a 15-point action plan devised and final recommendations handed down in October 2015. 'Tax base erosion and profit shifting' refers to the practice of MNCs by which they use aggressive tax planning and tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low- or no-tax jurisdictions (OECD, 2017). Where the related party borrower is in a high-tax jurisdiction and the lender is in a low-tax jurisdiction, benefits automatically flow (Burnett, 2015: 1). The result is two-fold: first, the income base which is being taxed may be reduced leading to lower taxes collected, and second, profits may still be taxed, but in a lower tax jurisdiction, thereby also reducing the overall amount of taxes collected. As such, there is base erosion in the borrowing jurisdiction, often a resource-rich developing country, and profit shifting to the lending jurisdiction, often a tax haven (Burnett, 2015: 1).

Broadly, proponents of formulary apportionment as a solution to these base erosion and profit shifting practices argue that MNCs should be treated as unitary entities (Picciotto, 2016), while the current global tax system treats them as a group of separate entities, each with its own income to be taxed in its own jurisdiction. Under a unitary taxation regime with a formulary apportionment model for distribution, the global income of the MNC is distributed among taxing jurisdictions based on allocation keys; normally a combination of sales, labor, and assets. Unitary taxation and formulary apportionment were specifically ruled out by the OECD as an alternative to the current arm's length principle in the transfer pricing regime on the basis that it believed consensus on this proposal was not possible, nor was formulary apportionment immune from manipulation. Yet, in theory at least, it more accurately reflects the position of a MNC as a whole as a well-designed system would ensure that all income of a MNC is taxed, and that it is taxed in the location of the economic activity giving rise to the income. Such a regime then leads to a 'fairer' allocation of taxing rights.

Despite a general formulary apportionment approach being specifically excluded from consideration in relation to Actions 8–10 of the OECD BEPS agenda for reform, in the initial *Public Discussion*

Draft to Action 4: Interest Deductions and Other Financial Payments, one of the key structural design issues centered on whether limitations on the deductibility should be based on the position of an individual entity or the MNC as a whole; the former reflecting the separate entity approach and the latter representing the group approach. The proposed group method was a method designed for the allocation of interest deductions to jurisdictions by reference to the position of an entity's net external group interest expense. This proposal would do two things. It would limit the interest expense claimable by the whole group to interest paid to creditors outside the group; that is, it would for tax purposes disregard interest payments among group members. This approach is akin to a limited formulary apportionment model in that it would only be used for interest expense and not be applied to the broader net income of the group. This approach would limit an entity's interest deductions by reference to the group's actual third-party interest expense and then, within the group, interest expense would be matched with economic activity however defined. The proposal for a limited formulary apportionment model to allocate worldwide interest expense based on an allocation formula is not new and is argued to 'solve' many of the problems associated with the current regime (Graetz, 2008).

It is widely accepted that MNCs should be able to claim tax relief for the real cost of borrowing. But this needs to be balanced with the possibility of excessive deductions being claimed through tax planning strategies. The OECD recognized that a way to achieve this balance is to encourage entities to adopt funding structures that more closely align the interest expense of each of the parts of the MNC with that of the overall group (OECD, 2014). In its Public Discussion Draft, the OECD explains:

> Group-wide rules limit an entity's deductible interest expense with reference to the actual position of its worldwide group. [There are] … two basic premises. Firstly, that the best measure for total net interest deductions within a group is the group's actual net third-party interest expense (i.e. total interest paid to third parties less total interest income received from third parties). Secondly, that within a group interest expense should be matched with economic activity. Where net interest expense is matched with economic activity, groups will obtain tax relief for

an amount equivalent to their actual third-party interest expense. (OECD, 2014: 27)

As previously stated, this approach would limit an entity's interest deductions by reference to the group's actual third-party interest expense and then, within the group, interest expense would be matched with economic activity. The consequence is that the total interest deduction does not exceed the value of the group's actual third-party interest expense. By only taking into account actual third-party interest expense, the group-wide rules also take into account changes in funding needs of the entity as a whole as well as decisions of management, market conditions, and sector specific issues (OECD, 2014: 27). The OECD suggests two variations on the group ratio rules. The first would allocate the group's net third-party interest expense among members of the group based on a measure of activity such as earnings or asset values, while the second would compare relevant financial ratios of an entity with the equivalent ratio of the entity's worldwide group (OECD, 2014: 29). This chapter favors the former method as the appropriate allocation key because it is the closest approximation to economic activity and therefore the best proxy for determining the deemed interest expense allowed as a tax deduction with actual interest ignored.

In addition to proposing an allocation of net third-party interest expense, it is proposed that the measure of activity for the purposes of allocation should be earnings, as they are the 'clearest indicator of value creation across a group' (OECD, 2014: 36) and ensure that net interest expense is allocated to the location of economic activity. Using assets as an alternative allocation key raises issues around the assets to be included (for example, only fixed assets or also intangible assets), and where they are located and their value, and is therefore potentially faulty, and unlikely to reflect economic activity in all but the simplest of cases. Using earnings as an allocation key also has wider profit shifting implications, as it is only through increased earnings that an entity operating in a particular jurisdiction can increase its interest deduction. Earnings may be measured in several ways. However, the most common method is to determine earnings before interest, taxes, depreciation, and amortization, known as EBITDA. EBITDA is also generally viewed as a means of determining an entity's ability to meet its obligations to pay interest expense and for that reason is an ideal proxy for determining interest deductions. Earnings before tax is an alternative method for determining the allocation but raises issues around the fact that interest has already been deducted as has the cost of assets. This may be considered problematic in the sense that interest expense should be allocated on the basis of actual earnings in a jurisdiction without taking into account any sort of interest deduction or allowance for assets. The process for determining the deemed interest deduction for an entity in a given jurisdiction would entail the calculation of the group's net third-party interest expense and total earnings or assets. The parts of the group would then determine their allocation of the group's net third-party interest expense by reference to a ratio of earnings or assets. This amount would subsequently be deemed to be deductible and actual interest would be ignored.

Adoption of group-wide interest allocation rules raises key issues that would need to be addressed in a similar vein to a broader unitary taxation with formulary apportionment model. These issues include such questions as to the entities included in the group, the methodology for determining the group's net third-party interest expense, the method of measuring economic activity, and mismatches between accounting and tax rules (OECD, 2014: 32). However, the policy rationale for a group-wide rule is sound as there should be a linkage between interest deductions and net external debt to recognize that MNCs are a single entity. There is a sound policy rationale in the proposal that interest deductions should be limited to 'real' interest expense of the group, disallowing internally generated deductions (Ting, 2017), as this mimics the economic reality of the MNC. Under this rule, if there is no debt external to the group, there is no interest deduction as the internalization by the MNC and operating as a group is recognized. As Graetz (2008: 492) explains,

> the mismeasurement of income, potential distortions in the location of investment, an increased incentive for debt over equity finance, distortions in the location of borrowing, and unjustified revenue transfers among countries – would all disappear if all countries allocated interest deductions to assets on a uniform worldwide basis and allowed a proportionate amount of interest expense to be deducted against income earned domestically without regard to where the borrowing occurs.

5. Recent Developments in Reform

Excessive debt loading and loan mispricing were a significant part of the OECD BEPS program with transfer pricing being the most discussed topic among stakeholders (OECD, 2017). Action 4 specifically dealt with limiting base erosion involving interest deductions and other financial payments, while Actions 8 to 10 addressed transfer pricing. Excessive debt loading is generally associated with tax base erosion as it provides an interest deduction for tax purposes where one would normally not be available. Compounding this is the fact that, through internal loans, MNCs may be able to claim interest deductions which exceed their external third-party debt (Panayi, 2015: 72). Further, an interest deduction, while recognized as an expense in one jurisdiction, may not be recognized as income in another jurisdiction, hence there is what is known as tax base erosion (OECD, 2014: 2). The tax base, or measure upon which an assessment of tax is founded, can be eroded not only in each domestic jurisdiction but, as the previous statement implies, it can be eroded at a global level when profits are moved to a non- or lower-tax jurisdiction.

Initially, the OECD BEPS program focused on developed countries, however, by 2014, developing countries were also expressing their concern and contributing to the program of international tax reform. At that stage, developing countries were surveyed by the United Nations (UN) to determine their 'priority' concerns. In their responses to the UN questionnaire, developing countries reported that transfer pricing was the issue of most concern, with interest deductions, in particular debt levels, also featuring prominently (UN, 2014). The questionnaire, undertaken by the UN specifically as a means of collating developing countries' concerns about BEPS and communicating with the OECD in relation to their BEPS project, reported that of the 18 countries which responded to a question about the relative importance of the OECD Actions, 10 countries included Action 4 (Interest deductions), with only transfer pricing actions rating higher.

Ultimately, the group-wide test discussed above was relegated to the category of an alternative model, with a fixed ratio model recommended as the best practice approach. This approach uses a fixed ratio of between 10 and 30 percent of its profit, measured using earnings before interest, taxes, depreciation and amortization (EBITDA) as the maximum net interest deduction allowed. The fixed ratio model is applied at a country level to the individual entities rather than taking into account the MNC group. As of 2019, all EU Member States have adopted this method, generally at a 30 percent limit. This solution is a blunt tool that merely limits the deductibility of interest but does not protect against loans generated internally for tax purposes nor against excessive interest rates.

The shift to a fixed ratio as the 'gold standard' appears to be largely driven by submissions received in relation to the initial Public Discussion Draft to Action 4. These public submissions, totaling 103 and running to 1,016 pages, argued that a group-wide test was of itself artificial and a step towards formulary apportionment that would, for example, 'irreparably damage the arm's length standard' (ICC, 2015). Other submissions argued that such an approach would be 'mechanical' and 'totally incompatible with transfer pricing taxation' (JFTC, 2015) and 'would remove the ability of individual territories to determine their tax policy' (PwC, 2015). There is little evidence as to why submissions objected so vehemently to a form of formulary apportionment. Nor do submissions contain any theoretical rationale for maintaining an arm's length approach. Rather, it appears that the written comments by industry and business representatives merely objected to a move away from the status quo (Panayi, 2015: 75). Following written submissions, the OECD held a day-long Public Consultation meeting on February 17, 2015. Similar sentiment was expressed by taxpayer representatives at that meeting with reservations focusing on 'administrability of the rule rather than its coherence at the level of principle' (Burnett, 2015: 3).

The strongest sentiment throughout the submissions was that an allocation of net third-party interest expense of the MNC was a precursor to formulary apportionment, which is directly contrary to the current position of the OECD and its support for the arm's length principle. Submissions argued that the OECD should not diverge from an approach that encouraged arm's length behavior among related parties. Yet, these arguments can be refuted on the basis that, as previously outlined, the arm's length standard itself is faulty and should not be maintained. Very few submissions, however, acknowledged the fact that limiting interest expense tax deductions to external loans would reduce interest deductions to a level well below what is currently allowed under approaches that treat entities as separate parts of the group. The adoption of a formulary apportionment approach limited to interest expense would still reduce base erosion and profit shifting and benefit all countries (BEPS Monitoring Group, 2015). Rather erroneously, as academic studies and the facts in the case of *Chevron* reveal, submissions to the Public Discussion Draft on Action 4 also suggested that regulatory and commercial considerations drive MNC funding structures and debt is not issued or located for tax purposes. Clearly, in the case of *Chevron* at least, this is a false claim.

Despite the OECD focus on excessive debt deductions in Action 4 and transfer pricing practices in Actions 8–10 of the BEPS program, the resulting recommendations have arguably fallen short. Action 4 final recommendations now involve a fixed ratio rule applied to the individual parts of the MNC with net interest expense deductible up to a benchmark ratio within a certain range. This recommendation aligns with the separate entity approach and allows MNCs to recognize internally generated transactions for tax purposes. While it somewhat limits tax base erosion and profit shifting, it fails to eliminate the source of the problem as a deduction is still ultimately available for internally generated debt up to the maximum (generous) ratio. Action 8–10 recommendations also continue to support the separate entity model on the basis that the arm's length approach remains the gold standard. This means that profit shifting can also continue within the bounds of what constitutes an external arm's length price for internally generated debt. Thus, even if countries adopt the suggested OECD reform measures, flaws in the existing models for addressing profit shifting via debt deductions remain.

6. The Way Forward

The outcome of the proposals under Action 4 of the BEPS program, as well as the transfer pricing actions, means that very little has changed to address excessive debt loading and loan mispricing, and the separate entity approach remains entrenched in domestic legislation and OECD recommendations. This fiction allows MNCs to continue to profit shift by creating interest deductions through intra-group loans. The rationale for maintaining the separate entity approach is often one of convenience, both in terms of the convenience of jurisdictions to apply their own tax rules to individual entities rather than the group and the convenience of path dependency or maintaining the current regime. Yet, both arguments are premised on the flawed separate entity principle.

A group-wide test has the greatest potential to reflect the true nature of the MNC group. It limits interest deductions to actual third-party interest expense and it directly links interest deductions to economic activity by providing a formula for jurisdictional allocation based on earnings or asset values. By doing so, such a rule prevents a MNC group from claiming a tax deduction for interest expense in excess of its actual interest costs (Panayi, 2015: 74). It also reduces the need to apply transfer pricing rules because the cost of intra-group loans is no longer relevant. In fact, the group-wide rule would remove the need for transfer pricing of related party financial transactions for tax purposes as the application of the rule would allocate an interest deduction to each jurisdiction based on the actual arm's length interest rate borne by the MNC (Burnett, 2015: 13). Beyond the revenue raising benefit, this is perhaps the greatest benefit for developing countries as it deals with both excessive debt borrowing and excessive interest rates in one measure.

In the long run, if all countries adopt such a rule, all net third-party debt is deductible. From a country and tax authority perspective, the approach is also relatively easy to administer. However, pragmatically, if some countries do not adopt such an approach, there is ongoing potential for tax abuse. For example, there is an incentive for MNCs to raise third-party (external) borrowings in countries that do not apply the rule and do not have robust protections around profit shifting. This potentially allows for 'double dipping' (OECD, 2014: 30), where a MNC gets a deduction in two different jurisdictions for the same expense. The duplication of deductions may be prevented by putting in place rules which limit deductions where a MNC operates in jurisdictions without group-wide rules. For example, conditions on deemed deductions could operate to ensure that no deduction is available where more than the group-wide ratio is deducted in non-adopting jurisdictions (Burnett, 2015: 5).

It must be recognized that, currently, a group-wide rule is not adopted by major OECD countries as their main rule to address excessive debt deductions (Lunardi, 2017: 315). However, such a rule is not without precedent. As Burnett points out, there are countries such as Germany (since 2008), Australia (since 2001), and New Zealand (since 1996) which have the group-wide rule as an alternative to a fixed ratio and/or arm's length rule (Burnett, 2015: 5). Further, there is no doubt that there is the potential for MNCs to take advantage of mismatches where there are non-adopters of a group-wide rule as it is a rule that is dependent on at least some degree of cooperation among jurisdictions. However, it should be recognized that 'as more countries adopt a group-wide rule or a group-wide element to a combined rule, the overall compliance burden of MNCs should reduce relative to present levels, as they and the tax authorities take advantage of group-wide systems and one-off calculations' (Burnett, 2015: 5).

Administrative obligations, compliance costs, and the complexity associated with such an approach will be highly dependent on the availability of group data and rules which recognize income and expenses being similar between jurisdictions where a MNC operates. The former issue of group data is potentially already being addressed through the requirements of country-by-country reporting which was Action 13 of the OECD BEPS program and has been implemented or agreed to by more than 100 countries. The latter issue of global acceptance is clearly more challenging. The deemed interest rule may also be resisted by countries that believe that a deemed interest deduction should not be allowable where no actual interest was incurred in the jurisdiction (Ting, 2017). This logic applies where the separate entity approach is maintained to some extent and it is not recognized that countries are able to tax a share of the global profits so global expenses should also be recognized. Consequently, some jurisdictions may see the move towards a limited formulary apportionment model which applies to interest expense only as not going far enough. However, it also needs to be recognized that even with a limited formulary apportionment approach, jurisdictions do get to tax larger profits of MNCs which arise out of the synergistic benefits of being global. Further, it has been suggested that there is no national competitive advantage in departing from this approach (Graetz, 2008). That is, individual nations will not gain by maintaining a traditional, alternate approach.

The case of *Chevron* clearly reveals the fictions surrounding the thin capitalization and transfer pricing rules which are currently the OECD recommended approach. This chapter has proposed an alternative for developing countries which would disallow the tax benefits from *Chevron*-type transactions. The proposal has been recognized by the OECD as a way to deal with the 'erosion of countries' tax bases by interest deductions' which is 'one of the simplest and most ubiquitous phenomena being dealt with by the BEPS initiative' (Burnett, 2015: 13). Yet, little traction came from such an obvious solution. Perhaps, as the world takes stock of *Chevron*, the practical ramifications of maintaining the arm's length approach will be clearer to many.

Ultimately, while the technical details may appear complicated, the premise of this chapter is simple. This chapter argues that the practices of excessive debt loading and loan mispricing, both of which take advantage of the separate entity approach, may be addressed with a limited formulary apportionment rule for debt. This approach applies a tax model of the global firm operating as a single entity and allows for profits to be taxed in the location of the economic activity.

Notes

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7 | JOINT TAX AUDITS BETWEEN DEVELOPED AND DEVELOPING COUNTRIES

Jörg Alt and Charles B. Chilufya[1]

Executive Summary

This chapter presents the case for joint tax audits, especially between developed and developing countries, and presents the experiences of Germany and Bavaria. The authors propose including joint tax audits in double tax agreements as this would greatly benefit attempts of developing countries to recover lost revenues and mobilize resources for development. The authors identify the legal foundations and international political commitments for joint tax audits and explore reasons why the instrument has only been applied on a limited basis.

1. Introduction

This chapter argues that joint tax audits are an important instrument for advancing developing countries towards tax justice and a better future for their citizens. They are among the most suitable responses in today's increasingly borderless economy and the current context of increasing international transactions by corporations, trusts, other enterprises, and individuals. The growing internationalization of business transactions implies that revenue bodies will have to collaborate more closely in order to enhance compliance with international standards embodied in national tax rules.

Between 2013 and 2017, three Jesuit-sponsored institutions in Kenya, Zambia, and Germany, namely the Jesuit Hakimani Centre, Jesuit Centre for Theological Reflection (JCTR), and Jesuitenmission, carried out research into the link between 'Tax Justice and Poverty'.[2] One of the main goals of the research was to understand practitioners' views of tax-dodging-related deficits via formal and informal interviews and to collect suggestions on how those could be addressed and amended. Within this context, the issue of joint tax audits emerged.

In starting their research, the authors looked for issues linked to business activity in each of the three countries where their institutions are located. In the process, they came across a German company, Ferrostaal, which had purchased a large piece of land in Mpika, in the Northern Province of Zambia, in cooperation with a South African Company, Deulco Renewable Energies, allegedly to plant Jathropha. Ferrostaal is not known for any involvement in agriculture, but rather for its 'industrial services' on a larger scale. What is also known is that the company has been cited for its involvement in a number of corruption cases and even charged huge fines. This made the authors wonder: why would Ferrostaal suddenly begin operations in a remote place like Zambia?

When the researchers visited the Ferrostaal project in Mpika in 2014, it was obvious that not much was going on there, despite press reports that at least a trial phase of the project was under way since 2011. At the same time, locals had been expelled from their traditional homesteads and security guards had been mounted to watch over the well-secured and fenced compound. When the authors dug deeper, the representative of Ferrostaal in Zambia, a lawyer, told them that he quit his job because of Ferrostaal's failure to pay him. But if this was indeed the case, who was paying the guards that were manning the Ferrostaal property? And why were people not permitted to return to their homes? The authors asked Ferrostaal via a registered letter on October 9, 2015 to comment on this state of affairs. Ferrostaal never replied.[3]

Why is a company, whose industrial stakes are not known to be in agriculture and whose past was littered with corruption cases, doing this? With the answer unknown, a former employee of Ferrostaal proposed that the solution would be to conduct a joint tax audit and, by going through the books at both headquarters and the local branch, find out who was paying what money to whom, for what purpose, and via what channels.[4] This would enable authorities to see whether any serious business was actually underway, or if this deal was just one of the many cases of tax avoidance, exploitation of tax incentives, money laundering, or land grabbing. The interview partner emphasized further that joint tax audits would generally be the best way to uncover the illicit practices of transnational corporations.

The legal foundations for tax audits already exist as do international political commitments to increase domestic revenue mobilization and the pledge of developed countries to support developing countries in this area. Yet, this instrument of joint tax audits has not been sufficiently studied, nor is it widely known, and nor do skilled and trained personnel exist. And it is not widely applied among even developed countries as it should be, and to the author's knowledge as of the publication of this article not at all applied between developed and developing countries or between developing countries. Existing literature on joint tax audits mainly focuses on the advantages of using them and the need to amend or provide for the requisite legislation, as well as a few examples of joint tax audits and the results of pilot projects done so far (Burgers and Criclivaia, 2016).

Why are joint tax audits even now so rarely employed? This is the question to which this chapter seeks to respond. The authors argue that it is in the interest of developed countries to assist developing countries in developing tools to enhance revenue collection, like joint tax audits, so that they may gain financial and economic independence. The authors further argue that developing countries should equally do all they can and play their role by enhancing cooperation among themselves.

The chapter proceeds as follows. First, it presents a short review of literature demonstrating how understudied the topic is thus far. Second, it seeks to evaluate experiences with the instrument and the status of its application. Third, it describes the legal foundations of joint tax audits. Fourth, the authors explain why in their view there is no transcontinental cooperation so far and finally, suggest reasons why this cooperation should be explored and implemented.

2. Joint Tax Audits: A Review of the Literature

A joint tax audit takes place when 'two or more countries join together to form a single audit team to examine an issue(s)/transaction(s) of one or more related taxable persons (both legal entities and individuals) with cross-border business activities'. This can be 'simultaneous' in two different places or a 'coordinated external audit' of two authorities in one place.[5]

Joint tax audits are different from Tax Inspectors Without Borders, a joint initiative of the OECD and UNDP, to offer support to tax administrations.[6] The initiative's goal is to strengthen local tax administrations in conducting better audits within their own jurisdictions. But given experiences in the field, even the OECD notes that there are shortcomings in the initiative, and that alternative cooperative efforts are needed. Joint tax audits are one such possibility.[7]

The OECD ranks joint tax audits highest in comparison with other options available for conducting cross-border tax audits in Figure 7.1.

Experts normally attribute the emergence of this new instrument to three initiatives:

1. The Forum of Tax Administrations Report on Joint Audits (2010);
2. The OECD Base Erosion and Profit Shifting (BEPS) initiative, introduced in the wake of diverse data leaks on tax dodging (Offshore Leaks – see International Consortium of Investigative Journalists, 2013; Luxembourg Leaks – see International Consortium of Investigative Journalists, 2014);
3. The African Tax Administration Forum (ATAF) preparing the way for such joint undertakings.

The German Federal Ministry of Finance has noted:

> Joint external tax audits are an appropriate means for ascertaining all facts with a cross-border dimension, especially

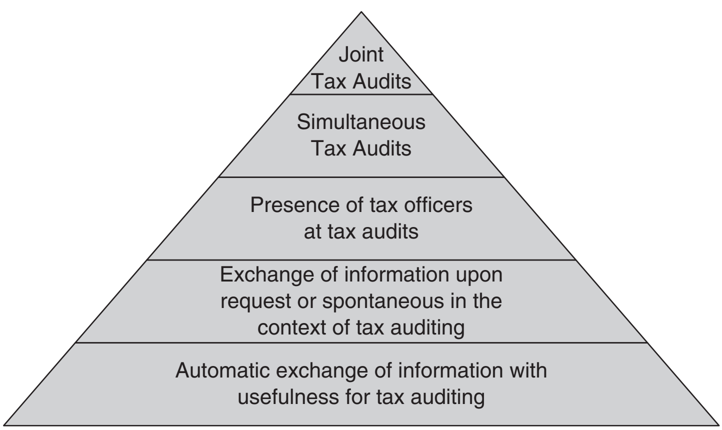

FIGURE 7.1 Approaches for cross-border exchange of information for tax purposes, increasing in complexity

Source: OECD (2017: 81)

> in connection with transfer pricing issues; questions regarding permanent establishments; investigations of tax planning and tax avoidance schemes; and investigations of complex business restructuring schemes. (Bundesministerium der Finanzen, 2017: 18)

Currently the theory and practice of joint tax audits are still under-developed. One of the most recent and thorough academic contributions is an article by Burgers and Criclivaia (2016), which provides an excellent overview of the related literature and scholarly discussion. Regarding existing legal frameworks, they distinguish between two kinds of joint tax audits. The first, are joint tax audits that take place on a Mutual Agreement Procedures (MAP) basis, where even the company involved in the audit agrees to participate in the audit. The second kind are joint tax audits with the explicit aim to uncover crime, where it cannot be expected that those under examination agree to participate. In regard to the latter, Burgers and Criclivaia concede that the legal framework is not yet adequate to cater for such involvement, which leaves only the first kind of joint tax audit available for the time being. Here, Burgers and Criclivaia draw from the experience of multistate joint audits in the United States and of a pilot project of five cases between Germany (coordinated by the Federal Central Tax Office) and the Netherlands. Burgers and Criclivaia propose why a more widespread testing of joint tax audits may be useful in that they could:

a. reduce compliance costs of both tax administrations and taxpayers;
b. encourage companies to work more effectively with revenue administrations;
c. facilitate cooperation between revenue bodies;
d. lower tax risks;
e. increase the quality of work;
f. deter double non-taxation, aggressive tax planning, and tax fraud;
g. prevent tax authorities' free rider problem;
h. increase tax compliance;
i. reduce corruption; and
j. guard against conflicts of interest among participating parties.

Burgers and Criclivaia 'urge' more countries to engage in joint tax audits to substantiate their arguments (2016: 343f.).

One year later, the OECD published its report 'The Changing Tax Compliance Environment and the Role of Audit', based upon a survey taking stock of various international initiatives, such as the United States Foreign Account Tax Compliance Act, the BEPS initiative as well as increasing cooperation among tax administrations, for example, within the Joint International Taskforce on Shared Intelligence and Cooperation and the OECD Forum on Tax Administration. Section 4 of this chapter focuses on how those developments specifically impact cross-border tax audits (OECD, 2017: 80). Here, joint tax audits are suggested for situations where tax administrations have common or complementary interests in auditing a particular multinational corporation (MNC), while the traditional forms of cooperating via the exchange of information or mere presence of tax auditors are deemed to be insufficient. The OECD report, which mentions the five German–Dutch pilot cases as a practical example (2017: 85f.), recommends that those pilot projects are already 'seen as an important development for enhancing tax certainty and helping to avoid the triggering of resource-intensive and lengthy Mutual Agreement Procedures' (2017: 91).

This chapter contributes additional evidence from experiences in the German state of Bavaria and with Zambia, most importantly based on the 50 joint tax audits that have been conducted in the meantime by the Bavarian International Tax Center. That is ten times the number on which previous publications have been based.

3. Methodology

A major methodological problem for the authors is that joint tax audits are a fairly new instrument. So far, there are only a very small number of tax administrations applying this instrument, and as a result, collecting experiences with its practical benefits and downsides is limited. This chapter aims to add to the literature on the usefulness of this tool in theory and practice.

Accordingly, work for this contribution started with a literature review, followed by the development of a semi-structured questionnaire based on the review and our previous research findings. Personal consultations with key stakeholders were conducted to get a better understanding of the practice of joint tax audits so far, and their potential for greater use in the developing country context. Table 7.1 shows a list of key stakeholders consulted in this process.

4. The Bavarian Experience

The German system of tax legislation and administration is very peculiar and highly complex. While legislation is mainly done on the federal level in parliament and the chamber of states, tax administration and revenue collection are mainly conducted at the level of the 16 states (Länder), and revenue is shared following complex formulas of apportionment among the three levels of government, namely municipalities, states, and the federation. It should be noted that the individual states are key informants on the practical enforcement of tax laws and tax administration. In other words, the Federal Central Tax Office is comparatively weak, not in terms of competence, but in resources and executive powers.

Bavaria set up its International Tax Centre (ITC) in 2013. The ITC's goal is

> creating a working platform for international administrative cooperation. The ITC is organizationally affiliated to the

TABLE 7.1 Key stakeholder consulted formally or informally for information on joint tax audits

	Category	Stakeholders
A	Government ministries and (inter) government(al) agencies	1. Bavarian State Ministry of Finance 2. Bavarian International Tax Centre (ITC) 3. German International Cooperation (GIZ) 4. Zambia Revenue Authority (ZRA) 5. Bank of Zambia 6. OECD
B	Policy think tanks and professional bodies	1. International Bureau of Fiscal Documentation 2. Zambia Tax Platform 3. Centre for Trade Policy and Development 4. Zambia Institute for Policy Analysis and Research
C	Civil society organizations	1. The Jesuit Centre for Theological Reflection 2. Action Aid 3. Tax Justice Network

> Bavarian Ministry of Finance and the Regional Development and Identity, but is in functional terms available for the entire Bavarian Tax Administration. The primary intent is to use the working platform to accelerate the cooperation between Bavarian and European tax officials and to coordinate activities. (Oertel et al., 2015)

Furthermore, the ITC has a coordinating function between the Federal Central Tax Office and the Bavarian Tax Administration. The legal framework available so far requires an operational focus within the EU member states.[8]

As of July 2017, the ITC had conducted approximately 50 joint tax audits with 11 states since 2013, with Austria, Croatia, Italy, Netherlands, and Sweden being the most frequent partners. Even though this number is ten times higher than the five cases conducted by the Federal Central Tax Office, it is only a fraction compared to the 2,500 cases with cross-border issues reported for the same period to the Bavarian Department for External Relations (Auslandsfachprüfung), the regular support unit for tax auditors (Bayerisches Landesamt für Steuern, 2017: 113ff.). Respondents observed that the reason for this (still) comparatively small number is the highly complex nature of joint tax audits and that each joint tax audit raises unforeseen and new issues which need to be dealt with as is normal with pioneering instruments.

Each joint tax audit is said to be a unique learning experience due to differences in language, culture as well as legal tradition and categorization. For example, in joint tax audits, challenges of varying degrees often arise: How can the problem of sovereignty and responsibility be resolved if the visiting representative wants to question a witness? Solution: The representative of the host state needs to be present so that they are in principle the one doing the questioning even though the other is speaking. How should one deal with the fact, that, when questioning a witness, Italian law requires a written transcription of the entire interview (otherwise it is invalid in legal proceedings), even though this is neither required from the European Mutual Assistance Act nor German practice? Solution: The Italian national law needs to apply (Eisgruber and Oertel, 2017).

On the whole, staff members of the ITC as well as their partners in, for example, Austria and Sweden, confirm the positive outcomes hypothesized by Burger and Criclivaia: Joint tax audits are considered to be a 'model for success in international tax law' (Spensberger et al., 2017). The fact that an increasing number of transnational corporations ask for this kind of audit suggests furthermore that they also see advantages in having this instrument in place: clarifications can be sought within one auditing procedure,[9] the statute of limitations (Verjährung) can be avoided, and transparency contributes to legal certainty (Rechtssicherheit), providing guidelines for future procedures. Therefore, it is not surprising that almost all of the 50 audits were concluded by mutual consent. Last, though not least, the surplus revenue collected in Bavaria with this new instrument between 2013 and 2016 was 180 million euros.[10]

5. The Zambian Experience

Interviews with ZRA officials revealed that Zambia has not yet engaged in any joint tax audits. Even though Zambia has joined relevant agreements such as the African Tax Administration Forum Agreement on Mutual Assistance in Tax Matters (AMATM)[11] and amended its Income Tax Act, Value Added Tax Act, and Property Transfer Tax Act, there has not yet been any serious action to match provisions enabling joint tax audits. This is because Zambia has only recently ratified the AMATM, which will convey the following benefits:

i) information can be exchanged with ATAF member countries on tax matters;
ii) both simultaneous audits and joint tax audits can be conducted with tax administrations in Africa that are members of ATAF; and
iii) assistance can be given in the collection of taxes owed to Zambia by any person that may be resident in an ATAF member country and vice versa.

ZRA interview partners indicated that Zambia was willing to engage in joint tax audits, but what is missing are cross-border partners willing to join forces both within Africa and beyond. The need and usefulness of the instrument as well as the possible benefits posed by Burgers and Criclivaia were discussed in interviews with ZRA officials. However, due to the absence of practical experience, only a small number of expectations and assumptions were voiced which will be discussed in the sections of the chapter that follows.

6. Transcontinental Experiences So Far

Bavarian interview partners did not know of joint tax audits with any developing country, including in Africa. They, too, did not perceive legal problems, since those could be resolved with the legal instruments mentioned by the Zambian partners as well as Double Tax Agreements (DTAs) and Tax Information and Exchange Agreements. At the same time, no joint tax audits have been planned with developing countries for the short- and medium-term future, even though there are a number of MNCs registered in Bavaria with have activities and interests in up to 200 states worldwide, including Africa. The lack of interest in joint tax audits with developing countries rests in the fact that the main task of the Bavarian Tax Administration is to collect revenue for the Bavarian state.[12] This, on top of existing resource constraints, makes them opt for cases in states where the Bavarian MNCs have their largest amount of economic activity. Beyond that, Bavarian respondents argued that the complexity of cases requires tax administrations of comparable experience and resources. In this regard, noticeable differences exist even among EU member states, which impacts the speed and ease of conducting joint tax audits.

Regarding Africa, German interview partners who had spent some time there via the German International Cooperation Agency opined that tax administrations there should first achieve some good level of financial governance and stability for domestic operations. A second concern was whether Africa is ready to invest in the training of tax administrators, which takes close to 12 years according to the Bavarian interview partners. Another problem is seen in the inability of African tax administrations to retain their best experts who, all too often, move for financial reasons and prefer to work in the private sector. For this reason, support via other existing programs such as Tax Inspectors Without Borders should be given preference, a position which was repeated by Steffen Scholze, a civil servant working at the Joint Tax Coordination at the German Federal Central Tax Agency, during a conference organized by the authors of this chapter in Nairobi in March 2019.

7. Legal Bridges[13]

There is agreement among the interviewed experts that any legal obstacles to joint tax audits can be overcome in principle by making use of various legal frameworks that have been established within the OECD/G20 framework. These include the Convention on Mutual Administrative Assistance in Tax Matters (CMAATM), and related Multilateral Competent Authority Agreements, such as the Common Reporting Standard (CRS) and Due Diligence for Financial Account Information. The CMAATM was amended by a Protocol in 2011, allowing participation of other countries as well.[14] Article 6 of this Convention requires its participants to also sign the CRS Multilateral Competent Authority Agreement, in order to adopt the CRS for their exchange of tax information.[15] However, even though the latter is a multilateral instrument, the facilitation of actual exchange of information between competent authorities requires the negotiation of bilateral instruments between future cooperation partners.

Another useful multilateral instrument within the OECD context is the Multilateral Authority Agreement on the Exchange of Country-by-Country Reports as well as the standardized electronic format, setting the standard for the exchange of Country-by-Country Reporting between jurisdictions and enabling the automatic exchange of tax relevant information on revenues, profits, taxes due or paid, employees, and assets of each entity.[16] Those options have been transformed into a legal basis for European Union member states by the EU's Mutual Assistance Directive of 2011.

Against this background it would be possible to include joint tax audits into the DTAs between Germany and over 90 states worldwide, including Zambia. Germany and other developed nations could, for example, as the Netherlands did, review and renegotiate its DTAs with developing countries merely for reasons of fairness.[17] There are good reasons for doing so: in its analysis of tax treaties between developed and with developing countries, Action Aid (2016) classifies ten bilateral tax treaties concluded by Germany, among them that with Zambia, as 'very restrictive',[18] a critique upheld by the Eurodad Tax Avoidance Report of December 2017.

8. Practical Obstacles in the Way

Interview partners from the GIZ staff add a reason for the apparent lack of enthusiasm on the part of the German government to enable joint tax audits. According to them, 'there is not any good will to realize tax cooperation through joint tax audits'. They see resistance and lobbying against this instrument on the part of MNCs, who warn that those audits would create 'bureaucratic monsters'. GIZ experts added that lobbying against joint tax audits 'is in the best interest of multinational enterprises as they do not wish that tax auditors from some or all countries of operation join forces'. This seems to contradict the positive experience reported in Section 4. An explanation might be that tax audits within the highly organized EU states are hard to avoid and are thorough in whatever context they take place.

The next obstacle to deal with is the likelihood of increased strain upon expert personnel, who are very few in Africa and would be overburdened on account of the increased demands of a joint tax audit. From the perspective of developed countries, the problem of tight staff levels is worsened if state tax administrations are asked to assign capable employees to joint tax audit tasks through cooperating partners like GIZ. If this happens, the workload of those being seconded has to be spread among colleagues left behind, which would considerably increase their burden.

On the other hand, those working in the areas relevant for joint tax audits collect much more revenue than they cost in salaries and benefits. For example, in Germany, a tax auditor checking on large businesses collected on average 277,344 euros per year (2013); an officer checking on private wealth holders on average collected 143,679 euros per year (2013). A tax fraud auditor working in Munich can collect as much as 2.2 million euros per year (Alt, 2016a: 62ff.). All of this adds up to a lot more than the annual salary of those experts, which is around 60–70,000 euros. Similar surplus earning is reported from the Medium and Large Taxpayers Offices operations in Zambia. In 2014

> the MTO office conducted 5,030 audits while 184 audits were conducted under the mining sector in LTO, yielding Zambian Kwacha 1,013.3 million (70,545,095.30 Euro) out of which

> K172.6 million (12,010,070.46 Euro) was deferred tax. Further, ZRA charged penalties amounting to K828.9 million (57,649,944.90) in the same period of time for noncompliance to tax regulations. (Zambia Revenue Authority, 2015: 16)[19]

9. Tax Competition Instead of Tax Cooperation

In the final analysis, the situation is as it is because states are still operating within the modus of tax competition. More precisely, in the competition to safeguard and secure the residence of private and corporate wealth holders within their own jurisdiction, states offer corporations not only tax cuts and other concessions, but also other forms of 'lenient treatment', including when it comes to the thoroughness of conducting tax audits.[20]

Tax competition is probably the reason behind the inactivity and unwillingness of developed countries to be more rigorous on illicit financial flows (IFFs) and any attempt to curb them. One interview partner from the Bavarian State Crime Agency asked the simple but age-old question, *Cui Bono?* Who profits from IFFs? Eventually developed countries, of course, since the money leaving developing countries in illicit ways is not merely stashed away in tax havens, but also finds its way from there into lucrative and profitable investments in developed countries.[21]

Tax competition will eventually leave everybody worse off, since competition does not stop at developed and developing countries' relationships but continues among developed countries as well. The International Monetary Fund warns that tax competition is damaging the common good and admonishes states that engage in tax competition, arguing that the 'sum of losses … likely exceeds the gains', whereas 'the gains from closer cooperation might be considerable' (International Monetary Fund, 2013: 33).

10. Tax Cooperation among Developing Countries

In addition to being a mechanism for cooperation between developed and developing countries, joint tax audits can also be used among developing countries themselves, especially in Africa, where the ATAF promotes the use of joint tax audits, as a tool for fighting tax fraud, tax evasion, and aggressive tax planning, and provides the legal framework through the AMATM. Here, some recent progress can be noted. Interview partners from Zambia indicated that the governments of Zambia and South Africa are taking steps toward the implementation of joint tax audits. Revenue authorities from the two countries signed a Memorandum of Understanding in October 2017 setting out the context for enhanced collaboration in tax matters, which will include the implementation of joint tax audits.

However, even if some of the regional agreements mentioned in Section 7 above do not support joint tax audits, but merely exchange tax information on request and facilitate exchanges for more traditional assistance in tax collection, their cooperation should be encouraged more effectively since all experience collected in this field can be used to develop capacity for the time when joint tax audits within the ATAF context are possible. Practical skills gained that way would also challenge the observation of the Bavarian tax official, quoted above, who asserted that African tax administrations are 'overtaxed' with domestic tax issues and therefore unable to cooperate in cross-border audits. In addition, any cooperation between tax administrations will reduce corruption due to the 'many eyes principle', that is, it will reduce the temptation to engage in corruption since eyes from outside are also watching or observing the transactions.

11. Conclusion

There are admittedly many important avenues to advance tax justice in this world. We believe that for pragmatic reasons, under the present as well as the emerging legal and cooperative framework, advancing joint tax audits could be an important step that would be relatively easy to implement – if the political will exists. The usefulness of this instrument to uncover tax related misbehavior is confirmed by experience, from its use in developed countries so far, including in Germany and Bavaria. This article puts forward the argument that this tool can also potentially achieve the desired objective to increase tax revenues in developing countries.

Notes

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2 More information on the project and its partners can be accessed online at taxjusticeand-poverty.org. For specific information about the research methods see Alt et al. (2017).

3 For more information on this example see Alt (2016b).

4 For more information see Alt (2016b).

5 See Forum on Tax Administration (2010: 5), Bundesministerium der Finanzen (2017), and Eisgruber and Oertel (2017).

6 See www.tiwb.org/.

7 See OECD Task Force on Tax and Development (2013: 21n17).

8 'The EU's Mutual Assistance Directive (Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation), together with Germany's EU Mutual Assistance Act (EU-Amtshilfegesetz), form the main legal bases that German tax authorities follow when carrying out mutual assistance in tax matters with other EU member states'. Quoted in: Chapter 4 of 'Tax information exchange: international standards' (2014, October 15). Article from the Ministry's August 2014 Report. Retrieved from www.bundesfinanzministerium.de/Content/EN/Standardartikel/Topics/Taxation/Articles/2014-10-14-tax-information-exchange.html.

9 In earlier times those clarifications had to be sought in subsequent steps and were extremely time consuming: Findings of one tax administration needed to be clarified with another, their agreed result had to be cross-checked with others etc.

10 See 'Söder: 3 Jahre Internationales Steuerzentrum: 180 Mio. Euro mehr Steuern. (2016, July 13). Retrieved from www.bayern.de/soeder-3-jahre-internationales-steuerzentrum-180-mio-euro-mehr-steuern-kontakte-zu-11-staaten-bayern-wird-competent-authority-fuer-italien/.

11 The AMATM is signed by 22 African states and is acknowledged to be the best legal framework existing for joint audits. It 'allows for the exchange of information, sharing of expertise, mutual administrative assistance and also for joint tax audits and investigations among African countries' (Burgers and Criclivaia, 2016: 317).

12 State tax administrations in Germany indeed have as prime responsibility the collection of revenue, while political responsibility for developmental aid and economic cooperation with developing countries is located on the federal level and organized via the German GIZ. It would therefore be at the federal level where discussions regarding assistance for developing countries would occur and from which tax auditors would then have to be requested, and seconded by, the German states.

13 The authors wish to thank Erika Siu, JD, LLM, co-editor of this book, for the valuable information provided for this section of the chapter.

14 According to the respective website '115 jurisdictions currently participate in the Convention, including 15 jurisdictions covered by territorial extension'. Information accessed on December 4, 2017. See www.oecd.org/ctp/exchange-of-tax-information/convention-on-mutual-administrative-assistance-in-tax-matters.htm.

15 According to the respective website, this instrument was signed by 96 states as of 10 November 2017. Information accessed on December 4, 2017, see www.oecd.org/ctp/exchange-of-tax-information/MCAA-Signatories.pdf.

16 According to the respective website, this instrument was signed by 67 states as of November 10, 2017. Information accessed on December 4, 2017, see www.oecd.org/tax/beps/CbC-MCAA-Signatories.pdf.

17 The Netherlands did this in the case of 23 developing countries, see Steinglass (2013).

18 See, for details, the interactive graphic at www.actionaid.org/tax-power.

19 NB: These are audits under the present legal framework! One may guess that joint audits generate even more surplus revenue!

20 Regarding Bavaria, those accusations are not only raised by the political opposition in the Bavarian State Parliament, but also research such as Alt (2016a) or Bach (2016).

21 While one interview partner talked of investment inside Bavaria, e.g. the Munich housing market, this has been studied more closely for investment flowing into the United Kingdom via the Jersey tax haven. See *Capital Economics* (2013).

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8 | TAX AVOIDANCE IN DEVELOPMENT FINANCE: THE CASE OF A FINNFUND INVESTMENT

Lauri Finér[1]

Executive Summary

Development finance institutions (DFIs) are publicly owned vehicles meant to support private sector development in developing countries. The goal of a DFI is to enhance the development impact related to projects it invests in by bringing in know-how related to the development aspects of business and by complementing and attracting private funding. The development impact of DFIs is often measured in terms of numeric financial indicators such as the amount of tax income generated in the developing countries. In this chapter, a tax avoidance case study shows how the development impact of a DFI can turn negative if its tax policy is not in line with its development goals. The case study involves Finnish DFI Finnfund's investment in a Malaysian timber plantation. Analysis of the case study shows that Finnfund's tax policy was vague and its own tax reporting did not include assessment of tax avoidance. It also shows that the anti-tax avoidance legislation in Malaysia was inadequate to protect its tax base. Based on the analysis, the chapter presents a list of policy actions that would improve the fiscal behavior of DFIs and eventually benefit the developing countries in which they invest. The list includes actions involving increased transparency, better-formulated policy goals, and more robust DFI corporate governance by the governments that own them. Also presented is a list of actions that would allow developing countries to independently tackle the tax avoidance presented in the underlying case study.

1. Introduction

Development finance institutions (DFIs) are specialized vehicles meant to support private sector development in developing countries

(OECD, 2017). DFIs are usually majority-owned by national governments and source their capital from public official development assistance (ODA) funding. In this chapter, the impact of DFIs' tax planning on development is presented through a tax avoidance case that involved the Finnish development finance company Finnfund. The case was revealed by the non-governmental corporate responsibility research organization Finnwatch in March 2017 (Finnwatch, 2017a).[2]

DFIs' financial support takes different shapes as they fund private companies directly in the form of loans and equity as well as indirectly through, for example, investment funds. DFI investments are of a temporary nature, which means their target is to exit funding projects when the business is running solidly on its own. DFIs also expect returns on investment, as do the private investors involved in the same projects. This means concessionary terms are not necessarily involved. The goal of a DFI is to enhance the development impact related to these projects by bringing in their know-how related to the development aspects of business and by complementing funding where private investment is lacking.

The role of private sector development funding has increased substantially as a tool to channel ODA. This has made DFIs major development players globally. For instance, the annual funding channeled through multilateral DFIs has increased from US$ 5 billion in 2000 to more than US$ 100 billion in 2015 (Ylönen, 2016: 73). This 'private turn' of development funding has also received criticism from many (Romero, 2016).

DFIs have been the subject of broader discussion on the efficiency of ODA, as different development vehicles, including civil society organizations, are often fighting for the same public funding (Kepa, 2017). Some believe that private sector funding has been used as a development tool based on wishful thinking rather than as a strategic approach with a specified causal relation between funding DFIs and real development implications (Ylönen, 2016: 71). Some have even argued that DFIs have been used as instruments to channel ODA to support local business interests, as DFIs often fund projects involving companies in their home country (Ylönen, 2016: 71). Still, many governments such as Finland's seem to have a strong belief in the ability of private investment to foster development (Donor Committee for Enterprise Development, 2010).

However, there seems to be a consensus that the evidence regarding the efficiency of DFIs in creating development is negligible

(Griffiths et al., 2014). The problem has become apparent in public evaluations of DFIs, due not only to methodological difficulties of evaluating DFIs' impact on development, but also to lack of transparency related to their investments (Ministry for Foreign Affairs of Finland, 2016; Independent Evaluation Group, 2014).

The development impact of DFIs is often measured in terms of numeric financial indicators such as the amount of tax income generated in the developing countries. However, much of the discussion on the efficiency of DFIs has been at a general level. In contrast, this chapter presents a detailed case study of Finnfund's tax avoidance that allows for analysis of whether DFIs are efficient users of ODA. Section 7 of this chapter incorporates this analysis into policy actions that would allow turning DFIs into tools that tackle tax avoidance that harms developing countries. Section 8 presents recommendations for developing countries to independently protect their tax base from tax avoidance arrangements.

2. Finnfund in Brief

Finnfund[3] is one of the 16 major bilateral DFIs listed by the OECD (2017).[4] The State of Finland owns 99.9 percent of its shares directly and through financing company Finnvera. The Confederation of Finnish Industries holds the remaining 0.1 percent share. Finnfund's assets worth €554 million at the end of 2018 were invested in the form of loans, equity, and funds that are controlled by intermediaries.

The significance of Finnfund has increased substantially since the right of center government in office from 2015 to 2019 increased capital allocated to Finnfund by a total €130 million (Ministry for Foreign Affairs of Finland, 2015). The increase was in contrast to a proposed €330 million cut in primary development assistance. This included cutting the funding of development NGOs by €49 million, a decrease of 43 percent (Kepa, 2017).

Finnfund was established and is governed based on the Finnfund Act (291/79). It is explicitly stated in section 2 of the Act that Finnfund's purpose is not to generate profit for its shareholders. Finnfund should finance companies operating in developing countries,[5] 'in which a Finnish interest is involved' for example, by acquiring shares in such companies, granting them loans and guarantees, and allocating resources for studies and reports for companies developing operations in developing countries. The involvement of a

'Finnish interest' is interpreted loosely to mean, for example, that a Finnish enterprise is somehow involved in the funded project or that the project promotes a certain development goal set by the Finnish government.

According to the Finnfund Act, the current Finnish government has ultimate control over Finnfund's operations (Finnfund, 2017c). Finnfund is steered by the Ministry of Foreign Affairs which annually drafts a memorandum defining its objectives for operations and financial profitability (Finnfund, 2017b). The board of directors discusses implementing these objectives with the executive management team. Finnfund also has a supervisory board that oversees the company. However, the board and the supervisory board are merely advisory bodies that hold only nominal formal power.

3. The Finnfund Tax Avoidance Case

Finnfund's investment portfolio is divided into three general categories. At the end of 2016, 54 percent of the €356 million development investments were loans. Direct share ownership constituted 26 percent of the portfolio and the remaining 20 percent were investments in funds controlled by fund managers working for third-party intermediaries. Finnfund never offers majority funding, which means it is a minority investor in projects involving private investors, entrepreneurs, and other DFIs. Finnfund's share in these projects usually varies from a few percent to 10 percent (Finnfund, 2017a).

In March 2017, Finnish corporate responsibility research NGO Finnwatch published a report on a tax avoidance case related to

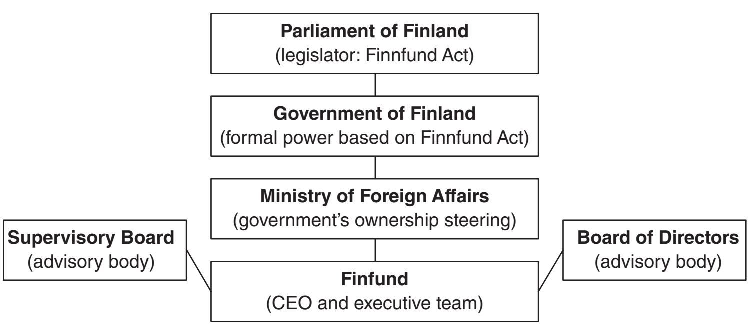

FIGURE 8.1 Finnfund legislation and governance structure

Finnfund's investment in a Luxembourg-registered forestry fund. Originally made in 2010, the €5 million and approximate 5 percent investment in Dasos Timberland Fund I (DTF1) was one of the largest investments for Finnfund that year. The fund is worth nearly €100 million and is managed by a Finnish investment advisory firm Dasos Capital (Finnwatch, 2017a).

Finnfund's own tax reporting is vague and does not allow assessment of tax avoidance related to its investments. However, Finnwatch based its report on publicly available documents, which were mostly public financial statements from trade registries and advance tax agreements leaked in the 2014 LuxLeaks scandal from the Luxembourg branch of a big-four tax advisory company (Marian, 2017). Financial statements of individual funds and limited companies are publicly available in Finland and Luxembourg as in most European countries.

The other investors in DTF1 included institutional investors such as pension funds and the European Investment Bank. Over 80 percent of DTF1's investments are in Finnish and Eastern European companies that manage forests in their countries. This is noteworthy because, according to the Finnfund Act, Finnfund is only allowed to invest in developing countries and Russia. DTF1's sole investment in a developing country is a 30.69 percent stake in Malaysian Hijauan Asia Sdn Bhd that has a timber plantation in the state of Sabah. DTF1's investment in Hijauan is approximately €12 million, which amounts to roughly 15 percent of its assets.

DTF1 was involved in thin capitalization tax avoidance arrangements related to at least three of its investments that Finnwatch studied.[6] One was the Malaysian investment in Hijauan while the two other arrangements involved companies managing forests located in Finland. The tax arrangements behind the investments were facilitated by an advance tax agreement (ATA) that was leaked in the 2014 LuxLeaks. The ATA, which enabled an effective tax rate below 1 percent for profits shifted to Luxembourg, was negotiated by the management company Dasos Capital and its advisors.

Moreover, DTF1 was managed by Finnish-based Dasos Capital's Luxembourgian subsidiary, which had also received a Luxembourg ATA that allowed an effective tax rate of 9.5 percent on average in the period 2009–2015. Dasos SA was a holding company with no employees and all its business was outsourced to its Finnish parent company Dasos Capital Oy. The arrangement allowed Dasos Capital to shift profits to Luxembourg and benefit from the ATA, as the nominal corporate income tax rate during that period was 20–26 percent in Finland and 29 percent in Luxembourg. However, Finnwatch (2019) revealed in 2019 that the Finnish Tax Administration audited Dasos Capital and reassessed its taxation for years 2012–2015 by applying the Finnish controlled foreign corporation rules on the arrangement.[7] As a result, the profits shifted to Luxembourg were taxed in Finland causing additional taxes and penalties totaling €215,000. Finnwatch based its revelation on Dasos Capital's 2018 financial statement made public in 2019. These findings were confirmed by Dasos capital.

DTF1 itself could avoid tax even more effectively using the Luxembourg structure. The LuxLeaks documents and Luxembourg financial statements show that taxable income from Malaysia and Finland was shifted to low-tax Luxembourg. Tax avoidance was the purpose of the arrangements as the ATA facilitated an effective tax rate below 1 percent. Until July 2019, Malaysia did not have any thin capitalization rules that could have protected its tax base from the arrangements (Swire, 2019).

However, Finnwatch could not find direct evidence of whether Hijauan had actually been able to avoid tax in Malaysia before 2017

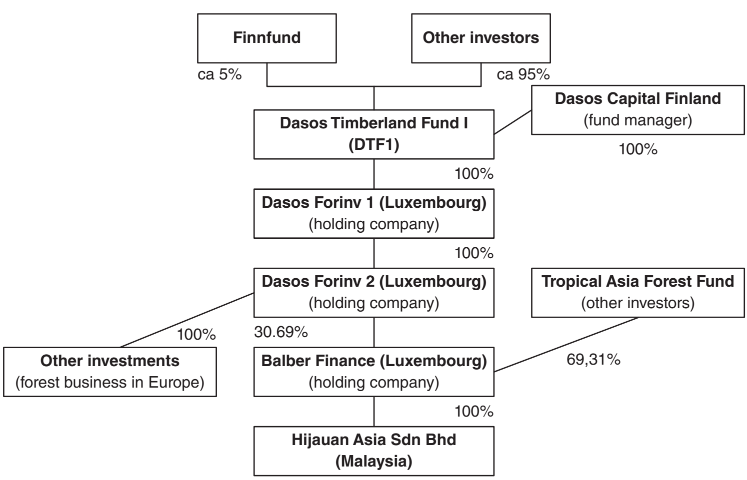

FIGURE 8.2 Dasos Timberland Fund 1 structure

since its financial statements were not publicly available. Since corporate income tax is assessed on profits, and it is possible that Hijauan was unprofitable, Hijauan may not have been required to pay any tax even without the arrangement. Moreover, Hijauan's subsidiary Hijauan Bengkoka Chipmill Sdn Bhd received a five-year tax holiday from the Malaysian government in 2011, which also may have decreased its income tax liability in Malaysia. However, since this deal was temporary and covered only one Hijauan subsidiary, the ATA with Luxembourg facilitated possible tax avoidance.

4. Finnfund's Tax Policy and Tax Reporting

Finnfund considers the tax payments made by companies it invests in as 'one of its most important development goals' together with other benefits such as jobs generated. Finnfund's (2017a) corporate social responsibility statement in 2016 stated: 'Finnfund is not allowed nor does it wish to promote in its operations any aggressive tax planning or tax evasion in the investee companies either'. However, Finnfund has used a rather peculiar definition where aggressive tax planning involves striving for non-taxation using artificial structures or exploiting non-arm's length prices in intra-group transactions involving developing countries.[8] The definition accepted by the previous 2015–2019 Juha Sipilä cabinet (Government of Finland, 2016) refers merely to illegal activities that tax authorities could tackle with current anti-tax avoidance regulation. The definition is noteworthy as it deviates substantially from the general understanding of the concept in which aggressive tax planning or tax avoidance is understood as being mostly legal arrangements that exploit loopholes in the international tax regime. For example, according to the OECD (2015a), aggressive tax planning involves 'intra-group arrangements that achieve no or low taxation by shifting profits away from jurisdictions where the activities creating the profits are taking place'.

Finnfund's tax reporting on its website and in its public annual reports has been vague. It reports only generic information about its tax impact although it has slightly increased the amount of reported data after the discussion over this case (see Section 5). Previously, Finnfund only produced a figure of total tax payments related to its investments that also included some non-tax related payments. Moreover, Finnfund presents all taxes paid by the companies it has invested in as a development impact even when Finnfund, as is usual, holds only a small investment in these companies.

Finnfund's latest tax reporting figures are from 2017, when nearly all (96%) of the reported corporate income tax of €205 million was paid out by financial intermediaries and companies Finnfund owns indirectly through funds where its ownership is always much lower than 10 percent. Finnfund's share in these indirect investments is further diluted as the funds such as DTF1 only own a minority share in the companies they invest in. In 2017, the total tax and other payments made by companies Finnfund invests in were €423 million. The excess tax impact reporting becomes obvious when this figure is compared to Finnfund's total investment assets of €393 million at the end of 2017. In other words, Finnfund is stating that every euro it invests generates nearly one euro of tax income each year.

Finnfund's non-transparent tax reporting does not allow for an assessment of whether its financing has had positive development impact. Apart from the questionable way of estimating tax impact, Finnfund sometimes includes in its tally payments that are not typically considered to be taxes. For example, Finnfund claimed that rent for forest land paid to the Malaysian state of Sabah was tax (Finnwatch, 2017a).

Finnfund uses similar reporting methods in all of its development reporting, and thus similarly overstates the number of jobs it creates. Such huge exaggerations make it impossible to assess whether Finnfund is effective compared to other DFIs or other development organizations. In September 2017, Finnfund (2017d) responded to the criticism over its reporting method, stating that it does not in its development reporting take account of the size of its investment in companies because 'this figure would not indicate the whole truth about Finnfund's development impact', since 'Finnfund's investment might have larger development impact than the impact estimated merely based on share of investment'. Finnfund has even claimed that in some cases its participation is necessary for the entire deal to get off the ground. Thus, it would be legitimate to credit Finnfund for all the taxes generated by the investment even if Finnfund were only a minority investor.

These claims are not supported by research or Finnfund's own reporting. In its annual reports, Finnfund does not specify cases where its investment would have been crucial in enabling the whole investment. Instead, several DFI evaluations done in other countries show most of the DFI investment would have gone ahead without any public support (Griffiths et al., 2014: 25–26). The recent overheating in financial markets and global increase in DFI financing has also led to a situation where DFIs compete for proper investment projects, which decreases DFIs' returns and their potential influence on investment (Carter, 2017).

Finnfund's own investment policy also conflicts with the claims that its investments would generate higher development outcome than its share in investment indicates. In 2016, indirect investments accounted for 82 percent of the tax impact reported by Finnfund but only 20 percent of Finnfund's investment portfolio. In other words, if Finnfund's participation in each project was crucial, the fund investments would generate seven times higher development outcomes in terms of tax compared to direct investments. Based on this logic, Finnfund should invest mainly through funds. Instead, Finnfund has decided to focus on direct investments that have generated only marginal amounts of tax income for the developing countries it invests in. Therefore, it could be assumed that the higher outcome mainly reflects the fact that Finnfund's ownership share in the fund investments is substantially smaller than in direct investments. That is, it can invest in more projects with the same amount of money and more projects generate more tax revenue.

Finnfund has not presented evidence of cases where its involvement had turned out so-called *operational additionality* that would have benefited developing countries (Griffiths et al., 2014: 25–26). Operational additionality could result for instance from influence on non-tax-avoiding finance structures that benefit a developing country by generating higher tax revenues. Conversely, the vast majority of Finnfund's reported development impact is generated through indirect fund investments, where Finnfund is merely a passive minority investor. Finnfund has stated that it is generally not involved in decision making related to its fund investments (Finnwatch, 2017d: 55). Therefore, it seems likely that Finnfund's efforts have only generated marginal operational additionality for developing countries, which is in line with previous DFI evaluations (Griffiths et al., 2014: 25–26).

5. Finnfund's Reaction and Public Debate

In March 2017, Finnwatch (2017a) published a report that revealed the flaws described above: the fund's tax avoidance structure as well as the fact that Finnfund had illegally invested in Finland and other non-developing countries. Finnfund and its investment partner Dasos Capital were given the report four weeks before the publication for comment. They did not correct any significant faults in the report during this period (Finnwatch, 2017b). Finnfund's reaction was defensive after the publication (Finnfund, 2017e). It denied Finnwatch's conclusions about its tax avoidance and illegal investments. Finnfund also claimed that 'not all the facts in the report are correct'. The media widely published Finnfund's claims without verifying them (e.g. Suomenmaa, 2017). A colorful debate ensued, wherein Finnfund did not manage to point out a single fault in the report or any errors in Finnwatch's conclusions (Finnwatch, 2017c). Finnfund also failed to address some of the allegations. For instance, Finnfund was unable to present the decision or other legitimation for its investments in Finland even though it is only allowed to invest in developing countries (Finnwatch, 2017c).

Finnfund did not deny the allegations about the fund's tax arrangements. Still it denied the charge of tax avoidance by stating that the arrangements were common practice for private investment funds. This argument failed to note the fact that such arrangements, while common practice, are indeed made to avoid tax. However, Finnfund's denial of tax avoidance could be justified based on their peculiar definition of tax avoidance as implying illegality (see Section 4). As discussed earlier, conventionally illegal arrangements are called *tax evasion*, whereas some legal arrangements, including thin capitalization, are characterized as *tax avoidance* (OECD, 2012).

The Ministry of Foreign Affairs responsible for Finnfund's steering did not confirm Finnwatch's allegations even though it, too, did not point out faults in them (Ministry for Foreign Affairs of Finland, 2017). However, the Minister of Foreign Trade and Development, Kai Mykkänen stated that Finnfund would not invest in funds utilizing such tax arrangements anymore. This could be interpreted as implying that Finnfund's arrangements were not fully acceptable.

Even though neither Finnfund nor the ministry admitted to any wrongdoing, the debate seems to have had an impact on Finnfund's tax policy. In September 2017, Finnfund (2017f) published a tax policy discussion draft open to the public for comment. In November 2017, it also held a public hearing for all the commentators, including NGOs.

The new tax policy, which incorporated some of the suggestions made by commentators, was published in January 2018 (Finnfund, 2018). The policy paper shows significant but still limited progress in transparency and refraining from tax avoidance. Finnfund 'encourages the companies it invests in to report to Finnfund annually the taxes paid on a country-by-country basis' and requires companies in its new projects to do so. Finnfund also aims to file publicly a country-by-country tax report that includes all the taxes paid by the companies it invests in. The annual report published later in 2018 includes for the first time country-by-country tax data from countries where Finnfund has at least five investments. The tax payments in other countries are presented on a continental level. Moreover, Finnfund aims to analyze beforehand the corporate structures related to its investments from a tax perspective. In 2019, Finnfund reported it had evaluated in 2018 the tax structures of all new investments according to the policy (Finnfund, 2019). Finnfund has also included clauses in its contracts regarding amending finance structures related to the investments. These clauses could result in the operational additionality discussed in the previous section.

While containing notable improvements, the new tax policy cannot be considered extremely ambitious. The policy is still vague and does not specifically prohibit practices such as thin capitalization, which might leave the door open for aggressive tax arrangements. Finnfund also seems to stick with its controversial definition of tax avoidance. The improvement in tax transparency seems to be only marginal, as the new policy envisages that Finnfund will not specify taxes by investment or type of tax. The lump sum figures also cannot be compared to country level profits or assets, which makes it impossible to detect possible tax avoidance. Finnfund also adheres with its policy of reporting total tax paid by the companies it invests in and not attributing the figures based on its share in the investment. Altogether, the new policy will not allow for assessing whether Finnfund has been effective in creating tax revenues in developing countries.

6. Tax Avoidance of DFIs: A Lesson Learned

Even if tax is not the only measure to assess a DFI's impact on development, the case of Finnfund shows that the development impact of DFIs is greatly dependent on their tax policies and practices as well as efficiency of local anti-tax avoidance measures. Financing tax-avoiding companies in developing countries might result in exploiting their natural resources without leaving much in return, since tax payments constitute much of the benefits for local governments. Obviously other issues, such as labor rights and the level of local workers' wages, also define how much a certain investment benefits the local community.

Are DFIs good tools for supporting development? The Finnfund case does not answer this question conclusively. More transparency is needed in its reporting to allow elected politicians, the media, and NGOs to ensure that public funding meant for development assistance is efficiently used. Finnfund's tax reporting does not allow objective analysis of whether it has done any good in terms of development. This is unacceptable for a DFI with assets over €500 million and 60 employees in a country that is known as a transparent democracy. In Finland, generally all public documents are public information. However, this principle does not apply to limited companies – even if publicly owned, such as Finnfund.

Due to the general lack of reporting, the research has not produced much evidence of DFIs' positive impact overall (Griffiths et al., 2014). There is research on the general positive impact of foreign direct investments, but the purpose of DFIs is not to fund ordinary investments that any commercial fund could undertake. Individual DFIs such as Finnfund employ dozens or hundreds of specialists that should have the skills to improve the development impact of investments – not just their profits. This is their publicly declared mandate; DFIs should not strive for higher profits but higher development impact. This means that for example, DFI's tax specialists should identify whether the fund's tax avoidance arrangements threaten developing countries' tax bases, and based on this analysis, the DFI should negotiate with the fund's other investors to refrain from these arrangements.

The lack of evidence on impact of DFIs is problematic in the wider context of ODA where private sector funding has alternatives.

DFIs are legitimate only if they are more effective than other tools of ODA or complement them. For instance supporting NGOs in developing countries or strengthening local institutions such as tax administrations might provide more sustainable development in the long run. Without identifying and measuring the causal implications of different types of ODA on development it is impossible to apply a strategic approach on development and governments have to rely merely on wishful thinking (see Section 1).

In an era of rising protectionism, non-transparent development vehicles such as DFIs could end up being used as tools to support national interests in the name of development assistance. In the case of DFIs such as Finnfund, which are also meant to support the companies they partner with in their home country, there is a risk that development purposes are pushed aside. The involvement of local companies also implies a risk of corruption. There is no direct evidence of such improper conduct in Finland, but Finnfund has funded several projects involving Finnish companies in which Finnfund board members have been stakeholders.

7. How DFIs Could Be Reformed to Support Development

Despite the risks and the lack of evidence discussed in the previous section, it could be argued that DFIs have a role to play in development. Regardless of whether DFIs are considered an effective tool or not, existing funds should be effectively managed. The case of Finnfund, however, shows that their role cannot be fulfilled without sufficient steering and control from the governments that finance them. How should *DFI good governance* be organized from the tax perspective? Below is a list of policy actions that would improve the fiscal behavior of DFIs. Adhering to the list could have a wider impact on tax avoidance, since other publicly managed investment vehicles such as public pension funds could utilize the same guidance, at least partially.

a) *DFIs should have a public tax policy regarding their investments.* The policy should state that DFIs should refrain from investments involving tax avoidance arrangements which harm development. This policy should apply to all DFI funding including direct loans and equity, as well as indirect fund investments. The policy should include a definition of tax avoidance. The definition could be based on the OECD's definition of base erosion and profit shifting (see Section 4). The general definition should be accompanied by a non-exhaustive list of examples of harmful arrangements, such as thin capitalization. DFIs should be especially critical about investments in the form of excessive lending that generally erodes the tax base in the developing countries. The policy should take into account all tax types, but the focus should be on corporate income tax as that is the most usual target of tax avoidance.

b) *DFIs should be transparent with tax payments related to their investments.* DFIs should report tax payments related to their investments specified by investment, taxation country, and type of tax. This report should include the DFI's attribution based on its share in the investment. A higher attribution could be additionally reported if there is credible evidence that the DFI's role has created more taxable income than its proportional share (for example, a fund has abandoned a tax avoidance arrangement due to the DFI's bargaining power, see (d) below).

c) *DFIs should require the investment funds and companies to publish their accounts as is done in most developed countries.* A country-by-country-report on taxes should be required from larger investments exceeding certain thresholds. This report and public accounts would help to identify tax avoidance and the validity of reported tax payments. A special transparency requirement should apply to investments channeled through secrecy jurisdictions. For example, most of Finnfund's fund investments were facilitated by tax havens such as Luxembourg.

d) *DFIs should have a public negotiation strategy for achieving their tax policy goals.* DFIs often have bargaining power related to their investments since they have substantial shares in them. Often there are several DFIs involved in the same investment, which multiplies the bargaining power. DFIs should have a strategy for how to use this bargaining power to enhance development. They should, for example, negotiate that funds and companies refrain from the harmful tax arrangements identified in the DFIs' tax policy (see action a). If the tax avoidance is extremely aggressive and the other investors are not willing to amend the structure, DFIs should back out of the investment.[9] DFIs should also refrain from investing in funds and companies that negotiate tax holidays with developing countries, since deals of this kind generate harmful tax competition that prevents poorer countries from developing their public services and infrastructure, which are vital for future business and development.[10] DFIs should also have a withdrawal policy for situations where tax avoidance is detected after the investment has been made. The tax policy should be included in the contractual terms involving for example, a contractual penalty clause.

e) *DFIs should have sufficient tax expertise to implement their tax policy.* Finnfund clearly did not have much expertise in tax issues, since they did not have a single tax specialist of their own. This kind of expertise is necessary to identify tax avoidance arrangements violating DFIs' tax policy.

f) *Governments should have credible steering and control over DFIs.* The Finnish government has clearly failed in its steering role and therefore Finnfund's mistakes needed to be corrected afterwards. Governments should have detailed steering documents that require DFIs to refrain from tax avoidance that harms development. This document should include a definition of harmful tax avoidance (see action a). The government should also monitor and evaluate DFI investments to ensure compliance. Contractual terms should be utilized to allow sanctioning of DFIs' executive teams if they fail to accomplish their targets and if they fail to abide by their policies.

g) *Governments should verify DFIs' tax policy through an independent third-party audit.* This could be done, for example, by a board of directors or supervisory board that should have sufficient expertise, authority, and independence. Finnfund has these institutions, but its third-party control was not credible. This was due to the fact that the board or supervisory board did not have sufficient formal authority over Finnfund. The board members were also not independent since many of them were executives in Finnfund's Finnish partner companies. The supervisory board members are politicians who generally do not have time or expertise to audit tax policy.

h) *DFIs should also be more responsive to the needs of developing countries.* They could for instance collaborate with local officials in order to identify potential loopholes in tax legislation. Developing countries could also benefit if DFIs identified legal loopholes and improvements such as necessary anti-tax avoidance legislation that would tackle arrangements employed by international investors (see Section 8).

8. How Developing Countries Can Protect Their Tax Base

The measures that governments can use to protect their tax base from tax avoidance of MNCs can be classified into two groups: increasing transparency and anti-tax avoidance measures. Implementation and details of some of the most common measures have been presented in the reports of the OECD Base Erosion and Profit Shifting (BEPS) project (OECD, 2019). These measures constitute a solution for developing countries willing to independently tackle tax avoidance by DFIs as discussed in this chapter. While implementing these measures, it is crucial to pay attention to exhaustiveness of the rules and look for loopholes in the legislation. For example, thin capitalization rules have been watered down in many countries by additional exceptions often supported by corporate lobbyist groups (OECD, 2016). Developing countries are even more vulnerable to this kind of lobbying as they are more dependent on foreign investment.

This list includes the most important rules developing countries should adopt to protect their tax base from tax avoidance:

a) *Thin capitalization rules.*[11] Thin capitalization discussed in this chapter is perhaps the most common form of tax avoidance by MNCs. There are various models of thin capitalization rules, some of which complement each other (OECD, 2016). The OECD recommends rules based on a formula in proportion to taxpayer's income before interest, tax, depreciation, and amortization (EBITDA). In July 2019, Malaysia – discussed in the case study of this article – adopted such rules, but their effectiveness has not yet been tested (Swire, 2019). Their rules include exceptions for DFIs as well as several other types of businesses.

b) *General anti-tax avoidance rule (GAAR).* GAAR is sort of a backup rule that could apply to all kinds of tax avoidance and neutralize its impact. However, GAARs are often ineffective in tackling tax avoidance as they are merely applied to purely artificial arrangements.
c) *Controlled foreign company rules.* The CFC rules mainly target local corporations that shift their profits to tax havens abroad and neutralize the effect of such arrangements (see Section 3 for example, OECD, 2015b).
d) *Hybrid mismatch rules.* These rules tackle so-called hybrid arrangements that exploit asymmetric tax bases in different countries, for example, where an outbound payment is tax-deductible in a country but tax exempt in the inbound country (OECD, 2015c). Some countries such as France and Sweden also have rules where tax-deductibility of a payment abroad is denied if the other country does not levy a sufficient level of tax on the incoming payment (OECD, 2016).
e) *Transfer pricing rules.* These rules set the principles for intragroup transactions and are often based on the arm's length principle. These rules are complemented by exit tax rules and other rules governing dealings between permanent establishments located in different countries.
f) *Transparency of financial statements.* The financial statements of local subsidiaries and other companies are publicly available in most European countries but only in a few developing countries. The statements make tax avoidance transparent in many cases. This transparency puts pressure on tax-avoiding corporations and would be especially embarrassing for DFIs.

9. Conclusions

This chapter has presented a tax avoidance case study related to a publicly funded DFI's – namely Finnfund's – investment. The case study shows that a DFI's development impact could turn out to be questionable if the tax policy and steering of the DFIs is undermined. The case study also shows that it is not sufficient for DFIs to comply with local tax regulation, as these regulations could facilitate tax avoidance that can harm development. Also presented is a list of policy actions that would improve the fiscal behavior of DFIs, as well as measures that developing countries could adopt to protect their tax bases from the kind of tax avoidance described in the case study. These actions are also beneficial in tackling harmful tax avoidance more broadly and eventually in making global financial markets more stable and competitive.

Notes

1 PhD Candidate, University of Helsinki, Faculty of Law. Special adviser, Finnish Ministry of Finance.

2 The author has previously worked as a researcher for Finnwatch, but did not take part in the research project involving Finnfund discussed in this article.

3 The full name is Finnish Fund for Industrial Cooperation Ltd.

4 In addition to bilateral DFIs there are multilateral DFIs such as the International Finance Committee (IFC) managed by the World Bank.

5 These developing countries are classified by the Development Assistance Committee (DAC) of the OECD. The government has used an exception in the act to allow investments in Russia.

6 Kerrie Sadiq analyzes similar arrangements in another chapter of this book. Thin capitalization is generally understood as tax avoidance, where multinational corporations (MNCs) or international investors use excessive debt funding, often at excessive interest rates, to shift taxable profits generated in one country to another country with a substantially lower or zero corporate income tax rate. This kind of tax avoidance is possible as interest costs of loans are generally tax deductible and many tax havens exempt the corresponding interest income from tax.

7 *Controlled foreign corporation rules* are specific anti-tax avoidance rules meant to tackle profit shifting to subsidiaries in low-tax jurisdictions. When the rules are applied, the profits of the tax haven subsidiary are taxed in the jurisdiction of the parent company. Usually the possible tax paid out in the tax haven is credited in the parent company's jurisdiction. The details of the rules vary between countries.

8 The international corporate tax system is based on two pillars: *the separate entity doctrine* and *the arm's length principle*. According to these principles, individual entities belonging to the same MNC are separately liable for their taxes and should use *arm's length prices* in their mutual transactions, i.e. *transfer pricing*. These doctrines facilitate tax avoidance as MNCs are able to shift profits from one country to another by manipulating either transfer prices or the corporate structure or both. Many countries also have anti-tax avoidance regulation that for example, restricts the use of so-called *artificial* structures to avoid tax (see Section 8).

9 Negotiating might be difficult as many investors are shortsightedly looking for higher returns without caring about the harmful side effects of tax avoidance. In the long run, tax avoidance and tax competition cause welfare losses and also harm economic growth and investment returns (OECD, 2015a).

10 Annet Wanyana Oguttu discusses harmful tax competition in another chapter of this book.

11 Also known as the interest deduction limitation rules.

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9 | RAISING REVENUE AND IMPROVING HEALTH THROUGH TARGETED FISCAL POLICIES

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Executive Summary

Worldwide production and consumption of alcohol, tobacco, and sugary drinks heavily contributes to the global disease burden, productivity losses, and environmental harms, but the companies that profit from the sale of these goods fail to compensate for these costs in tax revenues to governments. The failure of the market to address harms caused by these products requires fiscal interventions by governments to recoup these losses and curb consumption. We provide an overview of excise tax policies applied to the consumption of tobacco, alcohol, and sugary drinks.

We also show that the production of these harmful products is concentrated among a handful of very large multinational corporations that simultaneously operate in several countries through multinational structures, which enable these firms to take advantage of differing national corporate income tax laws to avoid paying their fair share of corporate income taxes to the countries from which they derive profit. We find that for the ten-year period 2009–2018, countries have lost corporate income tax revenues from the four largest multinational tobacco companies alone of about US$ 23.5 billion due to tax minimization practices on the one hand and tax competition across countries on the other, representing about one-third of these firms' reported tax payments over the period.

> Sugar, rum, and tobacco, are commodities which are no where necessaries of life, which are become objects of almost universal consumption, and which are therefore extremely proper subjects of taxation. (Adam Smith)

Introduction

Worldwide, production and consumption of alcohol, tobacco, and sugary drinks heavily contribute to the global disease burden, productivity losses, and environmental harms, but the companies that profit from the sale of these goods fail to compensate for their costs in tax revenues to governments. For example, tobacco use not only causes seven million deaths each year, but also costs the world's economies over US$ 1.4 trillion in healthcare expenditures and lost productivity (Goodchild et al., 2018), equal to almost twice as much as the global retail value of tobacco products.[5] In addition, over 200 health conditions are attributable to alcohol consumption, not to mention road accidents and violence. Alcohol consumption is the cause of over 5 percent of all deaths annually and costs economies between 2.1 and 2.5 percent of GDP-PPP (WHO, 2017b: 6–7). Finally, one-third of the global population is overweight or obese, and the global economic impact of obesity is estimated at US$ 2 trillion (Dobbs et al., 2014: 1). Among the diseases related to obesity, Type II Diabetes alone affects over 370 million people worldwide, with health care costs ranging from US$ 670 billion to US$ 1.19 trillion globally (International Diabetes Federation, 2015: 58).

The failure of the market to address harms caused by these products and their related economic impacts requires interventions by governments to recoup these losses and curb consumption. This chapter begins by explaining why private market agents fail to internalize the social costs of these products when making production and consumption decisions. These market failures suggest that governments should play a critical role in quantifying the negative externalities generated by harmful products and in implementing appropriate policy interventions to internalize these costs.

While all interventions may not be price related, this chapter focuses on price-related instruments, and specifically, taxation. Apart from corporate income taxes, governments also levy excise taxes, and consumption taxes, such as value added tax and general sales taxes at varying rates on harmful products. These taxes result in higher retail prices, which force both producers and users of harmful products to pay their fair share on the one hand, and to raise the necessary revenue needed to compensate for damages of harmful products on the other. In comparison to other important policy interventions, targeted fiscal policies have a unique potential to efficiently achieve tax justice and better health outcomes.

Section 2 of this chapter provides a brief overview of the design of excise tax policies applied to tobacco, alcohol, and sugary drinks. We provide examples of the types of taxes and show from these examples how the choice between various tax instruments depends on the specific political, social, and economic circumstances.

Moreover, it cannot be ignored that the production of the abovementioned harmful products is concentrated among a handful of very large multinational corporations that simultaneously operate in several countries. These global companies do not pay their fair share of corporate income taxes to the countries from which they derive profit, due to two primary reasons: (1) tax minimization strategies that take advantage of outdated international tax standards implemented through bilateral tax treaties that do not completely ameliorate the conflicts of varying tax laws and entity classifications; and (2) tax competition among countries, which drives down nominal corporate income tax rates worldwide.

We combine several data sources to empirically evaluate the amount of corporate income tax revenue loss due to tax minimization strategies by large tobacco companies and find that for the 10-year period (2009–2018), countries have lost corporate income tax revenues from the four largest multinational tobacco companies alone of at least US$ 23.5 billion due to these firms' tax minimization strategies on the one hand, and tax competition across countries on the other, representing about one-third of their reported tax payments over the period. Thus, Section 3 of this chapter focuses on the three drivers of corporate income tax revenue losses, especially from developing countries, and suggests ways in which countries can curb these losses.

Section 4 concludes with policy recommendations for design of fiscal policies to address harmful products.

1. Economic Rationale of Taxing Harmful Products

Governments around the world have followed Adam Smith's advice, with most countries imposing a variety of taxes on tobacco products and alcoholic beverages, and an increasing number implementing taxes on sugary beverages and unhealthy foods. These taxes include excise taxes, customs duties, value added taxes, general sales taxes, and special levies that fund particular programs.

Governments have used these taxes to accomplish multiple, and at times competing, goals. Historically, revenue generation has been the primary aim of tobacco and alcohol taxes. From an economic perspective, these products are good targets for taxation given that they are typically produced by a small number of manufacturers, have relatively few substitutes, and have demand that is not highly responsive to price, at least in the short run. Given this, they satisfy what economists call the Ramsey Rule for economically efficient consumption taxes (Ramsey, 1927). That is, because of the relative inelasticity of demand, these taxes can generate considerable revenues while creating fewer unintended distortions in the market than would result from taxes on goods and services for which demand is more responsive to price.

In addition to using these taxes to generate revenues, some governments have pursued other goals through the types of taxes they apply. Some have used high customs duties to protect domestic producers from outside competitors. Others have done the same by applying taxes that vary based on the source or type of tobacco or alcohol contained in a product, the price of the product (where foreign brands are expensive relative to those produced domestically), or other product characteristics. Some governments have adopted what they consider to be a 'pro-poor' policy that keeps taxes low on relatively inexpensive products or brands while more heavily taxing more expensive products or brands in order to keep retail prices low for the products/brands most widely used by the poor.

In more recent years, however, governments have begun to use taxes to promote public health by discouraging the use of harmful products, leading to reductions in the death, disease, and economic costs caused by consumption of these products. As described below, evidence demonstrates that these taxes, by increasing prices, lead to reductions in tobacco use, excessive alcohol consumption, and sugary drink consumption, as well as the many harmful health, social, and economic consequences of consumption. Furthermore, these taxes often have a relatively larger impact on consumption by vulnerable populations – youth and young adults, the poor, and pregnant women – making them particularly effective in reaching populations that are often less responsive to other interventions.

Moreover, failures in the markets for these products have become increasingly apparent, creating an economic rationale for these taxes. One such market failure is the presence of what economists call negative externalities – costs that are not borne by the consumer of the product, but by others in society. For example, as described above, there are clear negative health externalities from tobacco use, given the well documented health consequences of exposure to environmental tobacco smoke. Similarly, many of the health and social consequences of excessive drinking fall on non-drinkers or moderate drinkers, including those resulting from alcohol-involved traffic crashes, alcohol-induced violence, and fetal alcohol syndrome caused by drinking during pregnancy.

Finally, as detailed above, to the extent that health care is publicly funded, there are also financial externalities, as the considerable costs of treating the health consequences of smoking, excessive drinking, diabetes, obesity, and other conditions caused by consumption, are subsidized by others in society. Some have argued that these costs to government are at least partially offset by reduced pension payments and health care spending resulting from the premature deaths caused by consumption of harmful products (e.g., A.D. Little, 2001). In an analysis of the impact of a federal cigarette tax in the United States (US), however, the Congressional Budget Office concluded that the net budgetary impact, accounting for increased Medicare and Social Security costs due to reduced smoking, would be positive in the long run (CBO, 2012). Others have highlighted the perverse implications for public policy resulting from this narrow budgetary perspective, which taken to its extreme implies that governments should not engage in efforts to extend lives beyond retirement age.

In addition, there are information failures in these product markets, given that the full risks of consumption are often poorly understood by a significant portion of the population. These failures are exacerbated by the early ages at which use is often initiated and by the habitual or addictive nature of consumption, something that few new users comprehend, as well as the extensive marketing of these products. Recent advances in economic theory imply that the internalities, that is, the direct consequences of use on the user, resulting from individuals' self-control failures that lead to greater use than desired are yet another market failure that calls for government intervention in these markets (Gruber and Koszegi, 2008).

Taxes can be used to correct for these negative externalities, an idea first proposed by economist Arthur Pigou, hence the term 'Pigouvian taxes' (1920). In this sense, taxes on these products can be considered 'fair' given that the taxes reflect the costs to society, which result from an individual's consumption that are not otherwise fully reflected in prices. Ideally, these taxes would be high enough to account for the external costs, that is, costs to others, of consumption. In practice, though, this is far from the case, even in countries where taxes are relatively high, suggesting that these taxes are not close to punitive levels that exceed compensation for externalities.

While Pigouvian taxes can be considered fair from an economic perspective, there are concerns about the regressive nature of these taxes, given that the poor often spend a larger proportion of their incomes on the taxed products. While it is the case that consumption taxes are generally regressive, the same may not be true for increases in existing tax rates. As discussed below, and consistent with economic theory, the demand for tobacco, alcohol, and sugary drinks among lower-income groups is generally more responsive to tax and consequent price increases than demand among higher-income groups. This implies that the health benefits of higher taxes are progressive, given larger reductions in use among lower-income groups as taxes rise. In addition, recent research on tobacco taxes suggests that tobacco tax increases are financially progressive, once the reductions in health care spending and increases in incomes that follow tax-induced declines in use are taken into account (Fuchs et al., 2017). Finally, how the new revenues generated by these taxes are used can further allay concerns about the fairness of these taxes. For example, most of the new revenues from the tobacco and alcohol tax increases included in the recent 'sin tax' reform in the Philippines were dedicated to the country's universal healthcare program, greatly expanding access to health care among low-income Filipinos (Kaiser et al., 2016).

Next, we discuss different experiences with excise taxes on harmful products.

2. Design of Excise Taxes on Tobacco, Alcohol, and Sugary Drinks

As mentioned above, in many cases the historical motivation for excise taxes has been to generate revenue. However, as the health consequences of the consumption and the negative externalities became more widely known and as the evidence of the effectiveness of taxation as a tool to reduce their use has grown, the motivations have shifted considerably to use as a health policy tool, now widely recognized by the global economic community, including specific recognition for tobacco taxes by the World Bank (1999) and International Monetary Fund (2016).

An excise tax is a type of indirect tax applied to the sale or consumption of a particular product. Excise taxes are applied to both domestically manufactured and imported goods, but not on goods that are exported. Import tariffs and duties are generally not favored since increasing import tariffs and duties will not apply to domestically produced products and an increase in the tax rate may thus not reduce overall consumption insofar as it merely shifts consumption from imported to domestically produced commodities.

Excise taxes can be applied as specific or ad valorem taxes. Specific taxes apply the tax based on volume/unit (for example the number or weight of cigarettes or the volume of beverage) while ad valorem taxes apply the tax as a percentage of value (for example percentage of wholesale price, percentage of ex-factory price, or percentage of retail price). In both cases, the taxes can be applied uniformly across all values or product characteristics, or tiered (in other words, differentiated by value or product characteristics). Some countries apply only specific or ad valorem taxes, while other countries apply both (called a mixed system). In a smaller number of cases hybrid systems are used. Examples of this include systems where an ad valorem tax is implemented subject to a specific floor. For example, in Turkey in 2010, an ad valorem rate of 63 percent of retail price was applied with a minimum amount of tax of 2.65TL/pack (WHO, 2010).

Alternatively, a tax may be set as an ad valorem rate but implemented as a specific rate: for example, the specific tax on cigarettes in South Africa is R7.15/10 cigarettes. However, the rate is adjusted each year such that the excise is 39.7 percent of the retail price of the most popular brand (Blecher, 2010). In other cases, either a specific or ad valorem tax is applied based on certain conditions. For example in the European Union, countries must apply both specific and ad valorem taxes, of which the specific component should be between 7.5 percent and 76 percent of the total tax burden and where the total value of the excise tax should be a minimum of EUR 90 per

1,000 cigarettes and account for at least 60 percent of the weighted average retail price; however, if the excise tax exceeds EUR 115 per 1,000 then the 60 percent floor is not required (Blecher et al., 2012).

In almost all cases, excise taxes are collected very early in the supply chain to improve tax administration. This is almost always at the point of importation or manufacture. However, excise taxes are still considered consumption taxes since they are intended to increase the retail price of the product and are thus paid by the consumer.

Specific considerations and examples of excise taxes on tobacco, alcohol, and sugary drinks are explored in the following subsections.

2.1 Tobacco

Increases in taxes that result in increases in prices reduce tobacco consumption and at the same time result in increases in tax revenues. This relationship is defined by the price elasticity of demand, or the percentage change in consumption as a result of a 1 percent change in price. Price elasticities have been widely studied and the consensus is that the price elasticity centers on -0.4 in high-income countries and between -0.2 and -0.8 in low- and middle-income countries (NCI and WHO, 2016). This means that a 10 percent increase in real price (in other words, inflation adjusted) will result in a 4 percent reduction, on average, in consumption in high-income countries and between 2 percent and 8 percent in low- and middle-income countries. This relatively price inelastic demand means that consumption declines are less than proportional to the increase in price, meaning that tax revenues will increase as a result of the increase in the tax rate.

South Africa is one of the most notable examples of these relationships in action. Between 1961 and 1991, real taxes and prices fell by 72 percent and 45 percent, respectively, causing an increase in consumption of 245 percent (Figure 9.1). From 1991 to 2018, increases in excise taxes and real prices, by 572 percent and 236 percent, respectively, resulted in dramatic declines in cigarette consumption (by 60 percent). These declines in consumption are attributable to the tax and price increases because the most substantial declines occurred before the imposition of tobacco control measures like smoke-free areas and advertising bans in 2001 (Chelwa et al., 2017). While volumes declined, the even greater increase in the tax rate meant that tax revenues increased dramatically, by 168 percent in real terms, between 1991 and 2018 (Figure 9.2).

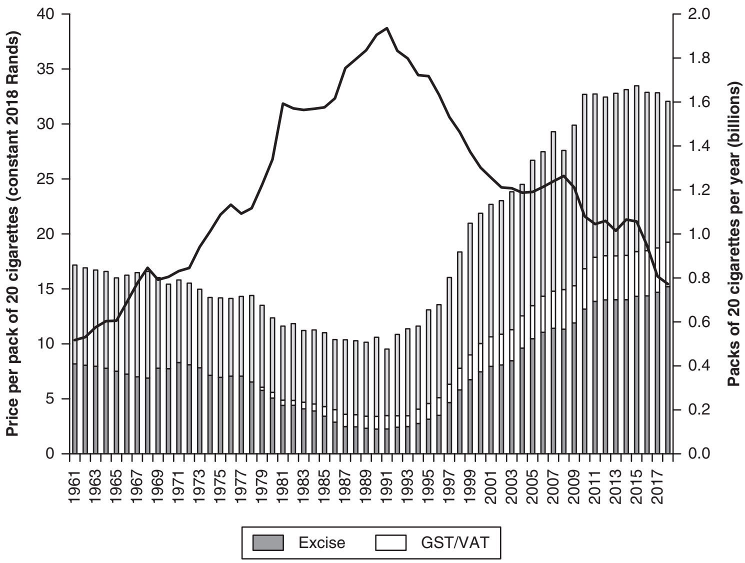

FIGURE 9.1 Real taxes, prices, and consumption of cigarettes in South Africa, 1961–2018 (constant 2018 prices)

Source: Economics of Tobacco Control Project, University of Cape Town.

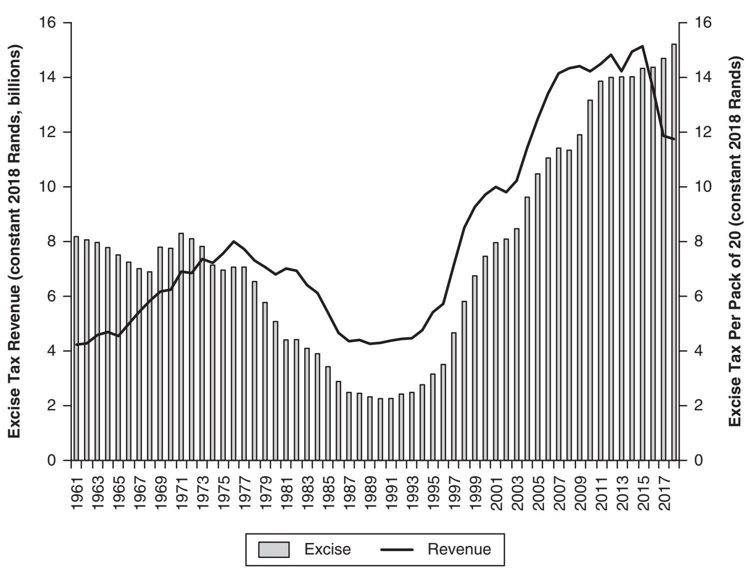

FIGURE 9.2 Real excise taxes and revenues in South Africa, 1961–2018 (constant 2018 prices)

Source: Economics of Tobacco Control Project, University of Cape Town.

There is significant variation in both tax structures and rates by country, income group, and region; however, there is a consensus that uniform specific taxes or mixed systems, which rely more on the specific component, are optimal from both a public health and revenue generating perspective (WHO, 2010). This is embodied in the Guidelines for Implementation of Article 6 of the World Health Organization Framework Convention on Tobacco Control, which recommends that countries implement such systems (WHO, 2014). Specific taxes are easier to administer and less susceptible to undervaluation and transfer pricing. Furthermore, technological advancements in track and trace systems have made it particularly easy to monitor volumes and thus to collect specific taxes.

Specific taxes reduce the price variation between brands compared to an ad valorem tax, which decreases opportunities for consumers to trade-down to cheaper brands in response to tax/price increases. Thus, specific taxes reduce the incentives for tax avoidance but also improve the effectiveness of the tax as a public health instrument. Specific taxes also provide an increased incentive for producers, distributors, and retailers to increase prices by more than the increase in tax ('over shifting'), which also results in greater reductions of tobacco use. Increases in specific taxes also result in equal increases in taxes across all brands and a more equal increase in price across the price spectrum. Specific taxes have also been shown to result in greater stability and predictability in revenues, although mixed systems with large specific components may generate the greatest revenues. Tiered systems with different rates for varying types of products undermine the advantages of specific tax systems and amplify the disadvantages of ad valorem systems.

Both specific and ad valorem taxes need to be adjusted regularly in order to keep pace with inflation to ensure that tax revenues are protected against inflation. Ad valorem systems maintain an automatic adjustment, although this can be undermined through undervaluation and transfer pricing. For example, under an ad valorem system where the cost-insurance-freight price is used as the excise tax base and where the producer and importer may be owned by the same multinational holding company, the producer may under-invoice to lower excise taxes and then shift the profits through transfer pricing methods to jurisdictions where the income tax rate is lower than the ad valorem excise tax rate.

Figure 9.3 shows the distribution of tax structures by income groups in 2008 and 2018 using data from the WHO's Global Tobacco Control Report (2019) and WHO Technical Manual on Tobacco Tax Administration (2010). High-income countries tend to have specific-only or mixed systems although the number for mixed systems is heavily influenced by the European Union member states that are required to employ a mixed system (Blecher et al., 2013). All systems are prevalent in middle-income countries while low-income countries rely heavily on ad valorem systems. The trend between 2008 and 2018 is encouraging, with a significant reduction in the use of ad valorem systems, the decline driven mostly by low-income countries, and significant increases in the use of specific and mixed systems.

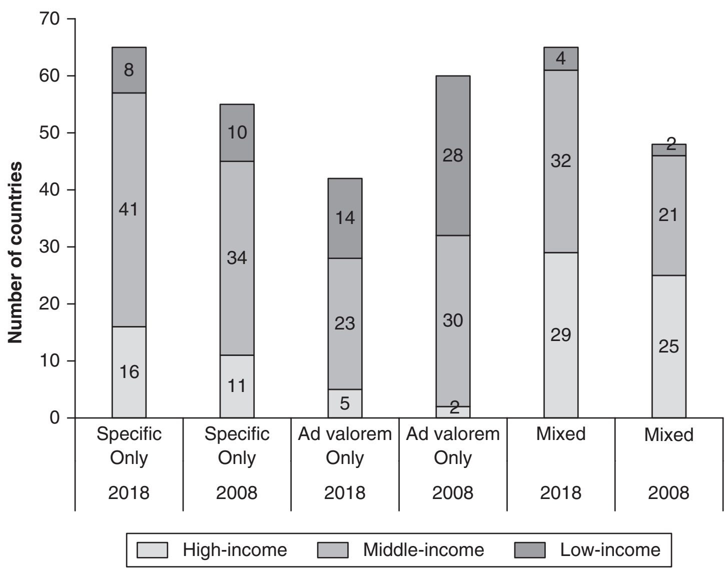

FIGURE 9.3 Tax structures by income groups in 2008 and 2018

Source: WHO's Global Tobacco Control Report (2010 and 2019).

Note: There were 172 and 163 countries in 2008 and 2018, respectively. Some moved between income categories. For example, there were 40 low-income countries in 2008, but only 26 in 2016, and 85 middle-income countries in 2008, but 96 in 2018. Furthermore, there were a small number of countries for which data were available in 2018 but not 2008, and vice versa.

2.2 *Alcohol*

Just like tobacco, alcohol is relatively price inelastic (Nelson, 2013). This is supported by the literature; however, it is complicated by the pattern of drinking, both in terms of intensity as well as product variation. Much of the harm and externality of alcohol use is driven by high-intensity users who are less price sensitive than low-intensity users (Shrestha, 2015). This might suggest that a disproportional share of the reduction in overall volumes as result of a tax-induced price increase will be attributable to low-intensity users who cause little externality. However, there is strong evidence to suggest that tax increases do result in substantial declines in alcohol-related injuries and violence (Lavoie et al., 2016). Higher taxes/prices may be achieving these positive effects not so much by inducing heavy drinkers to drink less but rather by depressing the number of heavy drinkers by reducing and delaying initiations.

Alcohol tax and price are complicated by a large degree of product heterogeneity with variation in product, primarily beer, spirits, and wine, in alcohol strength as well as variation in serving sizes and prices by retail environment. Beer (including cider) are the lightest alcohol strength with most beer between 3 and 6 percent alcohol volume. Beer is by far the most widely consumed alcohol by both absolute volume and volume of pure alcohol. Wine has significant variations in alcohol strength with most non-fortified wine (including both still and sparkling wine) in the low teens in terms of alcohol volume percentage. Fortified wine and brandy have much higher alcohol content but are relatively small components of the market. Distilled spirits, including vodka, gin, whiskey, and a variety of regional and national variations have high alcohol volumes often around 40 percent and account for the second largest share of the market after beer.

Specific tax systems are preferred to ad valorem tax systems for alcohol for many of the same reasons as tobacco; however, mixed systems are also useful in that they are able to generate significant revenues from high-priced wine and spirits. Thus, an optimal tax system may make use of a specific tax, but also an additional ad valorem tax on spirits or wine.

Since the strength of the alcohol is directly related to the negative externalities, the tax base becomes more important. Under a specific tax system favored for tobacco, the specific tax is levied usually on the number of cigarettes, but sometimes on the weight of the product; however, the latter is not considered best practice since producers may avoid the tax increase by lowering the quantity of tobacco in the cigarette and thereby avoid the tax increasing resulting in an increase in the price and encouraging smoking cessation (nearly all the reduction in harm from smoking is gained through cessation or reduced initiation, not through reduced intensity). Translating this specific tax system to alcohol would mean levying the specific tax on the volume of the beverage independent of the strength. However, a significant number of countries levy the specific tax on the volume of alcohol rather than the volume of the beverage, thereby taxing the dose of alcohol. For example, instead of levying a tax of $1 per liter of beer, one might levy a tax of $25 per liter of absolute alcohol. For a light beer of 3 percent alcohol strength, the tax would be $0.75 per liter of beer and thus lower than the flat tax, but for a heavier beer of 5 percent alcohol strength, the tax would be $1.25 per liter of beer, yet a 4 percent beer would be the same under both scenarios. Similar systems can be employed on distilled spirits where alcohol strengths also vary and can be adjusted relatively easily by manufacturers.

Generally, a uniform specific tax would act as a mechanism to reduce the demand (or quantity demanded) for tobacco or alcohol. However, when the tax is shifted to the dose the tax could affect either demand or could affect consumption through the supply side. If producers, distributors, and retailers pass the tax differences on to consumers, then this would affect the demand side, reducing the demand for higher-alcohol beers relative to lower-alcohol beers and thus, a shift in consumption patterns towards lower-alcohol beers would reduce total alcohol consumption. However, an alternate mechanism is that producers, distributors, and retailers do not pass on the price differences, but rather, shift marketing activities (including advertising, sponsorship, and promotions) to lower-alcohol beers since they would become relatively more profitable.

A prominent example of this occurred in South Africa where the excise tax on beer and spirits was changed from a uniform specific tax to a dose-based tax (tax per liter of absolute alcohol) in 1998. Blecher (2015) showed that after the change in system, combined with increases in the excise tax per liter of absolute alcohol, there was a significant shift in advertising from higher- to lower-alcohol beers. The average alcohol content for each Rand spent on alcohol advertising declined from nearly 5.2 percent in 1999 to a little more than 4.7 percent in 2013, a decline of approximately 10 percent. During the same period, the liters of absolute alcohol per adult from beer declined from 4.4 liters to 3.9 liters, a decline of nearly 12 percent. The total volume of beer consumed remained relatively unchanged, meaning that there was no compensation in the aggregate of consumers drinking more beer to achieve the same dose. If consumers had compensated by drinking more beer, then the goals of the dose-based tax system would have been undermined.

This type of dose-based system is linear; however, some countries have attempted to implement a tiered system to achieve a similar effect. Mongolia does this on vodka by employing three rates of excise on the following tiers: less than 25 percent; 25 to 40 percent; and greater than 40 percent. The excise is Mongolian Tugrik 2900, 5800, and 13050 per liter of vodka for each category, respectively. Vodka is most often sold with an alcohol volume of 40 percent, however, unsurprisingly, nearly all vodka in Mongolia is watered down by manufacturers and distributors to 39 percent (97 percent of the volume of vodka was less than 40 percent in 2016), thereby avoiding the more than double excise if it were 40 percent. A linear dose-based system would remove such incentives for tax avoidance and allow the manufacturers and distributors to locate at their preferred alcohol strength and tax yield.

2.3 *Sugary Drinks*

More recently, as rates of overweight and obesity and the associated diseases including Type II Diabetes have increased in many countries, particularly in low- and middle-income countries, significant attention has been given to the role that sugary drinks and even 100 percent fruit juices play in this increase due to the empty nature of the calories consumed. The calories are not accompanied by any other nutritional benefit in the case of sugary drinks and limited nutritional value in the case of 100 percent fruit juices. The use of taxes to reduce their consumption has been widely proposed. The effect of the tax on reducing volumes is likely to be significant since demand for the product is much more elastic than tobacco or alcohol due to the much larger range of substitutes (including diet drinks, milk, water, teas, and coffee) (Andreyeva et al., 2010). Most of these substitutes have no sugar or caloric value and those that do have significantly less.

Models have shown that reductions in volumes of sugary drinks will result in declines in rates of overweight and obese people and thus declines in the associated diseases. However, critics of the taxes have argued that declines in volumes will be substituted towards other calorie intake elsewhere in the diet. This criticism only considers the change in behaviors of existing users, but does not consider how increased taxes and prices will reduce and delay initiation, particularly by children, and thus bring about important long-run health benefits.

A key question is how to tax sugary drinks since there is limited country experience compared to tobacco and alcohol. However, conceptually, the experience of tobacco and alcohol is relevant to the design of optimal tax systems for sugary drinks. It is likely that alcohol is a better reference point than tobacco since alcohol and sugary drinks are both produced, distributed, and sold in similar supply chains; both are beverages; and the externality is related to dose (in other words pure alcohol or sugar) rather than the volume of the beverage. Furthermore, both products are very heterogeneous, compared to tobacco products, which are almost always sold and taxed as manufactured cigarettes.

The most prominent recent example of a country which implemented a sugary drink tax was Mexico on January 1, 2014. The tax was a uniform specific levy of one Peso per liter of beverage, which approximated 10 percent of the retail price. All sugary drinks including both carbonated and non-carbonated drinks were included in the tax, excluding diet drinks and water. The goal of the tax was to increase the price of sugary drinks relative to unsweetened beverages, thereby decreasing the quantity demanded of the former and increase the quantity demanded of the latter, with an expected decline in caloric consumption. Early evaluations have shown declines in consumption of taxed beverages and increases in consumption of non-taxed beverages (Colchero et al., 2016).

South Africa and the United Kingdom (UK) have proposed introducing such taxes, but rather than implementing a uniform specific tax like Mexico, they have both proposed rather innovative tax structures. South Africa proposes to implement a dose-based tax system where the tax is applied per gram of sugar per 100ml rather than per

100ml of the beverage. Furthermore, a threshold is applied where the first 4g of sugar per liter are excluded. Any added sugar above the 4g threshold is then levied with an excise tax of 2.1c per gram per 100ml. For example, a sugary drink with 4g of sugar will attract no excise tax, whereas other sugary drinks with 8 and 12g, will attract 16.8 and 25.2 cents, respectively. The goal is to create a supply side incentive for producers to reformulate products to reduce the sugar content as a mechanism of avoiding the tax partly or entirely. The incentive is linear and increases linearly as the sugar content increases, similar to South Africa's dose-based alcohol tax previously mentioned.

The UK has followed an alternative approach by implementing a tiered system (or thresholds). Rather than implementing a linear model, three categories are proposed: beverages with less than 5g of sugar per 100ml, which will have no tax; beverages with between 5 and 8g of sugar per 100ml, which will be taxed at GBP 0.18 per liter; and beverages with more than 8g of sugar per 100ml, which will be taxed at GBP 0.24 per liter.[6] Before the implementation of the tax, there has already been significant reformation. For example, Tesco supermarket has reduced the sugar content of its store brand soft drinks to below 5g of sugar per 100ml to avoid the tax,[7] while Lucozade, a popular sports energy drink, and Ribena, a popular fruit flavored drink, have reduced the sugar content by half to approximately 4.5g per 100ml.[8]

Generally, the discrete threshold systems require one to draw a line in the sand and potentially to be able to periodically adjust the thresholds. Furthermore, there may be challenges in getting the categories and rates correctly established to achieve the desired outcomes. However, dose-based systems, whether linear or threshold or a combination, allow the market to respond, in contrast to more heavy-handed interventions. Furthermore, the higher the tax rates per gram of sugar, the greater the incentives for supply-side responses through product reformulation or shifting of marketing emphasis. These may also minimize the beverage industry employment effects since there may be no decline in beverage consumption but rather substitution to lower sugar or no sugar products. However, allowing for these market shifts most certainly reduces the favorability of the tax as a revenue generator.

The above examples of excise tax policies on harmful products, such as tobacco, alcohol, and sugary drinks demonstrate that these types of tax instruments are available tools in not only generating revenue to compensate for their related economic harms, but also in incentivizing supply- and demand-side changes. However, such taxes do not exist in a vacuum, but are applied as part of an overall package of fiscal policies designed to address their use and health and economic externalities. Below, we turn to another fiscal instrument designed to tax the profits from the industries producing these harmful products: the corporate income tax.

3. Corporate Income Tax Revenue Loss

This part of the chapter focuses on how and the extent to which multinational companies engaged in the production of harmful goods – in particular, multinational tobacco companies – fail to contribute their fair share of corporate income taxes to the countries where they operate. In a companion paper (Dauchy and Siu, forthcoming) the authors estimate that over the ten-year period 2009–2018, countries have lost corporate income tax revenues from the four largest multinational tobacco companies alone of about US$ 23.5 billion due to tax minimization and tax competition, representing about 33 percent of these firms' actual corporate income tax remittances over the period.[9]

With the exception of a few jurisdictions broadly identified as tax havens, most countries tax business profits. At the same time, many businesses have operations across national borders as a multinational group of sometimes hundreds of separate entities. While they report their operations as a single corporate group for financial accounting purposes, they report taxable income entity-by-entity in each country where they operate. Since laws that stipulate corporate tax rates and the rules determining the tax base vary across jurisdictions, several countries have adopted bilateral or multilateral tax treaties to avoid double-taxation of the same income earned by businesses operating in multiple countries. According to the provisions of these treaties, countries agree to assign certain types of income to the residence country (where the investor resides) and often agree to limit source-based taxation (where the profits are generated) to zero or low tax rates.

However, these treaties do not fill all the gaps between conflicting domestic laws, and most countries lack a comprehensive network of tax treaties. There is no international body that governs cross-border taxation as there is for international trade. Instead, the Group of Twenty (G20) has mandated the Organization for Economic Cooperation and Development (OECD) to establish international consensus to tax profits 'where value is created' by agreeing to a common set of reforms to close loopholes for widespread tax avoidance by multinational companies, through an initiative known as Base Erosion and Profit Shifting. These reform efforts have achieved some results in the past six years, but consensus on international tax standards is still in a nascent phase, leaving ample opportunity for tax arbitrage by multinational corporations.

Due to the lack of data, most estimates of the size of the 'tax gap' due to tax avoidance or evasion are based on high-income countries.[10] Yet there is growing evidence that the effects of corporate tax minimization are likely to fall significantly more on low- and middle-income countries (Fuest and Riedel, 2012; Crivelli et al., 2015; IMF, 2015; UNCTAD, 2015). Although the pressure to forgo tax revenues in exchange for the promise of economic development is felt by all countries, low- and middle-income countries in particular have the most at stake given their greater need to attract investment, and their greater reliance on corporate income tax revenues. Corporate income tax revenues in these countries represent a greater share (15 percent) of total tax revenues than in high-income countries (8 percent) (World Bank, 2016).

Overall tax revenues represent a much smaller proportion of GDP (13 percent) in low- and middle-income countries than in high-income countries (35 percent), narrowing fiscal capacity to raise enough revenue to finance public programs and services, including health care, education, and sanitation (Janský and Prats, 2015). Low levels of tax revenue are due to several reasons including large informal sectors, high levels of poverty, and tax avoidance and tax evasion by companies and individuals, which add to weak fiscal and institutional capacity, insufficient enforcement measures, and lack of compliance.

In addition to tax minimization strategies, the lack of international cooperation also leads countries to engage in fierce tax competition aimed at attracting cross-border investment. Countries compete by reducing nominal corporate income tax rates known as the race to the bottom.

To illustrate how multinational tobacco firms fail to contribute their fair share of corporate income tax revenues to the countries in which they generate profits, two aspects – tax minimization and tax competition – are described and discussed in further detail below, and the resulting revenue losses over the past decade are empirically estimated. We also suggest defensive measures countries can take to appropriately tax these companies.

3.1 Tax Minimization

Corporate tax minimization, either legal (avoidance) or illegal (evasion) exploits the misalignment of domestic tax laws and the gaps inherent in the international tax system. Such 'optimization' is viewed as an important corporate strategy used by multinational corporations to compete in international markets and increase after tax profitability (Desai and Dharmapala, 2009; Clausing, 2016; Gravelle, 2009).

Strategies used by most multinational companies to reduce tax payments generally revolve around shifting income from high-tax to low-tax jurisdictions. For example, Schwarz shows that among US multinationals, the share of retained earnings is significantly larger in low-tax countries than in high-tax countries (2009). Multinational firms are comprised of multiple legally separate entities that engage in transactions with each other to contribute to overall global profits. Taxable profits, however, are calculated at the entity level – not at the global level. Because of the separate entity accounting principle, corporations tend to structure themselves in ways to take advantage of the ability to shift profits among the subsidiaries of the corporate group. Transfer prices approximate the value of goods and services exchanged between corporate subsidiaries as if they were independent companies operating at arm's length. However, when those transfer prices inflate or deflate the value of goods and services for the purpose of increasing taxable income for subsidiaries in some jurisdictions while decreasing taxable income for subsidiaries in other jurisdictions (usually for the purpose of lowering the overall tax bill), transfer mispricing occurs.

Worldwide production has become increasingly services oriented over time, representing less than a half of global GDP in the 1960s and expending to more than three-fourths of GDP (68 percent) by 2015.[11] Even for companies producing tangible goods, a significant share of income from the sale of those goods is now attributed to intellectual property such as brands, copyrights, and patents. In

2015, 87 percent of firm value among the S&P 500 corporations was intangible assets (Contractor, 2016). Under the separate entity principle, a multinational firm's brand name or loans can be owned or issued by a holding company in a country with low or no taxation (or a preferential tax regime, such as a patent box), and a significant share of the revenues of all the subsidiaries (which are located in higher tax countries) can be paid to the holding company in exchange for the use of the brand or in loan fees. In this way, the overall tax bill is minimized. For example, Dutch tax authorities have recently taken administrative action against British American Tobacco (BAT) for GBP 902 million in taxes (plus penalties and interest) avoided from 2003 to 2016 through inflated loan fees paid by Dutch BAT subsidiaries to BAT's UK holding company, which issued the loans (Goodley, 2019).

Current reform processes under the OECD are seeking to curb losses from this arbitrage. As a result of the recent Base Erosion and Profit Shifting reform, OECD and G20 countries agreed to four 'minimum standards': information exchange on multinational companies' tax payments, revenues, employees, and assets on a country-by-country basis; evaluation of preferential tax regimes through the Forum on Harmful Tax Practices; enhanced efforts to improve tax dispute resolution between treaty partners; and treaty abuse clauses in bilateral tax treaties. In addition, the process agreed to certain 'best practices' that, while not mandatory, are recommended, including limitations on deductions for interest payments to related parties; and best practices to prevent double-deductions of expenses, and/or non-taxation because of entity classification misalignment. However, the separate entity principle and transfer pricing rules remain intact.

Further work of the OECD/G20 Inclusive Framework is attempting to develop consensus on tax standards to address the digitalized economy, which includes a 'significant economic presence' nexus rule to replace a physical presence requirement; and new profit allocation rules, which include a fractional apportionment approach that would reassign taxing rights of countries 'over a proportion of [a multinational] group's profit (however defined), rather than over the profit from specific transactions or activities undertaken by particular separate entities' (OECD, 2019a: 20). Proponents of global profit consolidation with fractional apportionment have argued that this type of system would curb tax minimization practices (Picciotto, 2017). In its early attempts at a consensus, however, the OECD Secretariat has retained use of the transfer pricing system, at least in part, to allocate routine profits (OECD, 2019b).

Apart from the misalignment of national tax rules and tax arbitrage through transfer mispricing, governments directly provide other methods of tax minimization that result in high variation between the nominal or statutory corporate income tax rate (CTR) and a company's effective tax rate (ETR). These include tax incentives through free trade zones, tax holidays (sometimes for up to ten or more years), tax credits or accelerated depreciation allowances on certain business assets, special rates on certain types of income, such as patent boxes for income generated from intellectual property. As a

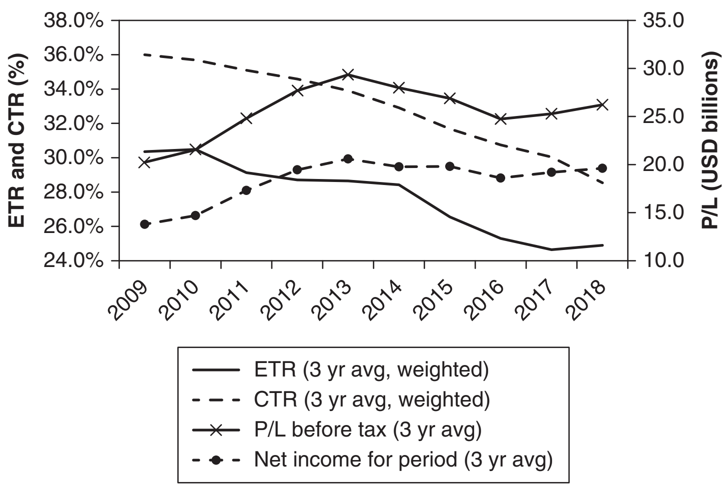

FIGURE 9.4 Combined effective tax rates, corporate tax rates, and profits of four largest multinational tobacco companies, 2009–2018

Sources: Companies' balance sheets. Corporate tax rates are from the OECD's Tax Tables and include both central and local corporate income tax rates.

Note: Three-year weighted average effective tax rates are computed from companies' reported tax payments and profits before taxes (P/L before tax) averaged over three years. Statutory corporate tax rates are three-year averages weighted by companies' profits before tax and include central and sub-regional statutory rates.

result of these tax incentives, nominal rates rarely match up to effective tax rates of multinational firms.

Focusing on the four largest multinational tobacco companies and using their annual financial reports, we find that their combined ETR dropped from an average of 30.4 percent in 2007–2009 to an average of 24.9 percent in 2014–2018 (Figure 9.4).[12] During the same period and using the statutory corporate tax rates in the US, UK, and Japan weighted by these companies' pretax profit shares, we also show that the weighted average statutory CTR dropped from 36 percent to 28.5 percent.[13] The fact that the four transnational tobacco companies' combined effective tax rate is consistently smaller than their combined corporate tax rate suggests that these companies use tax minimization strategies in countries where they operate.

From this information, we first evaluate the tax revenue loss due to tax minimization, that is, due to the gap between companies' ETRs and countries' statutory CTRs. We find that over the ten-year period 2009–2018 governments could have collected about US$ 11.21 billion of additional tax revenue, or 15.7 percent of their combined reported tax payments, if the four multinational tobacco firms had not used tax minimization strategies, that is, if they had paid the statutory CTR instead of their reported ETRs (Figure 9.5 and Table 9.1).

3.2 Tax Competition

Although there are many ways for governments to compete to attract investment, such as offering generous tax incentives, a global trend over the past three decades has been to reduce nominal corporate income tax rates with greater reliance on consumption taxes (Fitzgerald and Siu, 2019). On average, nominal corporate income tax rates have plummeted by an average of 20 percentage points since 1980 and continue to fall as countries have increasingly seek to attract mobile sources of income, such as financial capital and intellectual property (IMF, 2014). Corporate tax rates have dropped faster in developing countries than in advanced economies from 1990 to 2015, a decrease by 18 and 13 percentage points respectively, on average (IMF, 2017). Moreover, multinational companies that produce and commercialize harmful products recognize that tax competition has driven their effective tax rates downward in spite of increases in pretax profits.[14]

To evaluate the size of the corporate income tax revenue loss from multinational tobacco companies due to tax competition, we compute the amount of tax payments that these companies would have paid to the governments in countries where they operate if the CTRs of these countries had not decreased since 2007 and compare this amount to the corporate income tax that these companies would have paid if their profits were taxed at these countries' actual, yearly CTRs. To do this we use data on corporate tax rates over time in the country where the companies operate and apply it to the distribution of their pretax incomes across countries. We obtain consolidated pretax profits from the companies' financial statements and distribute them across countries using data on companies' sales

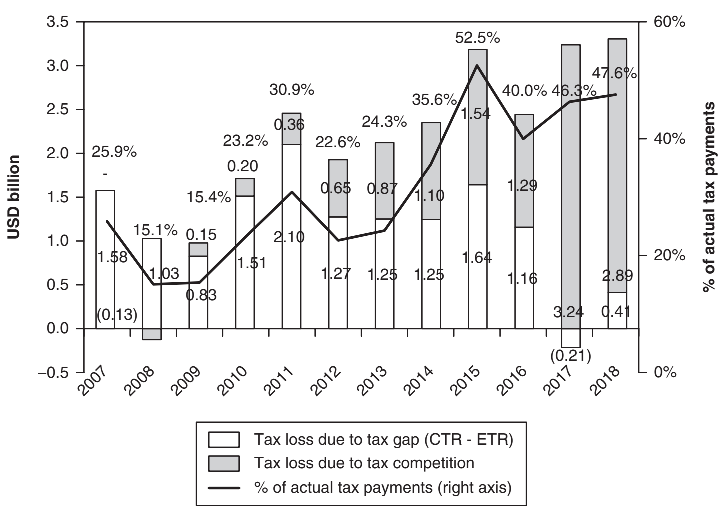

Figure 9.5 Estimated total corporate income tax revenue loss, four major multinational tobacco companies, 2007–2018

Sources: Dauchy and Siu (forthcoming); income statements of Phillip Morris International Inc (PMI), Japan Tobacco Inc (JTI), British American Tobacco Plc (BAT), and Imperial Brands Plc.

Note: Statutory CTRs are from the OECD database, inclusive of local corporate taxes. Sales of cigarettes are obtained from Euromonitor. Calculations of the tax revenue loss are exclusive of BAT's acquisition of Reynolds American International in 2017, as this event was a single event, yet had major implications for BAT's corporate tax remittances in 2017 (BAT benefited from a large corporate tax credit of US$ 10.96 billion that year, in large part due to RAI's deferred tax benefits).

over time and across countries.[15] We estimate a loss in corporate tax revenue from multinational tobacco companies due to tax competition among countries amounting to US$ 12.29 billion over the decade 2009–2018, or 17.3 percent of their combined reported tax payments over the period (Figure 9.5 and Table 9.1).[16]

However, as noted above, countries not only compete for foreign investment by lowering CTRs. Tax competition also affects domestic laws that determine the tax base as well as tax treaties that stipulate lower withholding rates on income from royalties, dividends, and other types of income. For example, multinational corporations engaged in the production of harmful products tend to invest heavily in research and development activities to promote and trade new products (also called 'new generation goods'). Because of their intangible nature, these investments provide opportunities for companies to relocate profits from high-labor or high-consumption countries to low-tax countries. The special tax treatment of intellectual property

TABLE 9.1 Estimated tax revenue loss from four major multinational tobacco companies, ten-year rolling averages over 2007–2018

Values in US$ billion	2007–2016	2008–2017	2009–2018
Actual tax remittances	69.8	70.2	71.2
P/L before tax	248.2	253.4	262.7
P/L for period [net income]	176.5	181.7	190.3
Licit cigarette sales			
[a] Tax loss due to companies' tax minimization, or tax gap (CTR-ETR)	13.61	11.82	11.21
[b] Tax loss due to international tax competition effect	6.04	9.28	12.29
[c] Total tax loss [a+b]	**19.7**	**21.1**	**23.5**
–> % of actual tax remittances	28.2%	30.0%	33.0%
–> % of P/L before tax	7.9%	8.3%	8.9%
–> % of P/L for period [net income]	11.1%	11.6%	12.3%

See notes for Figure 9.5.

income by patent box regimes provides corporations strong incentives to move intellectual property into these countries. For instance, by 2015, 15 countries in Europe had enacted patent box regimes in which income from intangible assets (royalties, licensing, sales of assets) is taxed at much lower rates than general corporate income (Bradley et al., 2015). Although the evidence of the effectiveness of patent boxes to increase government revenues is scant, given that patent boxes only began to appear over the last decade, a 2014 study concluded that the revenue losses outweighed revenue gains (Griffith et al., 2014).

Our findings show that multinational tobacco companies have significantly more legal presence (or presence 'on paper') than actual economic presence in countries with zero withholding tax rates. We find that the worldwide share of the four multinational tobacco companies' subsidiaries located in these countries is between 4.5 and 11 times larger than their worldwide share of sales in these countries.[17] For example, 25 (7.7 percent) of all Imperial Brands subsidiaries are located in countries with zero withholding tax rate on royalty income, while only 0.7 percent of the companies' sales occur in these countries. The extent of patent ownership in low-tax countries provides further evidence of the importance of intangible assets in profit shifting strategies. We find that a significant proportion of patents owned by the four major multinational tobacco firms are registered or invented in tax haven and low-income countries.[18] For instance 46 of 67 patents owned by BAT are registered in countries with patent box regimes and 41 have lead inventors in countries with a low withholding tax rate on royalty income.[19] Furthermore, multinational tobacco firms' intangible assets are a significant share of total assets. In 2018, total intangible assets represented 90 percent of all tangible and intangible assets and 68.1 percent of total assets (Figure 9.6).[20]

The OECD Forum on Harmful Tax Practices adopted regulations to restrict the use of patent boxes by requiring 'substantial activity' through a 'nexus' or 'modified nexus' requirement (OECD, 2015). Under this minimum standard, taxpayers' eligible research and development expenditures may only qualify for tax incentives (for example, expensing, tax credits, lower rates) related to intellectual property (IP) income to the extent those expenditures are incurred in the same tax jurisdictions where the IP is created and income on IP collected. It was also agreed that the only IP assets that

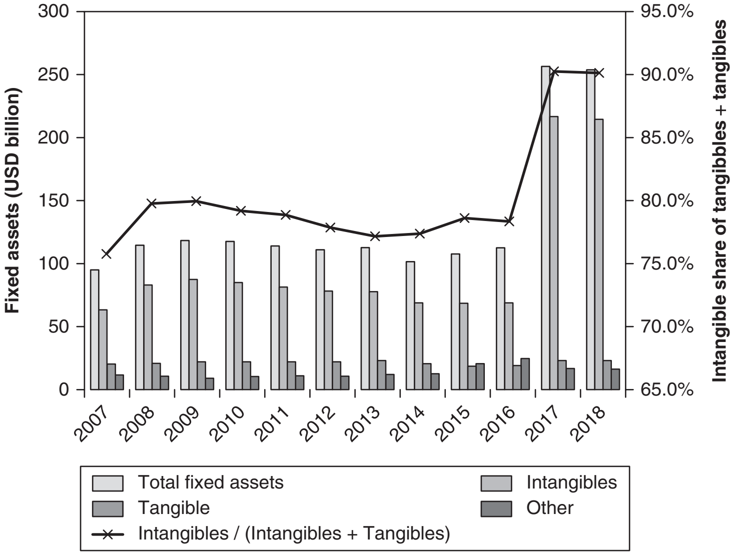

FIGURE 9.6 Fixed assets by type, total for four major multinational tobacco companies, 2011–2018

Sources: Companies' balance sheets. Other assets include unusual assets that cannot be included in the other categories. A typical example for tobacco companies is long-term prepaid charges, such as settlement charges for litigations, recoverable taxes. The large increase in 2017 and after is due to BAT's acquisition of Reynolds American International, implying a large acquisition of intangible assets and goodwill.

could qualify for tax benefits are patents or assets similar and functionally equivalent to patents, and copyright software. The Forum reviewed 43 preferential tax regimes and found 16 wholly or partially inconsistent with the nexus criterion. Some countries have already proposed amendments to their existing IP box regimes, while others have decided to introduce patent boxes, which are compliant with the modified nexus requirement (for example Italy and Ireland in 2015).

4. Conclusion

This chapter has cited the health and economic costs from tobacco, alcohol, and sugary drinks and explored the economic rationale for taxing these products to address their respective societal harms. Moreover, the chapter explores examples of government interventions using excise taxation for each of these three products to internalize their costs. Finally, the chapter turns to taxation of the profits generated by the industries that produce harmful products and estimates the corporate tax income revenue losses over the past decade from four multinational tobacco companies. Against this backdrop, below are policy recommendations for governments that seek to address harmful products through taxation to not only raise revenue, but also internalize the social costs from these products.

The first recommendation is to rethink the purpose of the excise tax on harmful goods. As mentioned in Section 2, although traditionally excise taxes have been applied for the general purpose of raising revenue, as governments begin to provide health care to treat the increasing incidence of chronic disease related to the consumption of these products, approaching excise taxes from a public health and/or environmental perspective makes sense. In order to internalize the costs of these harmful products, the full costs must be identified and quantified. Toward this end, governments may wish to perform a cost–benefit analysis of these harmful products to national welfare. Such analysis would include: (1) benefits from production and consumption,[21] including increased employment, technology transfer, etc.; and (2) costs in terms of public/private health expenditures, productivity costs from increased morbidity and mortality, environmental harms, including toxins in soil, water, and fisheries, increase in attributed violent acts, road accidents, property damage, etc. Countries can also use the increased tax revenues to fund public health.[22]

The second recommendation is to enforce and administer all tax laws effectively. Any tax structure must be reinforced by strong administrative and enforcement systems, which are especially critical in the most vulnerable countries with weak administrations subject to corruption. For example, distributors and other points of sales should require licenses, with tracking and tracing of the products at each stage of the supply chain with significant financial penalties for non-compliance.

The third recommendation is to prevent leakages through effective information exchange between countries through country-by-country reports, as well as public registries of beneficial owners of interests in any entity, including companies, trusts, international business corporations, and assets.

The final recommendation is to engage in regional and international cooperation on the harmonization of policies. International cooperation among governments with strong institutions can protect tax systems, strengthen borders, and improve the efficiency of government measures (Blecher and Drope, 2014).

Notes

1 JD, LLM, Project Deputy Director, University of Illinois at Chicago.
2 PhD, Associate Director, International Research, Campaign for Tobacco-Free Kids.
3 PhD, Senior Economist, Health Policy Center, University of Illinois at Chicago.
4 PhD, Research Professor, Director, Health Policy Center, University of Illinois at Chicago.
5 In 2012, the global retail value of tobacco was US$ 774.9 billion. Euromonitor International. www.portal.euromonitor.com/. These costs do not include environmental harms from tobacco production and use, such as ground and water contamination by over 7,000 toxins from littered cigarette butts (one-third of all cigarettes) and agricultural crowding out in food scarce countries (WHO, 2017a: 24).
6 Note that the thresholds are designed in terms of a per 100ml base while the tax is levied on a per liter basis.
7 www.independent.co.uk/life-style/health-and-families/health-news/tesco-cuts-sugar-soft-drinks-obesity-matt-davis-a7401801.html.
8 www.dailymail.co.uk/health/article-3919462/Lucozade-Ribena-reduce-sugar-content-50-avoiding-Government-s-sugar-tax.html.
9 The findings are derived from financial statements of the four largest multinational tobacco companies excluding China: Japan Tobacco International (JTI), Philipp Morris International (PMI), British American Tobacco (BAT), and Imperial Tobacco Plc. (ITC), exclusive of the acquisition of Reynolds International by BAT in 2017.
10 Reviews for specific countries or group of countries include Heckemeyer and Overesch (2017), Dharmapala (2014), and IMF (2014), among others.
11 World Development Indicators, World Bank.
12 We compute the ETR as a weighted average ETR across the four firms based on pretax income. Companies' ETR are defined as the ratio of reported tax liability (bottom line taxation in income statements) and pretax income (P/L before tax).
13 For the corporate income tax rate, we use the combined federal and sub-national tax rates, as reported in the OECD corporate tax rate database. As of 2016, for instance, the combined federal and sub-national tax rates were 39.9 percent in the US, 20 percent in the UK, and 23.4 percent in Japan.
14 For instance, Japan Tobacco Inc. states in its 2016 Annual Report: 'Despite the increase in profit before income tax, income tax expenses decreased … as a result of the decrease in effective tax rate in both Japan and international tobacco businesses'.
15 Corporate income tax rates are obtained from various sources including the OECD corporate income tax database, OECD corporate income tax tables, and KPMG

worldwide corporate income tax rates and combine federal and local corporate income tax rates. Tobacco companies' sales are obtained from their annual financial statements and distributed across countries using cigarette sales over time from Euromonitor International.

16 On the one hand governments would have collected US$ 9.21 billion if tobacco companies were taxed at the actual CTR. If in addition the average CTR was the same in 2016 as in 2017, governments could have collected US$ 5.8 billion. Including both tax minimization strategies by multinational tobacco companies and tax competition among governments, the potential revenue loss from the corporate income tax of the four multinational tobacco companies is around US$ 15.01 billion.

17 Dauchy & Siu (forthcoming), using Bureau van Dijk's Orbis ownership database. Worldwide withholding tax rates are obtained from Comtax® Basic Global.

18 Dauchy & Siu (forthcoming), using corporate income tax rate data from KMPG, and the OECD tax database, and companies' patent ownership is obtained from PATSTAT.

19 The larger number of patents owned in countries with patent box regimes for BAT and Imperial Brands is not surprising as most of their patents are registered in England, which adopted a Patent Box in 2013.

20 Balance sheet intangible assets include goodwill and other intangibles. Goodwill generally reflects the valuation of acquired companies. Other intangible assets usually include the value of intellectual property associated with acquired assets (for example, trademarks, patents, copyrights, distribution networks, brand names). The large increase in 2017 and after is due to BAT's acquisition of Reynolds American International, implying a large acquisition of intangible assets and goodwill.

21 Chaloupka et al. (2015) argue that nearly all of the 'lost pleasure' from tobacco use should not be included as a cost of tobacco control regulations because data show that most tobacco users regret starting, want to quit, and are struggling with or avoiding the withdrawal they would experience if they were able to stop.

22 For example, the Philippines earmarks all tobacco revenue to universal healthcare, other medical health services, and support to tobacco farmers. Cote d'Ivoire and Nepal earmark some tobacco revenue to specific diseases (e.g., AIDS, cancer). We note that investing tobacco taxes to health or other programs should not prevent the needed additional funding of these programs via other revenue sources (e.g., payroll taxation).

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10 | TAXING CARBON: TIME FOR A MULTILATERAL APPROACH[1]

Tatiana Falcão[2]

No single nation or region can single-handedly create a significant reduction in global carbon emissions.[3] According to the Organisation for Economic Co-operation and Development (OECD), even if a single country phased out its emissions completely, global warming would be unaffected.[4] If all of the OECD member countries came together in a joint action to reduce emissions, they still would not have been able to reduce global CO_2 emissions significantly. The phasing out of fossil fuel use in OECD member countries would have been outweighed by an increase in fossil fuel consumption in non-OECD countries over the decades following 1991.

When analyzing the basic structure of the United Nations Framework Convention on Climate Change (UNFCCC),[5] the most authoritative piece of legislation in the administration of climate-based emissions, one sees enormous attention devoted to countries' emissions-reporting obligations. That is due to the fact that the UNFCCC was introduced almost simultaneously with the Kyoto Protocol,[6] which imposes a quantitative restriction on carbon emissions. It is a policy designed to operate nationally or regionally – therefore on a downstream basis at retail level – and concentrating on emissions control, through the institutionalization of an emissions trading scheme. An emissions trading scheme (or cap-and-trade system) adopts an *ex-post* approach, by allowing the market to define the price of carbon according to the laws of supply and demand.[7] Therefore there is little or no government control over the price of the negotiated permits.

The Paris Agreement[8] was more recently introduced with the intention to correct this, by recognizing the importance of integrated, holistic, and balanced non-market approaches[9] to assist developed and developing countries in fulfilling their commitments to reduce greenhouse gas (GHG) emissions. It is the first time since the inception of the UNFCCC that the parties to the Convention have made an explicit commitment to make use of non-market approaches, including:

- carbon regimes, such as a carbon tax to put a price on carbon;
- energy and environmental taxes to discourage activities having a harmful impact on the environment; and
- sustainability incentives in the form of tax credits, deductions, subsidies, and other corporate incentives aiming to encourage certain behaviors.

The Paris Agreement also extended to developing countries the obligation to meet the climate commitments established in the Paris Agreement, through their own Nationally Determined Contributions. This is in stark contrast with the Kyoto Protocol, which had, until then, cast the obligation to reduce greenhouse gas emissions only on developed countries.

This chapter aims to describe some of the existing best practices in the administration of nationally derived carbon taxing policies that are in line with the Paris Agreement, with a two-fold objective: (i) to instruct governments about the main issues deriving from the administration of such a tax; and (ii) to inform how domestic carbon tax mechanisms may eventually lead to multilateral, regional, and international cooperative frameworks capable of enforcing an integrated carbon-pricing approach. The chapter ends with a proposition for a Multilateral Carbon Tax Treaty that would incorporate all of the best practices described in the first part of the text.

1. Carbon Taxation as a Sub-genre of Environmental Taxation in the Policy Design

To put carbon taxation into the larger context of environmental taxes, it is important first of all to note that a carbon tax is just one of the policy approaches that a country could adopt if it was aiming to reduce GHG emissions.

Elsewhere in this chapter, the important but rather academic differentiation between environmental taxes and environmentally related taxes is emphasized.[10] Under this conceptual approach, environmental taxes are those that have both an environmental purpose and effect, because the tax is levied on an item of pollution, such as carbon, and is therefore geared towards a positive environmental result, in this case, the reduction of carbon dioxide (CO_2) emissions.

A carbon tax is a tax that has an environmental purpose and effect, in the sense that the tax so applied can, by itself, lead to a reduction in the consumption of carbon-based products and to a reduction in carbon-based emissions. It does so because a carbon tax is a specific tax – it is a price per ton of carbon.

To illustrate this point, if one were to apply a carbon tax on fossil fuels, the tax would automatically create a price differentiation between diesel, gasoline, and natural gas. That is because diesel is more carbon intensive than gasoline, which in turn is more carbon intensive than natural gas. Therefore, a carbon tax of US$ 10 per ton of carbon would automatically impact diesel more than it would natural gas, and that would create a price incentive for consumers to purchase natural gas-based products (such as vehicles and machinery used in production processes).

The Carbon Pricing Leadership Coalition has predicted that a carbon price of US$ 40–80/tCO_2e by 2020 and US$ 50–100/tCO_2e by 2030 would be necessary to achieve the Paris Agreement targets.[11] That is an incredibly high price, especially considering that many countries are still subsidizing the use of carbon-intensive products (the antithesis to a carbon tax) by granting subsidies on diesel and other fossil fuels.

A carbon tax is easy to administer because the revenue-generating potential of the use of a fossil fuel can be determined even before the tax is applied. To the extent one knows how much fossil fuel is extracted from the ground or employed in a task, the taxpayer and the tax administration can foretell how much carbon tax revenue will be generated as a result of the use of that fossil fuel. That is because the correlation between the volume of fossil fuel product and the carbon content is mathematical. Therefore, provided the tax is applied at the upstream level (which can either be at extraction, if it is an extractive country, or at import, if it is a resource-poor country), then the tax administration can elect a proxy (which can be either the importer or the extractive company, for example) to collect the tax that would be incident on the entire production chain.

That is actually the most environmentally sound option too, because in that way, the country is capable of accounting for all of the carbon dioxide emissions derived from the product, without leaving any unaccounted emissions, also referred to in common literature as fugitive emissions.

As previously mentioned, an environmental tax is one with both an environmental purpose and effect. An environmentally related tax on the other hand is a tax that could bring about an indirect environmental gain and might have even been introduced with an environmental purpose in mind. However, it is ineffective at promoting a behavioral change and many times merely acts as a revenue raiser. A classic example of an environmentally related tax is a transport tax.

A transport tax related to the ownership and use of a motor vehicle is as a general rule considered to be an environmentally related tax, because it tends to be levied on vehicles, ships, and aircraft using public highways, rivers, and airports maintained by the government. The tax is not related to the size or the consumption of a vehicle, but to its potential to use public infrastructure maintained by the government and thus to contribute revenues for maintenance and use. In spite of that, several systems of motor vehicle registration taxation include differentials on the basis of CO_2 emissions, or other environmental impacts of the specific vehicle in question to encourage consumption and use of fuel-efficient and low-carbon vehicles. In this case, the tax would also be an environmental tax, not just an environmentally related tax.

Setting environmental taxes apart from environmentally related taxes is important, among other things, to monitor and assess how effective countries are in administering policies that are effective in reducing carbon-based emissions, and other forms of polluting emissions. Because most environmental taxes create a direct correlation between the item subject to tax (the pollution) and the revenue derived therefrom, the revenue data alone is enough to inform how high the price of carbon is set in a determined jurisdiction, and how efficient that jurisdiction is in reducing carbon-based emissions. The decline in revenue accumulation via the tax will be proportionate to the pollution (emissions) reduction verified domestically. By distinguishing the taxing types via an objective nomenclature, monitoring agencies would ideally be capable of verifying how efficient countries are in meeting the objectives of the Paris Agreement through the administration of taxes, by using revenue data.

2. Conferring Effectiveness to the Environmental Tax Policy

Although several countries already administer environmental taxes and environmentally related taxes, the application of carbon taxes is not as widespread. It is nevertheless noteworthy how fast carbon taxing policies are spreading amongst developed and developing countries. The effectiveness in the administration of the policy will depend on factors such as:

(i) the price at which they are levied, or price range;
(ii) the revenue destination (that is, whether the country employs the revenues from the tax for an environmental purpose, like developing new clean technology, or whether it just adds the revenue to the general budget);
(iii) the identification of the taxpayer (for example, in the EU, energy intensive industries tend to be outside the scope of incidence of carbon taxes because they are included in the European Trading Scheme – ETS), which is a cap-and-trade scheme. This compromises the reach of a carbon tax policy administered by select EU member countries choosing to combine carbon taxation and the EU ETS; and
(iv) the objective of the policy. If the objective is to reduce carbon emissions, then the policy has to be measured against that goal. If the objective is to lead to an economic switch into renewable resources, then the policy needs to be analyzed against this rather different goal, and in this case, one would expect to see more revenue deployment towards the development of clean alternative energy resources.

Many of the countries currently administering carbon taxes have also introduced parallel complementary measures, with the purpose of (i) addressing a local public health issue (for example, Chile); (ii) fighting climate change, through the removal of harmful fossil fuel subsidies (for example, Argentina); (iii) linking up the environmental tax program with other environmental programs for carbon pricing (for example, Mexico); and (iv) reducing plastic consumption (for example, Colombia).

The Chilean carbon tax policy framework, for example, was designed with the intent to substantially reduce or eliminate the release of small particulate matter, which contributes to respiratory diseases and other health problems in the general population. Besides the carbon tax, the country therefore also introduced two other taxes on contamination in 2017. The formula for application of these contaminant taxes aimed to reflect the different levels of damage caused by the release of an additional tonne of particulate matter, nitrogen oxide (NO), and Sulphur dioxide (SO_2), according to the territorial characteristics of the region. For example, the release of one tonne of particulate matter in a closed, valley area, whose particulate matter cannot be dispersed, is likely to be more affected than a beach area with high wind incidence and potential for pollution absorption. The formula administered domestically thus aims to reflect the different geographic conditions in the Chilean topography and therefore to also reflect the potential for damage caused by the release of an additional tonne in a particular community. These taxes thus aimed to also provide a price signal for local industry as to the most efficient location of operation.[12]

Therefore, from a Chilean perspective, the effectiveness of the carbon tax policy would have to be measured against its ability to significantly reduce or eliminate particulate matter from densely populated urban areas and to improve the air quality in the cities.

3. Put a Price on It!

Carbon tax rates are wide ranging and rarely have any correlation with the country's level of economic development. Data from the 2018 World Bank State and Trends of Carbon Pricing[13] demonstrates that the range of carbon tax rates may go from less than one dollar per ton of CO_2e (Poland and Ukraine) to US$ 139/tCo_2e (Sweden).

Amongst the highest chargers (qualified as those countries applying taxes higher than US$ 30/tCO2e) are Switzerland and Lichtenstein US$ 101/tCO_2e, Finland US$ 77/tCO_2e, Norway US$ 64/tCO_2e, France US$ 55/tCO_2e, and Iceland US$ 36/tCO_2e.

Within the mid-range of US$ 20–30 are Denmark, the province of British Columbia (Canada), the UK Carbon Tax Floor, Spain, Ireland, the province of Alberta (Canada), and Slovenia.

Lower than US$ 10 are: Portugal, Colombia, Latvia, Chile, Mexico, Japan, Estonia, Poland, and Ukraine.

What the data shows is that the level at which a country taxes carbon is not commensurate with its level of economic development, but rather with its historic commitment to taxing carbon. Therefore, the countries currently applying the highest carbon tax rates are those who have historically administered carbon taxing policies over extended periods of time. The Nordic countries, for example, are the highest carbon chargers in the world, and not surprisingly they have a long history deploying carbon taxes. Sweden, the highest taxing country, started applying carbon taxes in the early 1990s at a much lower rate than it does now.

What is important at this stage, therefore, is for countries to realize that they have got to have a carbon pricing initiative, and set a price for carbon. It does not really matter at an initial stage, whether the price is low or high. In fact, most countries will start with a low price and increase it over time. What is important is for countries to have well-defined carbon pricing policies that they can rely on for the next 10 to 50 years, because this will impact other areas of government administration, such as the policies administered for the exploration of mineral resources (if it is a resource rich country), environmental goals, and contracts signed by the public administration.

4. Best Practices in the Development of a Carbon Tax Policy

Existing country practices help illustrate the required actions for a country wishing to consider the introduction of a carbon tax policy approach to achieve a significant reduction of greenhouse gas emissions. This section concentrates on six actions that are likely to guarantee that the policy may be sustained over time, while providing a stable environment for economic development.

Action 1: Reform fossil fuel subsidies. Countries should reconsider their approach to subsidies. Urgent reform is needed in all countries to phase out fossil fuel subsidies that encourage the consumption of carbon-rich fuels. The subsidization of fossil fuels is a policy that objectifies a result that is diametrically opposed to the imposition of a tax. A subsidy, by definition, aims to stimulate a behavior (in this case, consumption of the carbon-intensive product). Cutting down on subsidies means putting fossil fuels on an equal footing, from a pricing perspective, with all other similar energy products. While some countries often justify the use of fossil fuel subsidies by the need to avoid an undue price burden on lower economic classes, it remains clear that subsidizing fossil fuels reduces the effectiveness and the efficiency in the administration of carbon tax policies.

Action 2: Create a system of redistribution. The redistribution system should be capable of alleviating the burden of the tax on the more vulnerable classes of society. It is frequently noted in literature that a carbon tax, like any indirect tax, is inherently regressive. One of the mechanisms to provide relief to the lower classes from the increased costs associated with the introduction of a carbon tax is therefore to establish a redistributive system whereby part of the revenues derived would be paid back to those with lower purchasing power, whether through direct tax transfers, or through a corresponding reduction in other taxes (such as labor tax). The province of British Columbia operates the only revenue-neutral carbon tax system in the world, meaning it recycles all of the revenue proceeds of the carbon tax to the general population, either through transfers or compensation measures, as further explained in Box 10.1.[14]

Box 10.1 Tax neutrality

Tax neutrality means that the tax is imposed in a manner that does not increase the overall tax burden to consumers in the long run. Countries that apply a revenue-neutral regime use compensatory measures to reduce the consumer's tax burden on other fronts, such as labor or income taxes. It is a policy that requires care, because labor and income taxes tend to be progressive taxes. Substituting direct taxes for indirect taxes could have catastrophic consequences if people's ability to pay is no longer considered. In this case, the progressive objective will be undermined.

The Canadian province of British Columbia, an early adopter of a carbon tax, is the most frequently cited example of a regime that was originally conceived of and implemented to be revenue neutral. The drafters planned for 100 percent of the revenue generated through the tax to be returned to British Columbian citizens through other tax reductions. The Revenue Neutral Carbon Tax Plan, as it was called when the province launched the program in 2008, envisioned personal and business tax cuts. Personal tax cuts included:

- a low-income refundable tax credit to ensure those with lower incomes were compensated for the tax;
- a forecasted reduction of the bottom two tax bracket rates by 2 percent for 2008 and 5 percent for 2009 and subsequent years; and
- additional personal income tax rate cuts.

On the business side, the government announced the following cuts based on the carbon tax revenue:

- a reduction in the general corporate rate to 11 percent on July 11, 2008;
- a reduction of the general corporate rate to 10.5 percent by January 2010 and to 10 percent by January 2011;
- a reduction in small business corporate income tax rate to 3.5 percent by July 1, 2008; and
- a reduction of the small business corporate income tax rate to 3 percent by January 1, 2010, and to 2.5 percent by January 1, 2011.

Most economic studies report that successful revenue recycling mechanisms are highly visible to the general public and explicitly showcase the benefits of the regime. As such, employing revenue neutrality from the start could ensure the maximum visibility regarding the use of revenues from the carbon tax and it might help explain the relative success of British Columbia's regime.

Whether revenue neutrality is a policy that interests all countries – and, more particularly, whether it interests developing countries – remains an open question. Developing countries have limited fiscal resources and require additional revenue to achieve sustainable economic development, build fiscal reserves to enable them to respond to extreme weather disasters that may be caused by climate change, and meet the most basic sustainable development goals such as eradicating poverty, alleviating hunger, and investing in education. Therefore revenue neutrality might not be the preferred policy approach for countries in need of additional resources.

Sources: British Columbia Ministry of Finance, 'Budget and Fiscal Plan 2008/09–2010/11' (February 19, 2008).

T. Falcão, 'Yellow Vests and Young Greens: Searching for Equity and Public Acceptance in Carbon Taxation', *Tax Notes International*, July 15, 2019, p. 227

Action 3: Introduce the tax gradually. Gradual introduction means having a plan for tax rate increases over a protracted period of time, of roughly 30 to 50 years. That is because carbon taxes tend to affect industries that rely on long-term investment, such as the extractive industries (particularly oil and gas extraction). Therefore, in order to maintain a positive relationship with foreign and domestic investors, it would be recommended for governments to forecast not just the initial tax rate in the bill introducing the carbon tax, but also all the upward adjustments it expects to make to the tax for the next 30 to 50 years. One approach might be to make adjustments to the tax every five years to start with, until reaching the target of US$ 40/tCO2e. From then on, further adjustments could be made every ten years.

Providing predictability in tax rate increases would not only provide legal certainty to the taxpayers, but also (i) continuity in the tax approach, by informing consumers and producers about what to expect; (ii) revenue certainty to the tax administration; and (iii) allow other members of government to factor the tax into public contracts.

Action 4: Earmarking the proceeds of the tax (or not). The easiest and most transparent way for a government to show the general public how carbon tax revenue will be employed is by earmarking revenues. However, earmarking is not always possible: some countries are restrained by constitutional limitations on earmarking.

Particularly in developing countries where fiscal space is limited and environmental policies are often not prioritized, symbolic or even legal earmarking of a portion of revenues can be an important tool that allows the government to raise awareness of the implementation of the tax, gain popular support for the measure, and ring-fence funds for a specific environmental cause.

For example, in Colombia, 100 percent of the proceeds of the carbon tax are earmarked, although only 30 percent are geared towards protecting the erosion of coastal areas, fighting deforestation, monitoring forested areas, preserving water sources as well as other strategic ecosystems and fighting climate change. The greatest share of the revenues are actually employed for the maintenance of peace in Colombia, by upholding the objectives of the *Acuerdo Finall para la Terminiacion del Conflicto Armado y Construccion de una Paz Estable y Duradera con criterios de sostenibilidad Ambiental*. This shows how sometimes, even in the rare cases where countries are allowed to earmark revenues, other policy objectives might take a lead over environmental concerns. In Latin America, Colombia is the only country example where earmarking is allowed. In all other countries employing carbon taxes (Chile, Mexico, and Argentina) the proceeds of the tax are destined for the general budget.

Depending on the country's legal framework, a trust fund supported by environmental tax proceeds could also be a useful tool for ensuring that at least some of the revenue from the environmental tax is used to develop new technologies or otherwise protect the environment. Independent government agencies could play a similar role.

In the absence of a legal framework that would authorize earmarking, revenue would simply flow to the general budget and the government might use the funds for whatever purpose it deems fit. This may not necessarily include environmental purposes or redistribution, even if these options are not excluded.

Action 5: Establish a transparent framework for communication with the main institutional stakeholders and the general public. Effectively communicating policy goals and expected outcomes must be an integral feature of the design and implementation of any carbon tax. An effective communication platform provides the framework to build acceptance internally, including across government sectors and ministries, and externally, among the many stakeholders affected by the tax and the general public.

The communication strategy should be diverse and targeted to reach all relevant stakeholders. Simple, clear, and nontechnical messaging should be used to communicate policies to the general public, explaining the policy approach according to the goals rather than focusing on the complex mechanics underlying the policy construct. To enable that effort, governments that want to implement carbon taxing and pricing policies need to understand their constituents, create a relationship of trust with the general public, engage with private businesses, and (ideally) formulate and communicate long-term policy approaches.[15]

Using public consultation procedures, public meetings, and other engagement and outreach techniques to involve stakeholders as soon as the government decides to introduce a tax law is good policy, especially in the era of online civic engagement. The goal is to make stakeholders speak out in support of the government, rather than against it and to inform the public debate so that the tax is generally perceived to be fair.[16]

Action 6: Address incoherent and inconsistent policies. Governments should stand back and consider the entire range of signals they are sending to producers, investors, and consumers. A key question is whether non-fossil energy investments can compete with fossil fuels in terms of their risk–return profile with the policy settings in place, both domestically and internationally. Appropriate measures (including price incentive measures) should be put in place to create an environment for non-fossil energy-producing technologies to thrive and compete with fossil fuels.

5. Could a Carbon Tax Bring Any Potential Competitive Disadvantage to a Country Trading in Products Internationally?

Equity is an issue that ought to be taken into account also under a competition framework. Because petrol is a commodity that is traded internationally, one of the options available to countries applying a carbon tax is to apply border taxes in order to safeguard the domestic industry's competitiveness in international markets. Border Tax Adjustments (BTA) work by either taxing an import, so that it is taxed at the same level as the domestically produced product, or on export, in order not to impose an undue burden on the nationally produced product when it is known that the foreign product is not burdened by an equivalent tax.

The World Trade Organization (WTO) is responsible for regulating when a border adjustment is admissible and when it is not. In order for BTAs to be admissible, the tax applied (or credited) must be applied both on foreign and domestically produced products. The tax cannot unduly burden a foreign-derived product. Moreover, the tax can only be applied on a product, not a process (also referred to as '*taxes occultes*' or hidden taxes).[17]

For example, a domestic tax on fuel can be legitimately applied on similar imported fuel, but a tax that is domestically applied on the energy consumed during an industrial process (for example, to produce steel) cannot be applied on similarly imported steel.

Unilateral border tax adjustments could be employed by countries currently applying carbon taxes, for example, in order to keep their competitive position in the global market. This approach would not be ideal, because it would undermine positive environmental action employed domestically. However, it might be a good stepping-stone to provide an incentive for countries to implement domestic environmental taxes without exposing their markets to a potential competitive disadvantage when competing for markets internationally.

To the extent more countries adopt similar measures, efficiency and environmental gains can be derived by making political decisions and working as a group to heighten the regional, and potentially global level of environmental protection.

6. International Cooperation and Carbon Taxation

Countries administering unilateral carbon-based measures and international organizations overseeing international agreements[18] that create obligations for only a limited number of countries are all faced with the same problem: the lack of a coherent approach with which to tackle carbon emissions on a global scale. The fear of losing domestic industrial competitiveness to foreign markets and the need to avoid overburdening domestic taxpayers with a bill that should be ultimately shared with the rest of the world[19] have, for many years, paralyzed actions to address climate change.

However, there are several ways in which countries can act unilaterally, regionally, and multilaterally in order to tax carbon at a level that is commensurate with the country's level of economic development. As mentioned above, the first step is to establish a national carbon tax policy to tax carbon at the earliest possible occasion.

The next step is to agree on an approach to taxing fuels employed in the shipping and aviation industries. These are highly polluting industries that cannot and should not be exempted from tax. Many countries in the developed world (like the Netherlands, France, and Sweden) are currently looking into ways to overcome the restrictions imposed by the Chicago Convention[20] on the taxation of fuel used in international aviation. However, no impediments exist against the taxation of fuel used for flights operated domestically. This is an area where countries might already consider imposing a tax, particularly considering the geographic dimension of some countries. Furthermore, there are no legal impediments to the taxation of fossil fuel employed in the shipping industry.

Following that, countries could then work on the formation of blocs of regional geographic or economic cooperation. For example, Mexico, Colombia, Chile, and Argentina all currently apply taxes on carbon. Mexico applies a carbon tax at US$ 5.70/tCO_2e, Colombia at US$ 5.50/tCO_2e, Chile at US$ 5.00/tCO_2e and Argentina at US$ 6.25/tCO_2e. Taken as a group, these countries are currently already administering carbon tax rates at similar benchmarks of roughly US$ 5/tCO_2e. Therefore, were there to be an interest in a regional coalition, it would be easy to permit the free flow of fossil fuels and combustible products that have already been subjected to a domestic carbon tax between the countries. Such a policy would reduce the need for certain exemptions conferred on exported fossil fuels, for example, and thus reduce complexity in the administration of the carbon tax.

The legal instrument that would make this cooperative measure viable would be the border tax adjustment discussed in Section 5. A BTA would allow Latin American countries to keep the carbon price applied domestically, without having to grant an exemption at the border when the product finally comes to be exported. Agreeing on a pre-set price range for carbon could create a market for products that internalize the cost of pollution on a regional basis, and therefore tackle climate change on a broader scale.

By bundling into groups, or acting unilaterally, countries interested in factoring the cost of carbon into production can help create momentum for other countries to also adopt carbon-pricing strategies. Concerted action by like-minded groups of countries could help protect the countries involved from shortfalls in international competitiveness and create pockets of geographic zones where the environmental cost of doing business is not subsidized. The same could hold true for the Nordic countries, for example, which all tax carbon.

To the extent that countries are clear on their policies towards carbon taxation it becomes ever less controversial to introduce unifying measures capable of addressing the issues pertaining to a continent, a region, and eventually, the globe.

7. Towards a Multilateral Carbon Tax Treaty?

A global solution seems ambitious, but is not too farfetched, and simply a necessity if the international community wants to tackle the emissions problem in a consolidated and efficient way. It would constitute a mere step forward from the commitments assumed in the Paris Agreement, through the administration of a coordinating measure such as a Multilateral Carbon Tax Treaty (MCTT).[21] A MCTT would engage both developed and developing countries on an equal footing. The multilateral context provides the correct environment for developed and developing countries to discuss a global price for carbon and have their suggestions given the same weight.

The objective of such a treaty would be to create a binding obligation for countries to apply a tax. This is an extremely unusual commitment to be made internationally, where the norm is that countries come to an agreement on how to allocate taxing rights. Levying a tax is a state action that is intrinsically connected to the enforcement of a country's sovereign rights. As a result, international tax treaties seldom create an obligation to tax or to identify the level at which the tax should be levied.

The carbon tax so imposed would be administrated as an excise tax, and many of the tax obligations would therefore be akin to those of a customs duty. Since customs and tax obligations are dealt with under different umbrellas in the international context, synergies between customs unions and international tax cooperation fora are bound to be created in the administration of the proposed MCTT.

The proposed MCTT should promote four underlying objectives, essential to creating a coherent international environment. They are referred in the text of the MCTT as 'prongs', and carbon tax policies are thus required to pass the 'four-prong test':

(1) they must generate revenues for the state imposing the tax and for the countries participating in the multilateral framework;[22]
(2) they must change consumer behavior by creating a significant price difference that would lead a consumer to opt for the less carbon-intensive product;
(3) they must reduce carbon released into the atmosphere and, in that way, confer a positive environmental result through the administration of the MCTT ; and
(4) they must allow MCTT members' internationally traded products to compete with non-treaty members' products, in parity of conditions (that is, no price distinction between the

products subjected to a carbon tax and those that were not) by allowing them an opportunity to apply a border tax adjustment when acquiring or consuming carbon-intensive goods from non-member countries.[23]

Finally, all of the above objectives are to be pursued simultaneously and none of them are to have precedence over the other.

It should be noted that prongs (1) and (3) are contradictory and could not possibly be pursued by the same instrument. A tax on carbon can only generate revenues provided that:

(i) the consumption of carbon-based products increases; or
(ii) the tax rate increases over time. A reduction in the release of carbon-based emissions will result from a reduction in the consumption of carbon-based products and will invariably lead to a reduction in the revenues accumulated via the carbon tax. This is an expected outcome and is the mechanism used to verify that the tax treaty is being administered successfully in different countries. The policy's success will be verified by a country's inability to collect surplus revenues from the carbon tax.[24] Revenue generation will continue to be an objective pursued by countries for as long as economies continue being reliant on carbon-intensive fuels. Therefore although the revenue generation goal will be less effective over time, countries will be able to meet prongs (1) and (3) concomitantly. Failure to meet prong (1) will indicate a total shift in a country's energy consumption pattern.

This is *the* characteristic that will distinguish this tax treaty from all other international climate-related policies currently in force. In order for it to work, the tax treaty must address all the major sources of carbon-based emissions while imposing the least burden on tax administrations to comply with the tax obligation. The only way this can be achieved is by imposing a tax on extraction of all fossil fuel resources – a source-based tax, levied on a territorial basis.

The proposed tax treaty focuses on the use of a specific non-market carbon approach: the carbon tax, due to its effectiveness in raising revenues, in particular in developing countries, where there is a general lack of capacity to enforce taxes and oversee trading in a regulated market.

The carbon tax acts by imposing a pre-emptive price on the emissions that a carbon atom is likely to generate as a result of its combustion. It is a tax applied at the upstream level, on the mineral ore, prior to its combustion.

The default rule of the treaty is for the carbon tax to be levied whenever the oil, gas, or coal is extracted from the ground. That would allow a country to tax the full carbon-emission potential of the mineral ore. When taxing carbon at the midstream (refinery) or downstream (consumption) phases of the production process, the tax is unable to take into account the emission losses that have already occurred when processing the mineral ore. These losses can account for almost 60 percent of the carbon potential of the mineral ore, depending on its quality.[25] Therefore, applying a carbon tax at downstream level (consumption) is equivalent to taxing only 40 percent of the carbon-based emission potential of any fossil fuel.

The carbon tax acts as a price control mechanism. As a result, countries are capable of making a direct correlation between the amount of carbon extracted and the amount of revenues collected. Consequently, it is possible to infer the amount of emissions released into the atmosphere without increasing the compliance burden. The success of the tax can be easily measured by its inability to generate tax revenues in the long run.

A reduction in carbon-based emissions and the consumption of carbon-rich mineral resources will necessarily lead to the development of new, cleaner energy resources. Setting a high carbon price will provide private entities with enough incentive to develop new, carbon-free energy resources in an attempt to reduce the cost of production and the cost of doing business. Likewise, the generation of extra revenue resources derived from the carbon tax will present governments with surplus funds with which to finance research and development of new technologies to be employed in the manufacturing sector. The development of new, ground-breaking technology is typically funded by public administrations, and the administration of a carbon tax might be the only way to raise the funds required to advance in this field. A carbon fund would be created to dedicate a portion of the revenues accumulated via the carbon tax to research and development.[26]

That does not mean that the MCTT will recommend earmarking the revenues derived via the carbon tax for one such purpose. Earmarking revenues via an international instrument is extremely difficult due to the different legal and constitutional constraints imposed by domestic systems. However, earmarking the revenues derived from the carbon tax should be stimulated in the countries with no legal impediments to doing so.

For the countries already applying carbon or energy taxes or employing an emissions trading scheme, the introduction of the proposed MCTT will allow them the opportunity to reform and perfect their national tax systems to eliminate the deadweight policy aspects that currently impede them from administering effective environmental taxes capable of generating a desirable environmental result.

The international context in which the treaty is to be proposed would provide countries that already are sympathetic to the administration of environmental taxes the political pretext and the legal support to justify the imposition of strengthened domestic measures.

8. Conclusion

Domestic implementation of carbon taxes is the first step to achieving a coordinated approach to price carbon at the international level. Regional and global coordination of carbon taxing practices will derive from the widespread implementation of carbon-pricing policies and techniques.

To the extent that countries clearly identify their carbon taxation policies, the idea of introducing unifying measures, capable of addressing issues pertaining to a continent, a region, and eventually the globe becomes ever less controversial. This may ultimately lead to a universal agreement on a price for carbon based on existing principles of environmental law and international taxation and making use of the international environmental agreements to which the international community at large is bound. Acceptance of carbon taxation as an instrument is a key step toward this ambitious goal.

Notes

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2 Manager, Green Fiscal Policy Network, United Nations Environment Programme, Fellow, European University Institute. Member, United Nations Subcommittee on Environmental Taxation. LL.M, University of Cambridge, LL.M, New York University, PhD, University of Vienna in Economics and Business. In 2019, Tatiana's contribution to the development of international tax policy and environmental taxation was recognized in the publication *WIN, Recognizing 100 Years of Women in Tax*.

3 J. Poterba, *Tax Policy to Combat Global Warming: On Designing a Carbon Tax*, National Bureau of Economic Research (NBER), Working Paper No. 3649 (1991), p. 3.

4 P. Hoeller and M. Wallin, *Energy Prices, Taxes and Carbon Dioxide Emissions*, OECD Economics Department, Working Paper No. 106 (OECD, Paris, 1991), p. 7.

5 United Nations, *United Nations Framework Convention on Climate Change* (1992), New York, available at: https://unfccc.int/resource/docs/convkp/conveng.pdf.

6 United Nations, *Kyoto Protocol* (1997), available at: https://unfccc.int/resource/docs/convkp/kpeng.pdf.

7 A cap-and-trade's operation system is not dissimilar to the trading of bonds in a stock market. The greater the demand for permits, the higher the price of carbon (i.e. the higher the price of the corresponding permits). Conversely, a low demand for carbon permits will lead to a low carbon price and to market failure, at least from an environmental perspective, to the extent the market is incapable of accounting for the environmental cost of pollution. The under-valuation of carbon in a market or fiscal approach means that society is ultimately paying for the environmental cost of production and transport of carbon-intensive products and activities.

8 *Paris Agreement*, adopted by the 21st Session of the Conference of the Parties under the Framework Convention on Climate Change (FCCC) on December 12, 2015; see https://unfccc.int/resource/docs/2015/cop21/eng/l09r01.pdf.

9 *Paris Agreement*, art. 6(8).

10 T. Falcão, 'Providing environmental taxes with an environmental purpose', in *Critical Issues of Environmental Taxation*, Volume 13: *Market Based Instruments: National Experiences in Environmental Sustainability*, edited by Larry Kreiser et al. (Cheltenham: Edward Elgar, 2013), pp. 41–62.

11 Carbon Pricing Leadership Coalition, *Report of the High Level Commission on Carbon Prices* (2017). Retrieved from https://static1.squarespace.com/static/54ff9c5ce4b0a53decccfb4c/t/59b7f2409f8dce5316811916/1505227332748/CarbonPricing_FullReport.pdf.

12 T. Falcão, 'Epílogo', in *Precio al carbono en América Latina: tendencias y oportunidades*, edited by Carlos Trinidad Alvarado (Lima: Sociedad Peruana de Derecho Ambiental, 2019).

13 World Bank, Ecofys, *State and Trends of Carbon Pricing 2018* (World Bank, 2018), https://openknowledge.worldbank.org/handle/10986/29687.

14 About the potential regressive effect of the carbon tax, see Economic and Social Research Institute, 'Carbon taxation in Ireland: distributional effects of revenue recycling policies' (June 6, 2019), www.esri.ie/publications/carbon-taxation-in-ireland-distributional-effects-of-revenue-recycling-policies. See also World Resources Institute, 'A carbon price can benefit the poor while reducing emissions' (December 15, 2018), www.wri.org/blog/2018/12/carbon-price-can-benefit-poor-while-reducing-emissions.

15 Stefano Carattini, Maria Carvalho, and Sam Fankhauser, 'How to make carbon taxes more acceptable' (Grantham Research Institute on Climate Change and the Environment and Centre for Climate Change Economics and Policy Report, December 2017).

16 Carbon Pricing Leadership Coalition, 'Guide to communicating carbon pricing' (December 2018).

17 T. Falcão, *A Proposition for a Multilateral Carbon Tax Treaty* (IBFD Online Books, 2019).

18 In this respect, see, for example, the UNFCCC (available at https://unfccc.int/resource/docs/convkp/conveng.pdf) and the Kyoto Protocol (available at http://unfccc.int/resource/docs/convkp/kpeng.pdf), both of which only create binding emissions reduction obligations for 'developed countries' (referred to in the UNFCCC as 'Annex I' countries).

19 Concern over international competitiveness was one of the main reasons leading to the repeal of the Australian carbon pricing mechanism. See the Clean Energy Legislation (Carbon Tax Repeal) Act 2014, No. 83 (July 17, 2014), available at www.legislation.gov.au/Details/C2014A00083. For comments on the Swedish approach to avoiding carbon leakage, see S. Akerfeldt and H. Hammar, 'CO2 Taxation in Sweden: 20 years of experience and looking ahead' (2011), www.globalutmaning.se/wp-content/uploads/sites/8/2011/10/Swedish_Carbon_Tax_Akerfedlt-Hammar.pdf, pp. 4–5. See also S. de Bruyn, D. Nelissen and M. Koopman, 'Carbon leakage and the future of the EU ETS market' (2013), www.cedelft.eu/publicatie/carbon_leakage_and_the_future_of_the_eu_ets_market/1361.

20 ICAO, Convention on International Civil Aviation (also known as the Chicago Convention), signed on December 7, 1944, www.icao.int/publications/pages/doc7300.aspx.

21 T. Falcão, *A Proposition for a Multilateral Carbon Tax Treaty* (IBFD Online Books, 2019).

22 It is important for the national tax administrations to generate revenues so that they may invest in the development of new, carbon-free technologies to sponsor the efficient use of energy and promote new energy resources. The reduction in carbon consumption and a shift towards other, cleaner energy sources will represent a change in paradigm. That will require public funding in order to occur. Private parties only promote research in projects that have the potential of being profitable, and therefore, a change in the way the world consumes energy will require public sponsorship.

23 This is the competition prong. The only way a tax can be applied by multiple parties without affecting these countries' industries' international competitiveness is if they are able to apply the same tax on the products deriving from countries that are not party to the agreement or do not apply a similar carbon tax. The WTO has some very specific rules to stop WTO members from applying taxes at the border towards some members and not others.

24 This is a result that is already demonstrated in at least one country applying a carbon tax, for example, Denmark. Denmark has been applying a carbon tax since 1992. In 2011, Denmark launched a new Energy Strategy, foreseeing a long-term transition into renewable energies and the total removal of reliance on fossil fuels. Denmark understands that this program will result in a reduction in tax revenues derived from the very high tax rates applied to fossil fuels. The government has

acknowledged an expected reduction in the tax base representing a big portion of the Danish revenue base. This measure will be countered through the introduction of new taxes and countering measures meant to forestall a public deficit. See Danish Government, *Energy Strategy 2050: From Coal, Oil and Gas to Green Energy*, No. 2011:7 (February 2011), pp. 5, 6 and 9, www.danishwaterforum.dk/activities/Climate%20change/Dansk_Energistrategi_2050_febr.2011.pdf.

25 See, in this respect, United Nations, IPCC, 'Fugitive emissions from oil and natural gas activities', in *Good Practice Guidance and Uncertainty Management in National Greenhouse Gas Inventories* (UN IPCC, 2000), pp. 103–127, available at www.ipcc-nggip.iges.or.jp/public/gp/bgp/2_6_Fugitive_Emissions_from_Oil_and_Natural_Gas.pdf. See also, on coal fugitive emissions, United Nations, IPCC, 'Fugitive emissions', in *IPCC Guidelines for National Greenhouse Gas Inventories*, Volume 2: *Energy*, chapter 4 (UN IPCC, 2006), www.ipcc-nggip.iges.or.jp/public/2006gl/pdf/2_Volume2/V2_4_Ch4_Fugitive_Emissions.pdf.

26 The carbon fund is intended to provide equilibrium between heavy revenue earners and poor revenue earners (i.e. resource-rich countries and those poor in natural resources). It would allow for research in ground-breaking technology to exist where the manpower and physical resources are available. One of the characteristics of this regime is that most of the revenues will derive from developing countries, which tend to have fewer means to promote research and innovation. Developed countries are resource poor, so they will not tend to have as many resources to devote to technology development. By equalizing the contributions to a common fund, the resources can be utilized where the means for research and development exist. See, in this respect, K. Kennedy, M. Obeiter and N. Kaufman, *Putting a Price on Carbon: A Handbook for US Policymakers*, World Resources Institute, Working Paper (April 2015), p. 2.

11 | TAXING FOR JUSTICE: FISCAL POLICY, INEQUALITY, AND HUMAN RIGHTS

Nikki Reisch[1]

Fiscal policy is human rights policy.[2] The link between the two fields is not merely academic. Mass demonstrations in countries across the globe in 2019 vividly illustrate the concrete nature of the connection and the urgency of understanding how taxes and expenditures affect people's lives.

In October 2019 alone, protests rocked Ecuador, Chile, and Lebanon, driven in each instance by public outrage over the state's announcement of regressive new economic policies – policies that hit the poorest segments of society hardest. In Ecuador, indigenous peoples and students led demonstrations against the elimination of fuel subsidies as part of an International Monetary Fund (IMF)-backed austerity package.[3] In Chile, which ranks as the most unequal country among the 36 member states of the Organisation for Economic Co-operation and Development (OECD),[4] an increase to the metro fare in the country's capital, Santiago, sparked the largest protests in decades.[5] In Lebanon, more than a million people took to the streets after the government announced a tax on phone calls made via WhatsApp, a popular and free internet-based communications application.[6] In each instance, protests triggered by specific fiscal policy measures expanded into broader expressions of discontent over mounting economic inequality, the high cost of living, the poor quality of essential services, and corruption among wealthy elites. One Lebanese protestor quoted by *Al Jazeera* explained, 'We're not here over WhatsApp – we're here over everything, fuel, food, bread, everything'.[7]

Mass movements underway since late 2018 in countries as different as Sudan and France have common roots in fiscal policies that exacerbate, rather than ameliorate, poverty and inequality. In Sudan, the popular uprising that eventually led to the ouster of President Omar al-Bashir was set off by a steep increase in the price of bread in

December 2018.[8] In France, the '*gilets jaunes*' (yellow vests) protests ongoing since November 2018 emerged in response to a proposed gasoline tax, and they have continued to serve as a vehicle for people to air grievances about a state perceived to be run by and for the rich.[9]

These popular uprisings have taken place in widely divergent economic, political, cultural, and institutional contexts. The living conditions of the protestors in Sudan and France, for example, are far from identical; the degree of hardship they face and the severity of their grievances are by no means equivalent. Nonetheless, the demonstrations reflect broadly shared outrage over regressive revenue-raising measures, spending cuts, and the sense that government serves wealthy individuals and companies, not the average person.

Taxation figures centrally in these struggles. Tax policy is a major contributor to the extreme levels of inequality within and between countries that have much of the world seething today. Yet, taxation can also contribute to the rehabilitation of the state as an instrument of equality and justice, and the restoration of social cohesion without which there can be no collective peace or prosperity.

Against this backdrop, this chapter makes the case for understanding tax policy as human rights policy. The first section presents taxation and human rights as twin components of the social contract. Introducing human rights into the analysis of tax policy completes the pioneering but partial picture painted over a century ago, when originators of the field of 'fiscal sociology' described a country's budget as 'the skeleton of the state' and 'the spirit of a people'.[10] The second section traces the four principal avenues through which tax policy affects human rights in developing and developed countries alike: resource mobilization, redistribution, regulation, and representation. The third section examines some of the chief constraints on the realization of these linkages in developing countries. External impediments include the persistent fiscal orthodoxy of the IMF, only thinly veiled by new euphemisms for austerity and privatization, and the continued erosion of developing countries' revenue bases through tax avoidance and tax competition – phenomena driven in large part by developed countries. The last section concludes with some reflections on constraints imposed by institutional and cultural history. In many developing countries, achieving tax justice requires breaking from the colonial past and the neo-colonial present to reclaim and reimagine the state. Colonial regimes employed taxation as a tool to enforce inequality, not an instrument to achieve justice. Neo-colonial forces, in turn, discourage the use of tax policy as a redistributive tool, and instead encourage the deployment of tax incentives to attract foreign capital and facilitate global commerce. The frayed social contract cannot be repaired without confronting the legacy of colonialism and its implications for the state's role in achieving the social good today. And taxation cannot be harnessed for that social good without confronting the longstanding segregation of decision making on fiscal policy and human rights policy.

1. Two Sides of the Social Contract

Human rights law and tax law are both fundamentally about the relationship between individuals and the state. On a basic level, human rights law establishes what the state owes to those it governs while tax law dictates what the governed owe the state. To be sure, in a democratic society, taxation defines not just our duties to the state as an abstract entity, but through the state, to society: 'Taxes formalize our obligations to each other. They define the inequalities we accept and those that we collectively seek to redress. They signify who is a member of our political community, how wide we draw the circle of "we"'.[11] Taxes also incentivize or discourage certain types of economic and social behavior.

Tax policy is quintessentially a social tool. It cannot be divorced from principles regarding social priorities and entitlements, which are human rights. If taxes 'set the boundaries of what governments can do',[12] human rights law sets the boundaries of what governments must (and must not) do. Human rights law provides a framework to guide social policy and resource distribution. It enunciates what governments must refrain from doing, and what steps they must take to protect and fulfill the realization of rights. Taxes are tools to translate this normative blueprint into practical action.

The power to tax derives from the consent of the governed to the government's collection and expenditure of revenues on behalf of the people as a whole. Likewise, the duties and entitlements that make up human rights reflect a presumption that the state exists by and for the people, and that the people likewise depend on the state for their welfare. Taxation and human rights are thus indispensable components of the social contract, which sets forth the rights and responsibilities of the government and the governed. Human rights provide the normative content of the 'contract' between the members of a political community and the state, while taxation provides the means of its implementation.

In many parts of the world today, however, the social contract is frayed and the function or value of the state itself is in question. Economic insecurity, radical inequality, extreme poverty, and the rise of illiberal populist regimes have contributed to disillusionment with government. It is no surprise, therefore, that tax policy and human rights are at the heart of fundamental debates about the appropriate balance between the public and private sectors, the distribution of resources, and ultimately what constitutes a just society and the social good.

2. Human Rights and Tax: Multiple Links

Taxation affects which resources stay in private versus public hands, which activities are encouraged or discouraged, how much is available to the state to spend, and who pays for and receives the public goods and services the state provides, when, and why. Human rights law also establishes parameters for not only how tax policy should be made, but also what policies are permissible, when, and why, setting parameters for the revenue-raising objectives and distributive effects of taxation, as well as the processes by which tax laws are adopted and implemented. As discussed below, tax policy affects the realization of human rights in all countries, developed and developing alike, through its role in resource mobilization, redistribution, regulation, and representation.[13]

Resource mobilization: All rights cost money and require public policies to support them.[14] Although long ignored by many proponents of human rights, civil and political rights, like economic and social rights, are resource-dependent. Providing due process of law, protecting the right to vote, enforcing the prohibition on torture, and eradicating discrimination, as well as guaranteeing other civil and political rights, demands funding. Taxes generate most of the revenue that states can use to protect and promote the rights of their populations. Because they largely determine the overall 'size of the pie', taxes are thus an indispensable part of the equation for assessing, in accordance with the relevant international legal obligations, whether states have taken steps to the 'maximum of available resources' to realize human rights.[15] To be sure, mobilizing adequate public revenues from taxation is a necessary but insufficient condition to guarantee the fulfillment of human rights. The effect on rights depends not only on how (and how much) revenue is raised, but how it is used.

Redistribution: State budgets are fundamentally about the redistribution of resources. Whether that redistribution is progressive or regressive depends on the nature of the government's tax policies and spending priorities. These, in turn, affect the types and degrees of inequality within the society. It is largely because tax policy transfers resources from one part of society to another that it is both unpopular and contested. But the controversy over tax policy also stems from the opacity of tax systems, which often makes it difficult to ascertain who actually bears tax burdens. It is true that taxes imposed on the richest 20 percent in most countries will end up paying for the vast majority of social protection services.[16] However, when one examines the rate of tax paid as a proportion of income, rather than in absolute terms, a different story emerges. In the United States (US), for example, largely due to the incidence of consumption and payroll taxes, which are generally regressive, the working class pays higher tax rates than the country's billionaires.[17]

Taxation is not merely part of the problem. It can also be part of the solution to growing inequality and persistent poverty. Data captured in the 2018 World Inequality Report, showing divergent trends in inequality in the US and Europe since the 1980s, underscore that progressive fiscal regimes can be effective in reducing wealth and income disparities.[18] Citing examples from South Korea, Namibia, and Uruguay, an analysis by Oxfam of how fiscal policy affects the economic divide similarly confirms the equalizing impact of measures such as increased tax rates on the wealthy, expanded social spending, and a higher minimum wage.[19]

To be sure, tax regimes alone cannot rectify structural biases in the status quo. South Africa, for example, reportedly has the most progressive tax laws in the world,[20] but the highest levels of economic inequality[21] – an apartheid legacy that some say cannot be overcome without stronger labor market policies, more effective social grants,[22] and a wealth tax,[23] as well as continued efforts to combat racial and gender discrimination.[24] Tax measures can, however, create conditions for achieving greater equality of both opportunity and outcomes. For example, well-designed inheritance and gift taxes can reduce the entrenchment of inequalities across generations and help level the playing field.[25]

Tax policies also affect the distribution of resources among states. The differential tax treatment of domestic and foreign companies in a given country and variations in tax law between jurisdictions influences the global flow and distribution of assets. As is discussed in the next section, the allocation of taxing rights between countries in the global economy – that is, the rules determining how much of a multinational corporation's earnings that each country involved in the generation of its profits may tax – has profound impacts on structural disparities between capital-importing and capital-exporting countries in the Global North and South.

Regulation: Tax policies can incentivize or disincentivize a vast array of economic, social, cultural, political, religious, artistic, and other types of conduct. The range of decisions influenced by tax considerations in any society is potentially infinite, including where children go to school, which media people watch or read, who gives money and for what causes, what forms of medical care are accessible, and what environmentally friendly measures are adopted.

On one hand, the potential of tax policies to change behavior can promote useful ends and address serious problems. For example, climate change poses perhaps the greatest threat to human rights in the world today. Carbon taxes and credits for renewable energy are among the creative fiscal strategies required to discourage fossil fuel consumption, incentivize the transition to a green economy, and finance the social measures necessary to mitigate the disproportionate toll that climate change takes on the poorest and most vulnerable communities.[26]

On the other hand, however, tax policies can have negative discriminatory impacts. The issue of gender discrimination in taxation is a particularly good example in this regard. Taxes 'affect patterns of marriage, childbearing, work, savings, education, charity, home ownership, and more'.[27] While it is relatively uncommon today for tax laws to explicitly establish different rates or benefits for men and women, less overt forms of gender discrimination persist. For example, there is growing outrage over 'pink taxes', which result in higher prices charged for goods marketed to women compared to those marketed to men or sold as gender-neutral, or fail to exempt goods that are necessities for women from taxation while other goods used by men or gender-neutral necessity items are exempted.[28] In addition, women are overrepresented among the poor and bear the brunt of cuts to public spending, whether through the direct loss of services on which they depend or the increase in unpaid care work they provide to make up for insufficient social support.[29]

Representation: Fiscal policies reflect and influence the nature of the relationship between the government and the governed. A state's reliance on taxes collected from individuals and entities in the country forms a bond between the government and the people, creating a two-way dependency. The famous slogan of the US revolutionary war, 'no taxation without representation', could well be turned on its head: no representation without taxation.[30] Scholars of the 'resource curse' have long documented how states that depend principally on natural resource rents rather than taxes for their public budgets display less accountability to society.[31]

Depending on their design, implementation, and enforcement, taxes can either reinforce or undermine the state's accountability to the public and the robustness of democratic institutions. The relative opacity or transparency of a country's tax system, the uniformity of tax law enforcement, and the relationship between the legal incidence of taxation (who is meant to pay) and its economic incidence (who actually pays)[32] can have significant effects on the state's legitimacy and the consent of the governed to pay taxes. In the US, investigative reports revealed that a low-income earner seeking to claim a tax credit from the federal government is more likely to be audited than someone earning 20 times as much.[33] In addition, the most audited areas of the country are all poor, Southern, and Black.[34] In the meantime, a large number of the top-earning corporations paid no taxes on billions of dollars of their income.[35] As the widespread protests of 2019 illustrate, when tax measures reflect a disconnect between the state and the population, whether by design or in effect, public trust falters and radical, even revolutionary, change may follow.

One of the most important dimensions of the relationship between human rights and tax policies in the current era is the increasingly global nature of many of the challenges the two fields face, thus altering the nature of the solutions needed. To a growing extent, both tax law and human rights law must now address cross-border and multijurisdictional phenomena, such as the extraterritorial human rights impacts of state conduct and the global operations of companies. The tax consequences of these phenomena are not confined to a single territory, because the sovereign territorial state and the footloose transnational corporation are increasingly rivals. This complicates efforts to control corporate conduct (the human rights advocate's problem) and to capture corporate profit (the tax collector's problem).

The legal and regulatory frameworks for managing these impacts, however, often remain rooted in one or another national jurisdiction. The growth of the global economy and the dominance of transnational enterprises today have eroded traditional notions of state sovereignty, enhancing the power and role of non-state actors domestically and internationally. This shift poses a host of questions about how to effectively regulate conduct, and implement and enforce principles and norms in a world in which neither cause nor effect respects national borders.

3. Constraints to Realizing the Linkages between Tax and Human Rights

Leveraging taxation to advance human rights requires rethinking the role of the state and repairing the frayed social contract. Countries need to reimagine fiscal governance in a world of growing inequality within and between countries. In developing countries, pursuing that endeavor involves surmounting considerable external constraints.

3.1 Developed Countries Undermine the Revenue Base of Developing Countries

Developing countries are constrained in their ability to harness tax policy for human rights because other countries, particularly in the Global North, enable corporate tax avoidance and place downward pressure on corporate tax rates. The use of tax havens and financial secrecy jurisdictions continues to rise, while fierce tax competition between countries has driven steady declines in corporate tax rates across the globe, threatening steep revenue losses in some states.[36] Transnational corporations, largely based in the Global North, regularly exploit differences in tax rates and accounting rules between jurisdictions to avoid significant tax payments. Such practices disproportionately harm developing countries because they depend more heavily on corporate taxes as a revenue source.[37] Developed countries contribute to these phenomena directly, by maintaining tax policies and financial reporting rules that facilitate avoidance or accelerate a race to the bottom, and indirectly, by failing to adequately regulate their corporations' tax activities abroad.

3.1.1 Tax Avoidance: Accounting Rules and Tax Transparency

Tax avoidance and evasion are by no means new phenomena. In 1980, the International Bar Association convened a conference on tax avoidance and evasion, noting that the 'game' between taxpayers and their advisers on the one hand, and government tax administrators on the other, was only likely to get more cutthroat.[38] Indeed, it has: the pervasiveness of the practices and the scale of the resultant revenue losses have garnered worldwide attention in the past several years, following unprecedented disclosures and sophisticated investigative reporting into the world of cross-border profit shifting and offshore accounts.

Between 2014 and 2017, a series of leaks and investigative reports exposed how various countries, banks, accountants, and law firms facilitate tax dodging by corporations and wealthy individuals. Some of the first disclosures revealed that Ireland,[39] the Netherlands,[40] and Luxembourg[41] have facilitated tax avoidance by some of the world's largest companies, including Apple, Starbucks, Disney, IKEA, and Fiat. In 2015, 2016, and 2017, revelations about the widespread, systemic nature of officially sanctioned tax avoidance and evasion schemes that benefit corporations and rich individuals[42] snowballed, from the Swiss Leaks scandal to the Panama Papers and the Paradise Papers in November 2017, fueling public outcry.[43] The Paradise Papers include 13.4 million leaked files that 'expose offshore holdings of political leaders and their financiers as well as household-name companies that slash taxes through transactions conducted in secret'.[44]

The practice is widespread. A study released by the Australian tax office in December 2017 found that more than a third of 'the largest public companies and multinational entities in Australia paid no tax in the most recent financial year on record'.[45] Similarly, a civil society report in the US found that 'in 2018, 60 of America's biggest corporations zeroed out their federal income taxes on $79 billion in U.S. pretax income. Instead of paying $16.4 billion in taxes at the 21 percent statutory corporate tax rate, these companies enjoyed a net corporate tax rebate of $4.3 billion'.[46]

Inadequate data, financial secrecy, and lack of consensus on definitions make it difficult to quantify precisely the scale of revenue losses due to corporate tax avoidance, particularly in developing countries. Some estimates place collective global losses between $500 and $600 billion per year; low-income economies account for some $200 billion of these losses (more than those same countries receive in foreign development aid).[47] There is widespread agreement that developing countries are particularly hard hit. While rich countries lose more tax revenues in absolute terms, developing countries lose more as a percentage of their GDP.[48]

Tax abuse, defined broadly as 'practices contrary to the letter or spirit of global or national tax laws and policies',[49] threatens rights, particularly in the Global South, for at least two reasons. First, because of overall resource scarcity, the consequences of lost revenues for the state's ability to combat poverty and fulfill its human rights obligations may be starker in many of the world's poorest countries than elsewhere. Second, many developing countries lack a broad tax base and suffer from weak tax administration, such that taxes paid by the corporate sector are among the few sources of public revenue.[50]

The international community has made notable progress in addressing tax avoidance – or at least in agreeing on the need to do so. The OECD/G20-led Base Erosion and Profit Shifting (BEPS) project, for example, seeks to ensure profits are taxed where they are generated and value is created, largely through a series of changes to accounting and reporting rules on intra-firm transactions, such as interest deductions and transfer pricing, and using complex, hybrid corporate structures to exploit advantages and loopholes in tax treaties. The BEPS project, however, does not address *tax competition*[51] – a phenomenon that some estimate may cause five times more revenue loss than the tax dodging described above.[52]

3.1.2 Tax Competition: The Race to the Bottom

Tax competition refers to the pressure between countries to adopt lower and lower tax rates. Such competition is most apparent in corporate tax rate trends, which have declined steadily over the past two decades,[53] but it can also be seen in efforts to attract foreign investment with tax holidays or similar incentives.[54]

According to the IMF, such 'incentives' are an 'especially prevalent form of tax competition'.[55] A report published by ActionAid in 2013 estimated that tax breaks for corporations, offered to lure investment, may cost African countries up to $138 billion per year.[56] In addition to profiling the human costs of such tax incentives (for example, by comparing lost revenues to health care services or teacher salaries that could have been paid for with those funds), ActionAid cites research showing that the inducements are neither necessary to attract investment nor a source of net benefits for the countries that offer them, in terms of overall levels of investment or economic growth.[57] Their arguments were echoed by one of the 2019 winners of the Nobel Prize for economics, who has called reducing taxes to boost investment a myth.[58]

So long as developing countries are convinced – or required by international lenders – to forgo tax revenues from corporations in order to attract foreign investment, they will have limited space to pursue the types of creative fiscal measures needed to tackle contemporary human rights challenges.

3.1.3 Taxing Rights: New Proposals to Reallocate States' Claims on Global Profits

After many years, the focus of the OECD-led BEPS process has finally turned to the fundamental issue of the allocation of taxing rights: which countries can tax multinational companies for what, and how much? That question about the presumptions underlying the current global allocation of taxing rights speaks to the mounting pressure from civil society and governments of the Global South to address the issues that have skewed the system in favor of capital-exporting and goods-importing countries with large markets, since the creation of the century-old international tax architecture.[59]

At the heart of the debate are questions about how to allocate rights to tax international corporate profits – by source, sales, or other factors, such as employee presence. The proposal released by the OECD in the fall of 2019,[60] however, has been criticized as doing too little to claw back profits booked in tax havens and favoring rich economies over poorer ones. An analysis by the Tax Justice

Network, commissioned by the Independent Commission for the Reform of International Corporate Taxation (ICRICT), compared the OECD proposal to two alternatives for reallocating taxing rights: one put forward by civil society and the other by the IMF.

> The proposals vary on how much of a multinational group's global profit is to be apportioned, and how the apportioning among countries is determined. The OECD and IMF apportion profits to countries based on the location of a multinationals' sales, whereas the tax justice campaigners' proposal apportions profit based on the location of multinationals' sales and employees.[61]

Furthermore, the OECD and IMF proposals focus apportionment of taxes on 'residual profits' – those produced by intangible assets – whereas the tax justice campaigners' proposal apportions all of a multinational company's profits based on sales and employment.

A lot remains to be done before any of these plans can be translated into much-needed revenue increases for developing countries. For one, data gaps pose a significant problem in terms of mapping a corporation's profits. An even more significant impediment may be securing developed countries' agreement to change a system from which they have benefited handsomely for many decades. As the consensus around the need for a major overhaul of the international tax system grows, critical thinking is needed to envision a new tax architecture, grounded in human rights principles and legal obligations, rather than business priorities and colonial legacies.

3.2 Bad Expert Advice

In the three decades that have passed since the emergence of the 'Washington Consensus' the discourse of development policy has changed considerably. But the core policy advice from the dominant international economic institutions, such as the IMF and the World Bank,[62] continues to track the central planks of the neoliberal agenda: increased competition, achieved largely through deregulation and exposure to international markets, and a smaller role for the state, achieved largely through limits on public spending and privatization.[63] For countries that depend on external financing, the conditions placed on concessional loans and grants represent a significant barrier to adopting rights-compatible fiscal policies. The analysis that follows discusses two of the central elements of contemporary fiscal orthodoxy: austerity and privatization.

3.2.1 Austerity by Another Name

Today, the IMF shuns the terms 'austerity' and 'adjustment'. It talks instead about 'fiscal consolidation', 'fiscal tightening', and 'fiscal sustainability'.[64] These are but the latest euphemisms for the IMF's decades-old prescription: reducing the public deficit and debt by cutting spending or raising taxes, or both.

The Fund's own research increasingly questions the wisdom of this now-standard policy advice. A paper published in 2015 noted that despite the Fund's emphasis on reducing public debt, there is little certainty as to what constitutes an optimal debt target. It cautioned that 'the costs of the tax increases or expenditure cuts required to bring down the debt may be much larger than the reduced crisis risk engendered by the lower debt'.[65] In other words, fiscal consolidation may take a greater toll on public welfare than any risk posed by a country's debt burden. Nonetheless, recent country assistance packages do not reflect the reported reconsideration of the Fund's approach.

The IMF's 2019 Agreement with Ecuador provides a useful illustration:[66] the program's primary aim of fiscal consolidation is to be achieved through 'reductions in public employment and lower government wages; a gradual elimination of untargeted fuel subsidies; an overhaul of the tax system; and efforts to better prioritize spending on both capital outlays and goods and services'.[67] Despite a pledge to make the tax system 'more growth-friendly *and more equitable*',[68] it is unclear how the planned reforms will achieve the latter. They include, among other provisions, measures to: increase reliance on indirect, rather than direct, taxes; improve the business environment and encourage investment; and eliminate levies on capital flows.[69]

Critics contend that the agreed 'fiscal adjustment and labor deregulation measures will have a significant negative impact on Ecuadorian families' day-to-day living standards, including increases in unemployment, inadequate employment and, most likely, poverty'.[70] Indeed, the IMF itself recognizes that '[d]omestic political and social opposition could create challenges for the implementation of the government's policy plans (particularly changes to fuel subsidies, the public sector wage bill, and the tax system)'.[71] To safeguard against negative impacts on the poor, the IMF contends 'the government is working with the World Bank to enhance the targeting and resources of the social safety net prior to any further reduction in subsidies for household consumption of fuel products'.[72] But increasing evidence shows that such targeting of social protection benefits often fails to reach the poorest households, due to data gaps and administrative challenges, and that restricting social spending to the most vulnerable populations erodes broader political support for public welfare systems.[73]

Major reductions in government expenditures like those planned in Ecuador provide the occasion to pick and choose which rights will be protected, to what extent, for whom, and how. Rather than reflecting on what rights have been constricted in the process of fiscal consolidation, the point for present purposes is that the process itself is not a neutral one in terms of its impact on rights. It can – and does – have a major impact on rights-related aspects of the budget, as it does on the welfare and entitlement side. In the era of what has been dubbed the 'consolidation state'[74] countries' legal obligations, under both constitutional and international human rights law, have been subordinated to fiscal consolidation as an end unto itself. Unless powerful economic actors, like the Fund, are made to reassess their approach, developing countries will have limited ability to reshape their budgetary priorities to align with their human rights commitments.

3.2.2 Privatization

Another consistent ingredient of the new fiscal orthodoxy is privatization. The IMF's 2019 agreement with Ecuador, discussed above, anticipates that the government will accrue fiscal savings through privatization of public assets, although it uses a euphemism to describe the measures: 'monetization' of 'public asset concessions'.[75] The inclusion of privatization targets in the reform package is not an aberration: a review of recent IMF Article IV staff reports in a range of countries revealed that privatization continues to figure prominently in the Fund's advice to governments.[76]

Privatization is both a driver and a consequence of fiscal consolidation. Privatizing state functions is widely seen as a way to cut public spending. At the same time, cash-strapped governments may have little choice but to cease certain services entirely or privatize them. Principal motivations for privatization include: the opportunity to generate a one-time injection of revenue into the budget by selling state assets; the assumption that the private sector is inevitably more efficient than the public sector; the likelihood that private enterprises will respond more effectively to market forces; the assumption that the entrepreneurial spirit makes private employers more open to technological and other forms of innovation; the assumption that privatized enterprises are less likely to be unionized and will thus not have to deal with unwanted demands from employees; and the pursuit of a libertarian ideological agenda that aims to 'deconstruct the administrative state'.[77]

Many of these justifications for privatization, however, have not been borne out by evidence.[78] The eclipsing of the public sphere by the private sector often complicates the exercise of taxation and regulatory oversight – potentially making state functions less, not more, efficient. There are parallels between the debates around the value-added tax and those around privatization of social services: in theory, both could achieve positive 'efficiencies'. In reality, however, correcting the regressive impacts of consumption taxes like the value-added tax and of market-led allocation, to ensure fair (or at least not grossly unequal) distributive outcomes, requires active intervention by the regulatory state and the resources to support it. Far too often, however, the transfer programs or regulatory policies designed to mitigate regressive tax incidence or correct market failures are not implemented or are poorly designed, leaving the promise of value-added taxes and privatization, as positive tools for the public, unfulfilled.

The bulk of the human rights literature on privatization has emphasized its effects on economic and social rights, including access to and quality of services like water provision, health care, and education. As the segregated, two-tier public and private systems of services in Chile vividly illustrate,[79] when services are privatized, the poor are often 'relegated to a new even more underfunded public sector'.[80] There are increasing examples, however, of privatization affecting civil and political rights, like the rights to justice, to personal security, and to vote.[81] As the market expands to ever-more sectors, economics increasingly determine one's capacity to access goods and services, and to exercise freedoms that are essential to human rights.

In a market system, discrimination based on one's ability to pay is not a flaw, it is a feature.

Moreover, by removing certain goods and services from the public realm, privatization shrinks the scope of discourse over tax policy and transfers decision making to market actors. These shifts affect the democracy-building function of taxation and restrict opportunities for the public, through the democratic process, to ensure conformity to human rights obligations.

The renewed push toward privatization in myriad realms, from criminal justice to public infrastructure such as water and sanitation systems and to services such as health care and education, both reflects and contributes to waning faith in the state. Rather than a tested and proven strategy for achieving fiscal efficiency, privatization has metamorphosed into an ideology of governance that defines the public good in terms of freedom from government.[82] Whether driven by existing budgetary shortfalls or ideology, the outsourcing of government functions to the private sector is poised to make the state's incapacity a self-fulfilling prophecy. The impoverishment of the state itself undermines the legitimacy of human rights and tax policy, alike, as both demand robust state action and citizen acceptance to be effective.

4. Conclusion

Taxation is as much a product as a determinant of culture and history. It is not possible to address the role of taxation in advancing or thwarting human rights without confronting a society's conception of and relationship to the state. And in post-colonial developing countries, one cannot talk about the role of the state today without understanding the history of the state as an enforcer of inequality and taxation as an instrument of oppression during the colonial era.[83]

Many developing countries are squeezed between a not-distant colonial past in which the state weaponized taxes to divide and dominate, and a present in which contemporary economic powers have demonized the state itself and shunned taxation as a tool of social transformation. Much of the post-colonial period, when new independent states were forming, has been dominated by neoliberal ideology, typified by an assault on the regulatory state, on the one side, and corporate pillaging, on the other. Post-colonial societies, therefore, face a double challenge of rehabilitating the notion of fiscal policy as well as re-envisioning the state itself.

The present crisis is as much a crisis of imagination as it is one of implementation. Despite states' commitments to abide by international human rights obligations, their policies around the world seem geared more toward protecting private wealth than guaranteeing public welfare. Unfortunately, in this era of rising nationalism, authoritarianism, and disillusionment with the traditional role of the state, there are precious few examples of fiscal justice serving as a tool for human rights. Far more widespread are worrying examples of fiscal conservatism, such as efforts to entrench in legislative and constitutional provisions constraints on fiscal policy options that are otherwise open to democratic decision making.[84]

Overcoming the challenges posed by extreme inequality and climate change – destabilizing forces that undermine the enjoyment of rights of all types – requires rethinking fiscal possibilities from the perspective of human rights. Such innovation demands at least three things: (1) better diagnosis of the effects of tax on human rights; (2) more policy experimentation; and (3) new strategies for accountability. On diagnosing the problem, human rights experts, such as the UN committees charged with interpreting and monitoring the implementation of human rights treaties, should systematically examine countries' tax policies and practices as part of their review of state party compliance with their human rights obligations. Building on the work of a coalition of civil society actors including the Global Justice Clinic at New York University School of Law, the Center for Economic and Social Rights, and the Tax Justice Network, several treaty bodies have begun to make questions about the impacts of tax laws both within and beyond a country's borders a standard part of their state party reviews.[85] But mainstreaming such scrutiny throughout the human rights system – and thereby habituating state authorities to consider their fiscal conduct as part of their human rights record – requires sustained pressure from civil society organizations and increased support from tax experts willing to offer technical assistance to human rights bodies.

Second, challenging the assumptions on which status quo fiscal orthodoxy rests requires experimentation. Embracing experimentalism demands greater political will from governments, flexibility from funders, such as the IMF, and concrete proposals from civil society.

Partnerships between tax experts and human rights advocates could amplify the sheer volume of policy proposals from which states may choose and improve design. If human rights experts identify distributive outcomes consistent with states' international legal obligations to respect, protect, and progressively realize rights, tax experts can identify fiscal measures that target those effects, rather than abstract notions of efficiency. Such partnerships could produce unexpected results – such as ways of scaling-up innovative municipal measures like a surtax on companies whose CEOs are paid grossly in excess of the average worker's salary, or documenting the economic and human rights benefits of using tax dollars to fund universal rather than targeted social programs.

Finally, any discussion of taxation from a human rights perspective necessarily raises questions of enforceability and accountability for abuses. Expertise in both tax and human rights is required to pinpoint the corporate decisions responsible for gross reductions in an entity's tax bill, to identify the state policies that permit such avoidance, to conceptualize what remedy means with respect to tax-related human rights harms, and to locate forums that might have jurisdiction to address a complaint.

By overcoming the artificial segregation of their fields to date, human rights and tax experts can generate the type of fiscal creativity needed to leverage tax for justice. Experts in both domains must admit that to silo each discipline is not only artificial, in that it distorts rather than reflects the way the world works; it is also a highly political act which deflects attention from common concerns about the social good.

Notes

1 Legal Director, NYU Center for Human Rights and Global Justice, J.D., New York University.

2 Some of the material in this essay was previously published by Oxford University Press in P. Alston and N. Reisch, eds., *Tax, Inequality and Human Rights* (2019). *See* P. Alston and N. Reisch, 'Introduction: Fiscal Policy as Human Rights Policy', in *id.* 1–30, and N. Reisch, 'Taxation and Human Rights: Mapping the Landscape', in *id.*, 33–57.

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12 | TOWARDS A JUST INTERNATIONAL TAX ORDER: GIVING CONTENT TO ARTICLE 28 OF THE UNIVERSAL DECLARATION OF HUMAN RIGHTS THROUGH THE GLOBAL TAX SYSTEM

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Executive Summary

Article 28 of the Universal Declaration of Human Rights (UDHR) calls for 'a social and international order' in which human rights can be fully realized. In a globalized world where actions and policies have effects far beyond national borders, concerted action in an equitable international system is necessary for the true fulfillment of human rights. And yet the international order remains a system where power and politics consistently take precedence over states' human rights obligations. The global tax system and efforts to reform it are a clear example of this failure to live up to the promise of UDHR Article 28. This chapter examines UDHR Article 28 and the global tax system as an illustration of how the international order fails to realize human rights and suggests what a global tax system that meets the requirements of UDHR Article 28 might look like. Finally, the chapter proposes some human rights-based advocacy methods that states and advocates could use to try to achieve such a system, including the use of the individual complaint procedures before Human Rights Treaty Bodies, the creation of a United Nations (UN) Special Rapporteur on Human Rights and Taxation, and the examination of tax-related issues during the Human Rights Council's Universal Periodic Review process.

1. Introduction

The drafters of the UDHR, seeking to forge a new world in the aftermath of a conflict that had consumed the globe, were acutely aware of human interconnectedness, and so they included UDHR Article 28, which calls for 'a social and international order' in which human rights can be fully realized. They recognized that in a globalized world where actions and policies have effects far beyond national borders, concerted action in an equitable international system is necessary for the true fulfillment of human rights. And yet the international order remains a system where power and politics consistently take precedence over states' human rights obligations. The global tax system and efforts to reform it are one prominent example of this failure to live up to the promise of UDHR Article 28. Rather than working in a democratic and holistic system to ensure an equitable allocation of taxing rights, rich countries have imposed a system of piecemeal treaties between individual nations and have concentrated reform efforts in an unrepresentative body, the Organisation for Economic Co-operation and Development (OECD). They have thus reduced both the voice and power that developing countries have in determining their own tax policies and the tax revenues that are available for such countries to spend to improve the lives of their people and fulfill their human rights obligations.

This chapter examines UDHR Article 28 and the global tax system as an illustration of how the international order fails to realize human rights. Recognizing that human rights problems can also be helped by human rights solutions, it makes suggestions regarding what a global tax system that meets the requirements of UDHR Article 28 might look like, and proposes some human rights-based advocacy methods that states and advocates could use to try to achieve such a system, including the use of UN Treaty Body individual complaint mechanisms, the creation of a UN Special Rapporteur on Taxation and Human Rights, and the use of the Universal Periodic Review procedure.

2. UDHR Article 28 and the Injustice and Inequity of the Global Tax Order

2.1 *A Just Social and International Order*

Article 28 of the UDHR represents an understanding that international cooperation and international solidarity are required in order to ensure that states have the ability to fulfill their human rights obligations. If the international order is unjust or exploitative, even the best-intentioned countries will not be able to meet the needs of their population. This understanding necessitates 'a structural approach to human rights, at both national and international levels' (Kunanayakam, 2013: 20). As Pogge (2011) has argued, states' and individuals' human rights duties entail an obligation to create supranational institutions that are conducive to the fulfillment of human rights and the reduction of global poverty. The necessity of 'an enabling international environment … for the realization of human rights' (Kunanayakam, 2013: 20) has become more and more evident in recent decades, as globalization makes clear that 'decisions made at the meta-State levels – in international organizations, foreign Governments and private networks – affect the fundamental human rights of ordinary people around the world, who have little say in making those decisions' (Rajagopal, 2013: 170).

Generally, however, human rights analysis has focused on individual violations of particular rights, rather than emphasizing structural causes of non-fulfillment of rights, particularly at the international level. As Pogge (2011) argues, this may be because the recognition of the effect of institutional design on the fulfillment of human rights would implicate many of those residents of developed countries, who theorize about human rights, but in a significant violation of human rights, 'design and impos[e] … unjust supranational institutional arrangements'. It is also true that these structural, global issues may be significantly more complex and less clear-cut than specific violations of individual rights, which may seem both more clear and urgent, especially in an environment of limited resources for addressing human rights violations. Further, multinational corporations and the very rich possess the power, resources, and understanding to shape international institutions to their benefit, to the detriment of the global community as a whole. There has thus been significant debate within and outside the human rights community over whether and how states can be held responsible for their extraterritorial human rights impacts and for their conduct as members of the international community.

The notion that fundamental reform of the structures of the international system is necessary for the achievement of human rights is still hotly contested, or, worse, ignored. The insight of the drafters of Article 28 has not so far been reflected in the international human rights system. This is evident in countries' approaches to international development cooperation, climate change, migration, investment, trade, and particularly evident in their approach to global taxation. Throughout the history of international efforts to address tax evasion and allocate taxing rights among countries, the system has been structured to favor developed countries, and particularly the rich and powerful within developed countries. At the same time, developing countries have been constrained in their ability to collect tax from multinational corporations doing business within these countries. Further, reform efforts in the dominant international institutions, such as the G20 and OECD, have consistently given developed countries a more prominent voice in the process. As many advocates have noted, such a system has troubling effects on the realization of human rights.

2.2 *Who Can Tax and How Much?*

Since the 1920s, when the international community first came together to try to solve the problem of taxation of multinational entities, the system has privileged the 'home' countries, where such entities are based (primarily in the Global North), over the 'host' countries, where they invest and conduct business activity (primarily in the Global South). This is accomplished through a system of bilateral tax treaties, all generally based on a model tax treaty developed by the OECD, an organization of wealthy countries. In this model convention the primary question has always been: when a corporation is registered in one country (the home or residence state), but does business in another country (the host or source state), which of these two countries has the right to tax the income arising from that business activity (Kane, 2015)? As McIntyre (2005) explains, the first OECD draft model tax treaty, which has provided the basis for tax treaties around the world, had the practical effect of 'erect[ing] substantial barriers to the exercise of source jurisdiction and … afford[ing] multinational firms with major opportunities for tax minimizing strategies'. Although there is an alternate model tax convention promulgated by the UN and specifically designed for treaties between developing and developed countries, the OECD model dominates (Steenkamp, 2013). Some developing countries have sought to find alternatives to this model or adapt it to their benefit with strategies like those illustrated by Randriamanalina elsewhere in this volume, but many are forced to accept treaties based on the OECD model because of their weaker bargaining positions, and for fear of being left out of the dominant system (Steenkamp, 2013).

As a result, developing countries are under pressure to negotiate multiple treaties that start from unfavorable terms. At the same time, they often find themselves in situations of competing to attract foreign investment with low tax rates for foreign corporations, in what has been termed a global 'race to the bottom'. Governments have been led to believe that offering significant tax incentives and low corporate tax rates is essential to secure foreign investment, even though the evidentiary basis for this theory is weak (Oxfam, 2016: 17–21). What is more, even when countries recognize the flaws in this system, they are not given an equal voice in seeking to correct them.

2.3 Domination of the Discourse by Developed Countries

Even in recent years, as countries in the Global North have begun to show greater concern over issues like tax havens, tax secrecy, and tax competition, reform processes have been concentrated at the OECD, effectively shutting out developing countries and their concerns. The most significant global tax reform effort of recent years is the OECD's Base Erosion and Profit Shifting (BEPS) project. While the BEPS project seeks to address problems that are common to many countries around the world, OECD member states' voices are privileged above all others in crafting the solutions. The OECD has created an 'Inclusive Framework' to bring more countries into the process of implementing the BEPS project, but while this allows developing countries a chance to collaborate on implementation and on the development of new reforms, the initial BEPS framework was very much a product of the OECD countries (OECD, 2017a).

Developing countries and those who advocate for pro-poor policies have long argued that international tax matters should be addressed in a forum where all states participate on an equal basis, and have particularly sought for an intergovernmental tax body to be created as an element of the UN system. While the UN has a committee of experts on tax matters, there is no international body that can negotiate tax issues on behalf of governments and make genuine and binding state commitments to reform. Recently, developing and developed countries clashed over this issue at the Third International Conference on Financing for Development held in Addis Ababa in 2015: developing countries in the G77 pushed to upgrade the tax committee to an intergovernmental body, but developed countries refused to entertain such proposals (Muchhala and Sengupta, 2015).

Participation has long been understood as a key principle for the achievement of human rights, but tends to be emphasized only at the local and national levels. However, participation matters at the supranational level, too. This means both that civil society should be able to participate in global discussions, and that 'there is a pressing need to strengthen the participation of developing countries in international economic decision-making and norm-setting' (Piovesan, 2013: 106). To fully address global challenges, the voices of the populations of developing countries need to be fully represented (Piovesan, 2013). As Kunanayakam (2013) puts it, 'discrimination against States and peoples at the international level has the same adverse effect as discrimination against individuals and groups within States: it perpetuates inequalities of wealth and power, and constitutes an obstacle to addressing inequalities through the process of development'. In the tax context, discrimination against developing countries has helped perpetuate the inequalities in taxing rights between source and residence countries by failing to allow developing countries to meaningfully participate in decision making and rulemaking around global tax policy. This failure to realize a key human rights principle at the international level damages the ability to realize human rights on the ground.

2.4 *Effects on the Realization of Human Rights*

A number of NGOs and human rights actors have begun to document the consequences that this global imbalance has on the realization of human rights within developing countries. Most prominently, a global tax order that is unjust and that creates opportunities for tax avoidance deprives all countries, but particularly developing countries, of resources that could be used for the realization of human rights. Article 2(1) of the International Covenant of Economic, Social and Cultural Rights (ICESCR), a key human rights treaty ratified by 165 countries, requires that states party to the Covenant devote 'maximum available resources' to the progressive realization of the rights contained in the Covenant. Although discussion of this requirement has largely focused on spending and resource allocation, revenue collection and mobilization is the other, equally important, side of the coin (Saiz, 2013: 80) – while it is true that governments must make responsible allocation decisions that comply with their human rights obligations, actually having resources to allocate is a necessary precondition for doing so. Additionally, a system that allows widespread tax evasion may undermine democratic institutions by undermining citizen confidence in the government and their sense of the social contract, thus eroding peace and security (Cobham, 2014). Conversely, a government with a fair and effective tax system can build citizen trust and a sense of civic responsibility, participation, and accountability (Sepulveda Carmona, 2014: paras 51–52).

Further, in both developing and developed countries, the abusive practices enabled by this tax system aggravate inequalities and may promote discrimination. As discussed above, loss of revenue from corporations and wealthy individuals who are able to exploit the international tax system may cause states to shift the tax burden to those who lack access to tax avoidance opportunities – those who are already poor. This only serves to entrench and exacerbate existing economic inequality (HLPIFFA, 2015: 56) and may, in particular, increase the tax burden on women, minorities, and others who are already subject to societal discrimination (Elson, 2006: 95). These groups are also likely to suffer the most when social services are underfunded as a result of lost revenues (Alliance Sud et al., 2016: 5).

Of course, these negative human rights outcomes are in part due to domestic policy choices, but they are also consequences of the international imbalances described above. The UN Committee on Economic, Social and Cultural Rights (2017: para. 37), which monitors the ICESCR's implementation, has clearly stated that in order to fulfill their obligations under the Covenant, states should address many of the flaws in the global tax system discussed above. The Committee has also called specifically on the United Kingdom to address the manner in which its tax policy allows for cross-border tax avoidance and to increase its diligence in combating global tax abuse (Committee on Economic, Social and Cultural Rights, 2016: paras. 16–17). Similarly, the Committee on the Elimination of Discrimination Against Women (2016: paras. 40–41), which monitors the implementation of the Convention on the Elimination of All Forms of Discrimination Against Women, has expressed concern that Switzerland's international tax policy may have 'a potentially negative impact on the ability of other States, in particular those already short of revenue, to mobilize the maximum available resources for the fulfillment of human rights'. The Committee on the Rights of the Child (2016: para. 75), which monitors implementation of the Convention on the Rights of the Child, has also called on states that are party to the Convention to engage in international tax cooperation to ensure that maximum resources are available for the realization of children's rights.

In short, the current global tax order is not conducive to the fulfillment of human rights because it privileges rich countries over poor ones both in terms of who is able to collect taxes and in terms of power and voice in shaping the system. The current system creates opportunities for tax avoidance by multinational corporations and wealthy individuals and impacts human rights by reducing the revenues that are available for the realization of rights, aggravating inequalities, and destabilizing institutions. But what kind of global tax order could actually facilitate the fulfillment of human rights, and how can human rights analysis and tactics be used to press for such an order?

3. What Would a Just and Equitable Global Tax Order Look Like, and How Can It Be Achieved?

3.1 Elements of a Just Global Tax Order

There are several ways the international community could come together to create a global tax system that enables the realization of human rights. As explained above, countries in the Global South and advocates seeking tax justice have long insisted that a just international tax order would be one in which all countries have an equal voice in governance and reform. This would require moving the responsibility for global tax reform efforts from its concentration at the OECD to a new intergovernmental tax body, likely under the auspices of the UN. Such a tax body could be structured to operate based on majority votes, in order to ensure an equal voice for every country participating. Although developed countries have long resisted calls for such a body, it would be a key element in a social and international order where human rights could be fully realized. As Sengupta (2013: 75) explains, a transparent intergovernmental forum is likely to be the most effective way to enforce international agreements regarding both taxation and human rights.

Within an intergovernmental tax body, developing countries could push to obtain a fairer allocation of taxing rights by revising the model tax treaty on which most bilateral tax treaties are based, or perhaps even by scrapping the fragmented network of bilateral treaties and instead negotiating a multilateral treaty with fair terms for all members. A multilateral treaty on profit allocation was developed under the auspices of the League of Nations in the 1930s, but never gained significant international traction (McIntyre, 2005). Under the OECD's BEPS project, 89 countries have signed a multilateral instrument that addresses certain specific tax issues, including hybrid mismatch arrangements, treaty abuse, and permanent establishment issues (OECD, 2017b). But while this treaty closes certain loopholes, it does not truly establish a new international tax order in the way that a comprehensive multilateral treaty could (Thuronyi, 2001: 1645–1646).

There are also several specific technical changes that could be made to the international taxation system to make it more just, including such recommendations as country-by-country reporting by corporations, automatic information exchange between countries, disclosure of beneficial ownership, and tighter regulation of financial and legal service providers, as well as a number of other policy proposals explored by Readhead, Randriamanalina, and Alt and Chilufya elsewhere in this volume. One key proposal in this area is the move to a unitary system of corporate taxation, such as the method proposed by Sadiq for corporate debt elsewhere in this volume, which would entail a fairer allocation of taxing rights between host and home countries. Such a system, however, would require much greater cooperation among nations than currently exists on taxation matters, and thus a genuine commitment to a more just tax order. Obtaining such a commitment would require a significant political change, particularly on the part of developed countries, and this is where human rights analysis and methods might play a useful role.

3.2 *Human Rights Methods for Achieving These Goals*

There is already significant international attention being paid to issues of global taxation, in a number of fora. Given this fact, and given that global taxation, despite the clear human rights impacts outlined above, has traditionally been outside of the purview of human rights analysis, what is to be gained by bringing a human rights lens to international tax issues or discussing these issues in human rights fora? And if there are benefits to be gained from a human rights-based approach, what additional human rights avenues exist for states and other actors seeking to create a more just international tax order?

3.2.1 The Benefits of a Human Rights Focus

While it is true that a number of international organizations and mechanisms have sought to reform the global tax system, they have generally acted from a purely economic perspective, operating in fora dominated by technocrats. Discussing the tax system in terms of human rights brings a new perspective, reframing the debate to focus more on the ultimate purpose of taxation, and on who benefits from tax policy. A human rights lens requires a focus on accountability for reforms and on participation (Biglino et al., 2012: 24–26). This lens demands that tax reform discourse be removed from fora dominated by wealthy countries and requires evaluation and enforcement of agreed-upon reforms. It also calls attention to the groups affected by tax policy, particularly the most vulnerable, and requires that policies be built on disaggregated data, understanding the effects that particular reforms may have on different groups within society (Biglino et al., 2012: 23). Ultimately, this causes those working on tax reform to consider not only how to maximize tax collection, but also how to do so fairly, and how to use the additional tax revenues.

These are not merely questions of rhetoric or of intellectual analysis but can have genuine, practical effects on the achievement of reforms and on the manner in which they are achieved. Linking global tax structures to their human rights impacts takes them out of the exclusive purview of economic and development specialists and makes these questions more relatable and understandable to a broader community, thus creating the potential for greater engagement by civil society and ordinary citizens around these issues (Lipsett et al., 2013: 9). When it comes to corporations, the 'naming and shaming' strategy of human rights advocacy has already been empirically demonstrated to have some effect on tax behavior (Dyreng et al., 2014). Especially in democracies, increased calls by citizens for a fairer global tax system may help bring about greater and more just reforms.

Further, human rights methods and systems provide an important platform for coalition building. As mentioned several times throughout this paper, inequities in the global tax system do not just impair the fulfillment of human rights in developing countries, but they also exacerbate inequalities and create resource gaps in developed countries, privileging the benefits to the rich and powerful few over the rights of the many all around the world. Thus this is an issue where political leaders and civil society organizations in the Global South can seek common ground and take common action with grassroots activists and traditional human rights advocates in the Global North, engaging in broad-based campaigns to influence policy at the global level. An important model for this sort of action comes from the climate change movement, where political leaders from countries most affected by climate change, particularly small island developing states, have united with activists around the world to push for recognition of the human rights impacts of climate change and to call for limiting global temperature increases to below 1.5 degrees Celsius above pre-industrial levels.

As referenced above, a number of human rights advocates and practitioners have already begun to make the link between human rights and the global tax system through reports by NGOs and by UN special procedures mandate holders, and in submissions to and the country reports of a number of UN treaty bodies. The following sections suggest three more human rights avenues that might be explored in order to more fully apply a human rights focus to questions of global tax and to expand the influence of human rights considerations on countries as they work to reform the global tax order.

3.2.2 Using the Human Rights Treaty Bodies' Individual Complaints Procedures

Each of the major UN human rights treaties has a Treaty Body – a committee of experts that is charged with interpreting the treaty and monitoring its implementation. As noted above, several of these committees have already begun to comment on the impact of tax policy on the human rights that they are charged with protecting. Through the adoption of optional protocols or making declarations under certain articles in the treaties, some states have also authorized these treaty bodies to hear individual (and sometimes group) complaints alleging violations of the rights contained in the treaties. These individual complaint procedures might provide a new avenue for advocates seeking to promote global tax justice. An individual might, for example, be able to bring a complaint against a tax haven, arguing that that state's tax policies have impaired the fulfillment of the individual's human rights.

The procedures vary somewhat from treaty body to treaty body, but generally, once an individual has submitted a complaint, the committee will first consider its procedural admissibility, and then, if it finds the complaints admissible, consider the allegations of human rights violations and issue a decision as to whether any violation has occurred. If the committee finds a violation, it will make recommendations to the relevant state, and initiate a dialogue with the state regarding the implementation of those recommendations.

There are three major potential hurdles for advocates seeking to bring one of these individual complaints to address tax justice issues. The first is that the relevant state must have agreed to be subject to such complaints. One hundred and sixteen countries have ratified the Optional Protocol to the International Covenant on Civil and Political Rights (ICCPR), while only 23 have agreed to be subject to complaints under the Optional Protocol to the ICESCR. Advocates bringing a claim will thus have to think carefully about selecting the committee before which to proceed. The human rights impacts of tax injustice, as discussed above, are quite wide-ranging, implicating the rights contained in a number of treaties. The Human Rights Committee, which enforces the ICCPR, has jurisdiction over the highest number of states and arguably the most developed complaint procedure. However, global tax justice issues have been dealt with more thus far by the Committee on Economic, Social and Culture Rights, the Committee on the Elimination of Discrimination against Women, and the Committee on the Rights of the Child.

Secondly, generally complainants must be 'subject to the jurisdiction' of the state against which they are bringing the complaint. Thus an individual living in a developing country would be unable to bring a claim against a tax haven without having some sort of jurisdictional connection to that tax haven. Accordingly the ideal complainant for such a case might be someone who has dual nationality in both a tax haven jurisdiction and a country that is harmed by the tax haven's policies, and who resides and pays taxes in the non-tax haven country, and is able to establish that there are fewer resources available for the fulfillment of human rights in the country where he or she resides as a result of the tax haven's policies. Finally, there is a question of the exhaustion of domestic remedies, which is a criterion for the admissibility of complaints to the treaty bodies. Any complainant who has not exhausted domestic remedies must be able to argue that domestic remedies are unavailable or ineffective. Thus in the case of a tax justice complaint, it might be possible for a complainant to argue that the domestic courts do not have jurisdiction to cover the international spillover effects of tax policy.

As noted above, the outcome of a successful complaint to a treaty body is merely a set of recommendations – these are not judicial proceedings and the committees do not have any power to enforce their judgments. Nevertheless, there is still significant potential value for advocates to bring one of these cases in the tax justice realm. There is a narrative value in being able to frame the effects of tax policy on the rights of individuals, in personalizing and particularizing abuses that are thought of as esoteric and abstract (Harrington, 2012: 180). This value can be generated just by filing the complaint and publicizing that filing, no matter the decision of the committee. However, if a committee does accept a complaint and find a violation, this will be considered an authoritative interpretation of the relevant treaty – a finding by a significant expert body that enabling tax abuse is a violation of human rights, and can therefore create another building block in the case for global tax justice as a human rights issue.

3.2.3 A UN Special Rapporteur on Human Rights and Taxation?

Another prominent mechanism in the global human rights system is the special procedures of the UN Human Rights Council. 'Special procedures' is the term used for a collection of 'independent experts appointed for fixed terms to examine either human rights generally within a specific country or one thematic right across the world' (Freedman and Mchangama, 2016: 168). Generally, they are empowered to conduct observational visits to review the human rights situation in particular countries, to communicate with states regarding specific allegations of human rights violations, and to report to the Human Rights Council and the General Assembly on themes related to their mandates. As referenced above, a number of special procedures mandate holders have been instrumental in highlighting the connections between taxation and human rights. However, there is no thematic mandate specifically devoted to this issue. It would be relatively simple to create such a mandate, as this can be accomplished through a majority vote in the Human Rights Council. The recent creation of the mandate of the Special Rapporteur on the Right to Development illustrates how one determined country (in this case India) can rally the support of a voting bloc like the countries of the Non-Aligned Movement in order to approve a new mandate (Timossi, 2016).

Recent years have seen a significant growth in the number of mandates created by the Human Rights Council (Freedman and Mchangama, 2016: 165), and there are genuine concerns regarding the proliferation of such mandates, including the under-resourcing of existing mandates (Freedman and Mchangama, 2016; Gutter 2007) and the possibility of states focusing on certain mandates in order to distract from or obscure their abuses in other areas (Freedman and Mchangama, 2016). All special procedures mandate holders may struggle to obtain state cooperation in their work (Gutter, 2007: 103), and must be diligent regarding the danger of politicization of the mandate (Gutter, 2007: 103–105). Mandates that are more focused on the so-called 'third generation' rights, and thus more concerned with structural issues than with individual violations may be particularly prone to such concerns (Freedman and Mchangama, 2016: 180–181). Nevertheless, there might be considerable value in creating a special procedures mandate that deals specifically and exclusively with questions of taxation and human rights.

Special procedures mandate holders have traditionally had significant flexibility in the way that they conduct their work and have developed innovative methods to advance their mandates (Gutter, 2007: 99). Further, although they are created by and report to the Human Rights Council, they are independent actors, promulgating their own views as subject matter experts, rather than purporting to advance the views of the UN or of any country or institution. In part as a result of these characteristics, some mandate holders have been particularly successful in addressing human rights abuses by the most powerful countries (Gutter, 2007), something that is particularly necessary in dealing with global taxation. At the same time, the objective of special procedures mandate holders is not to sit in legal judgment of human rights violations, but rather to 'engage everyone concerned in the dialogue, to remind them of international human rights law and to offer them technical support and assistance to improve their situation' (Kirby, 2010: 509). Because of their flexibility and non-confrontational approach, special procedures mandate holders may be particularly well-suited to address issues that traditionally emphasize technical assistance and cooperation, and indeed have already contributed significantly to analysis linking human rights and issues of economic and human development (Biglino et al., 2012: 20). On a practical level, having a special procedures mandate devoted to a particular issue can be an important reminder of the human rights dimensions of that issue, can provide support for civil society groups doing relevant work, and can bring increased attention to the issue from both the media and from other powerful actors, particularly within the UN system (Kirby, 2010: 505–508).

Accordingly, a UN Special Rapporteur or Independent Expert on Taxation and Human Rights would help to expand and sustain global attention to these important issues and contribute materially to the development of solutions to this pressing global problem. Although other special procedures mandate holders have already begun this work, there is enough to be done and it is a sufficiently unique issue to occupy the work of a dedicated mandate. Ideally, the person chosen to fill such a role would be selected from among the few scholars who have both technical expertise in international taxation and a significant understanding of and commitment to human rights. Of course, the state members of the Human Rights Council, in creating such a mandate, would have to endow it with adequate resources, without cutting into the resources of the other essential mandates. If these conditions are met, such a mandate holder would be an important independent voice for a more just global tax order, with the intellectual and moral credibility to bring together numerous stakeholders, bridge gaps between disciplines and political blocs, and speak the truth regarding tax and human rights abuses to even the most powerful countries.

3.2.4 Using the Universal Periodic Review to Raise Issues Regarding Taxation

The Human Rights Council's Universal Periodic Review (UPR) process is a relatively new mechanism within the UN human rights system. It is a peer review system in which all UN member states are evaluated every five years regarding the fulfillment of their human rights commitments. Each country presents a report on its human rights situation, which is supplemented by two reports prepared by the UN's Office of the High Commissioner for Human Rights (OHCHR) – one based on observations from within the UN human rights system and one based on submissions from civil society. Other countries are then able to make recommendations to the state under review, which are 'accepted', 'noted', or 'rejected' by the state under review, and then catalogued in a final outcome report.

The key innovation of the UPR is that it is designed to be a cooperative dialogue between equals (Dominguez-Redondo, 2012). It is a 'non-confrontational, consensual exchange between peers' (Gujadhur and Limon, 2016: 6). Accordingly, the recommendations offered by reviewing states during the UPR process have a particular power. As Gujadhur and Limon (2016: 18) describe, 'While critiques delivered by civil society, OHCHR and UN independent experts … are important, a UPR recommendation delivered by one State to another, especially where the receiving State accepts that implicit criticism and counsel, is enormously powerful'. Early evaluations have shown positive results in terms of implementation of recommendations from the first cycle of the UPR, particularly by developed countries (Dominguez-Redondo, 2012). Gujadhur and Limon (2016), in a study of 74 states evaluated during the first UPR cycle, found that nearly 70 percent of accepted recommendations were fully or partially implemented. The UPR is intended to involve a holistic approach, incorporating all of a given country's human rights commitments, and there is space to raise development issues (Dominguez-Redondo, 2012). However, the recommendations evaluated by Gujadhur and Limon (2016: 34) did not deal with questions of state conduct in the global sphere. A search of the database maintained by the NGO UPR Info[2] reveals only one recommendation that touches on issues related to the global taxation system, a recommendation made by Norway and accepted by Iceland during the second UPR cycle that Iceland 'improve financial supervisory mechanisms to ensure better control and transparency in order to combat corruption and tax evasion'.

The UPR thus represents a significant but largely untapped opportunity to raise questions related to the justice of the international tax order and its impact on human rights. Civil society actors concerned with these issues could begin to raise them in shadow reports to the UPR process, just as they have in similar reports to the treaty bodies. And more states might follow Norway's example and raise questions of how the policies and practices of the country under review impact the global tax system. These recommendations can and should explicitly deal with states' conduct on the global stage as members of international organizations with extraterritorial human rights obligations. The UPR has enormous potential to play a role in the evolution of human rights norms (Dominguez-Redendo, 2012). What better forum is there than one where all UN member states meet to cooperatively discuss human rights issues to contribute to the forging of a human rights-based social and international order, including an international tax order?

4. Conclusion

The global tax system is just one example, but a very good example of how international structures can not only fail to facilitate, but actually impede the realization of human rights at the local level. The current global tax order is unfair and is not conducive to human rights, both in terms of the content of the laws and policies that determine global taxation rights, and the manner in which those laws and policies are shaped. By mobilizing the mechanisms provided in international human rights law around global tax issues, states and advocates can introduce a human rights dimension to international economic and political discourse, applying human rights law, principles, and methods. Using these tools offers a hope that the benefits of globalization may be more fairly distributed, and that we can truly forge a social and international order in which all human rights and fundamental freedoms are fully realized.

Notes

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2 www.upr-info.org/database/.

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