DRAFT REPORT

on tax avoidance and tax evasion as challenges for governance, social protection and development in developing countries
(2015/2058(INI))

Committee on Development

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(*) Associated committee – Rule 54 of the Rules of Procedure
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MOTION FOR A EUROPEAN PARLIAMENT RESOLUTION

on tax avoidance and tax evasion as challenges for governance, social protection and development in developing countries
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The European Parliament,

– having regard to the Declaration of Monterrey (2002), the Conference on Financing for Development in Doha (2008), the Paris Declaration (2005) and the Accra Agenda for Action (2008),

– having regard to UN General Assembly resolutions 68/204 and 68/279 on the Third International Conference on Financing for Development, to be held in Addis Ababa (Ethiopia) from 13 to 16 July 2015,

– having regard to the work of the UN Committee of Experts on International Cooperation in Tax Matters¹,

– having regard to the UN Model Double Taxation Convention on Tax Matters between developed and developing countries²,

– having regard to the Directive of the European Parliament and of the Council on the prevention of the use of the financial system for the purpose of money laundering and terrorist financing³,

– having regard to the Commission communication of 21 April 2010 entitled ‘Tax and Development, Cooperating with Developing Countries on Promoting Good Governance in Tax Matters’ (COM(2010)0163),


– having regard to its resolution of 21 May 2013 on the fight against tax fraud, tax evasion and tax havens⁴,

– having regard to its resolution of 8 March 2011 on tax and development – cooperating with developing countries on promoting good governance in tax matters⁵,

– having regard to its resolution of 10 February 2010 on promoting good governance in tax matters⁶,

¹ http://www.un.org/esa/ffd/tax/
– having regard to its resolution of 8 October 2013 on corruption in the public and private sectors: the impact on human rights in third countries¹,

– having regard to its resolution of 26 February 2014 on promoting development through responsible business practices, including the role of extractive industries in developing countries²,

– having regard to its resolution of 25 November 2014 on the EU and the global development framework after 2015³,

– having regard to its resolution of 13 March 2014 on the EU 2013 Report on Policy Coherence for Development⁴,

– having regard to Article 208 TFEU, which establishes eradication of poverty as the primary objective of EU development policy and the principle of policy coherence for development,

– having regard to Rule 52 of its Rules of Procedure,

– having regard to the report of the Committee on Development and the opinion of the Committee on Economic and Monetary Affairs (A8-0000/2015),

A. whereas illicit financial flows (IFFs), i.e. all unrecorded private financial outflows involving capital that is illegally earned, transferred or utilised, typically originate from tax evasion activities, trade misinvoicing and abusive transfer pricing, against the principle that taxes should be paid where profits have been generated;

B. whereas IFFs represent roughly ten times the amount of aid money received by developing countries for poverty alleviation and economic development, representing an annual illicit capital flight from developing countries of an estimated USD 1 trillion;

C. whereas taxation can be a reliable and sustainable source of development finance if there is a progressive taxation regime, an effective and efficient tax administration to promote tax compliance, and transparent and accountable use of public revenue;

D. whereas fair tax regimes provide vital finance to governments to cover citizens’ rights to basic services, such as healthcare and education for all, and whereas effective redistributive fiscal policies are essential in decreasing the effect of growing inequalities;

E. whereas the potential benefits of taxation go beyond the increase in available resources to foster development, but have a positive side-effect on governance and state-building by strengthening democratic institutions, promoting long-term independence from foreign assistance and allowing developing countries to assume ownership of their policy choices;

¹ Texts adopted, P7_TA(2013)0394.
F. whereas developing countries face major political and administrative constraints in raising tax revenues as a result of insufficient human and financial resources to collect taxes, weak administrative capacity to deal with the complexity of imposing taxes on transnational companies, lack of tax collection infrastructure, a drain of skilled personnel away from tax administrations, corruption, lack of legitimacy of the political system, an uneven distribution of revenues and poor tax governance;

G. whereas, comparatively speaking, developing countries raise substantially less revenue than advanced economies and are characterised by extremely narrow tax bases, and there is considerable potential for increasing the tax-to-GDP ratio, especially in the least industrialised countries (LICs);

H. whereas developing countries have been offering various tax incentives and exemptions, leading to harmful tax competition and a ‘race to the bottom’ that brings greater benefit to multinational corporations (MNCs) than to developing countries;

I. whereas many developing countries cannot attain even the minimum tax level necessary to finance their basic functioning, their public services and their efforts to reduce poverty;

J. whereas developing countries are heavily underrepresented in the existing structures and procedures of international tax cooperation, and do not participate on an equal footing in the current global processes seeking to redefine international tax rules, such as the OECD base erosion and profit shifting (BEPS) process;

K. whereas revenue raising can have an important role to play in rebalancing gender inequalities;

1. Calls on the Commission to put forward an action plan, in the form of a communication, on supporting developing countries in fighting tax dodging and setting up fairer tax systems, taking into account the work undertaken by the Development Assistance Committee of the OECD in advance of the Financing for Development Conference in Addis Ababa, Ethiopia, to be held from 13 to 16 July 2015, and the impact of international tax treaties on developing countries;

2. Insists that effective mobilisation of domestic resources and a strengthening of tax systems will be an indispensable factor in achieving the post-2015 framework that will replace the Millennium Development Goals (MDGs), which represents a viable strategy to overcome foreign aid dependency in the long term;

3. Stresses that tax avoidance and tax evasion represent a considerable financial loss for developing countries, and that taking appropriate measures at national, European and international level against these practices should be a top priority for the EU;

Action plan for the fight against tax avoidance and tax evasion in developing countries

4. Urges the Commission to support developing countries and regional tax administration frameworks in the fight against tax dodging, in developing fairer tax policies, in promoting administrative reforms and in order to increase the share, in terms of aid and
development, of financial and technical assistance to the national tax administrations of developing countries;

5. Asks the Commission to give good governance in tax matters and fair tax collection a high place on the agenda in its policy dialogue (political, development and trade) and in all development cooperation agreements with partner countries;

6. Urges that information on beneficial ownership of companies, trusts and other institutions be made publicly available in open-data formats, in order to prevent anonymous shell companies and similar legal structures from being used to finance illegal activities;

7. Calls on the EU and the Member States to enforce the principle that multinational companies must adopt country-by-country reporting (CBCR) as standard, requiring them to publish as part of their annual report on a country-by-country basis for each territory in which they operate the names of all subsidiaries, their financial performance, relevant tax information, assets and number of employees, and to ensure that this information is publicly available;

8. Welcomes the adoption of an Automatic Exchange of Information mechanism, a fundamental tool for enhancing global transparency and cooperation in the fight against tax avoidance and tax evasion; acknowledges, however, that support and time is needed for developing countries to build the required capacity to send and process information;

9. Urges the Commission and all the Member States, following the example of some Member States, to conduct impact assessments of European tax policies on developing countries, in order to strengthen policy coherence for development and remove practices that have negative spillovers on developing countries;

10. Stresses than when negotiating tax treaties with developing countries, source-country taxation rights should be preserved, and the UN Model Tax Convention should be preferred to the OECD Model Tax Convention in order to avoid a bias towards developed countries’ interests and ensure a fair distribution of taxing rights;

11. Urges the EU and the Member States to ensure that the UN taxation committee is transformed into a genuine intergovernmental body equipped with additional resources, ensuring that developing countries can participate equally in the global reform of existing international tax rules;

12. Stresses that gender analysis should be made central to tax justice;

13. Calls on the EIB to ensure that companies that receive EIB support do not participate in tax evasion via offshore centres and tax havens;

14. Instructs its President to forward this resolution to the Council, the Commission and the governments and parliaments of the Member States.
EXPLANATORY STATEMENT

I. Understanding revenue mobilisation of domestic resources in developing countries

Why is revenue mobilisation important?

Domestic resources are and will continue to be the largest source of financing for developing countries. Though they have been growing as share of GDP over the last decade, the average tax-to-GDP ratio in developing countries is still too low: in comparative perspective, developing countries raise substantially less revenue than advanced economies. The tax-to-GDP ratio in low-income countries (LICs) is between 10% and 20%, and in many such countries it is less than 15% (this is generally considered the threshold below which governments find it hard to finance their basic functioning and services). For OECD economies, it is in the range of 30-40%. Experts agree that there is considerable potential to increase tax collection: calculations by Oxfam in 52 developing countries showed that an additional 269 billion USD could be mobilised to finance public services if tax collection were significantly improved. It is therefore essential to ensure that domestic tax collection becomes more predictable, stable and robust, and that all parts of society - individuals and companies - pay according to their means.

What are the problems with existing systems?

- **Trade**: In developing countries, a disproportionate share of public resources come from trade, which is easy to tax but exposes budgets to volatile commodity prices and does not provide enough scope for expanding tax revenue. Developing countries are having difficulties in compensating for the decline in trade taxes resulting from the current global context of trade liberalisation, and in shifting to other types of domestic resources.

- **Informality**: Informality represents a constraint to revenue mobilisation, particularly in developing countries where it is a widespread phenomenon both in urban and in rural areas. The administrative costs of reaching the informal sector are potentially high, since by its nature it falls under the radar of tax officials, and having a large informal sector makes broad-based taxation of income next to impossible.

- **Political constraints**: Socio-economic interest groups are likely to lobby governments to obtain fiscal benefits and to exert continuous influence on officials working in tax policy and administration, thereby promoting corruption.

- **Administrative constraints**: Tax administrations have varying capabilities when it comes to enforcing law and ensuring compliance. Especially when countries need to impose taxes on multinational corporations (MNCs), the complexity of the challenge poses a serious obstacle to developing countries. The drain of skilled personnel away from tax administrations towards international organisations and private-sector firms, the lack of tax collection infrastructure, and the need to update IT systems are further examples of the challenges that face developing countries.
• **Economic constraints**: Developing countries can often count on only a small tax base. In countries where a large proportion of the population lives in poverty, a considerable share of GDP is not taxable. Due to low economic development, the industrial sector is typically underdeveloped while the agricultural sector is large, and taxes from the former are usually easier to collect.

• **Race to the bottom**: In recent years governments of developing countries have continually lowered corporate tax rates, and have offered various tax incentives and exemptions with the aim of attracting investors and fostering economic growth. However, evidence shows that these incentives are not an important driver of foreign investment. Such practices therefore put economies against each other, competing to offer the most favourable tax treatment. This ‘race to the bottom’ brings greater benefit to MNCs than to developing countries.

• **Extractive industries**: Issues related to how resource revenue is shared between investors and governments are crucial for developing countries. The fiscal treatment of mining investments varies widely across countries, and arrangements are often ad hoc and not very transparent, negotiated directly between politicians and companies outside the tax system and without clear guidelines. There is a high potential for corruption and for a lower share of revenue.

What are the consequences?

**Illicit financial flows** (IFFs) represent all unrecorded private financial outflows involving capital that is illegally earned, transferred or utilised. In 2011, domestic resources lost by developing countries to IFFs added up to over 630 billion USD, equivalent to 4.3% of developing country GDP (with LICs being particularly affected). Illicit flows are only one way that developing countries lose out on tax revenues from corporations. Abusive tax avoidance - where companies try to dodge taxes through complex internal structures and by finding loopholes in tax laws - is another significant problem. Taxes on corporate profits have been declining across the world. This affects developing countries in particular because they are highly dependent on corporate taxation: corporate tax revenues constitute a significant share of their national income.

Literature and data on this topic are scarce, and this is partly due to the fact that the extent of tax evasion and avoidance is hard to measure. Broadly, ONE estimate that at least 1 trillion USD is taken out of developing countries each year through a web of corrupt activity involving opaque deals for natural resources, the use of anonymous shell companies, money laundering, and illegal tax evasion. Global Financial Integrity have estimated that the developing world lost 6.6 trillion USD as a result of illicit financial flows from 2003 to 2012. Oxfam reported that the amount of unpaid tax liability faced by companies in developing countries is estimated at $104 billion USD per year. Actionaid have estimated that the typical corporate tax gap in developing countries (the difference between the actual tax collected and expected tax collected), due to tax avoidance and evasion, is around 20%.

**Relevant modes of tax evasion in developing countries:**
• **Misreporting and non-declaration** of personal income or corporate profits to circumvent direct income taxation or tax obligations.

• **Trade mispricing** through faked invoices between colluding exporters and importers serves as a common way to transfer money illegally from developing countries to financial accounts abroad, with the purpose of evading taxes.

• **VAT fraud**, which involves making false statements about business transactions subject to VAT.

• **Bribery** of tax officials.

**Relevant modes of tax avoidance in developing countries:**

• **Profit shifting**: refers to the legal exploitation of loopholes in the legislative tax code. Typically, subsidiaries of MNCs are treated as separate entities by tax authorities. Profit shifting can be achieved by manipulating transfer prices or exploiting intra-group loans. Apart from that, MNCs can distort transfer prices to reduce the group’s overall tax burden by manipulating the allocation of profits in particular high- and low-tax jurisdictions.

• The deliberate **choice of location for certain intangible assets** (patents, trademarks and copyrights) offers MNCs an opportunity to optimise their overall tax liability within the legal framework.

• **Tax incentives and exemptions** are, under certain circumstances (nepotism, corruption, low transparency) ‘tax evasion with an official stamp on it’. Tax incentives can not only enable foreign firms to avoid taxation, but can give rise to domestic companies’ illegal tax evasion activities, by re-labelling domestic investments as FDI (‘round-tripping’) or selling businesses to subsidiaries disguised as new investors as a means to become eligible for tax holidays that are exclusively granted to new investors (‘double-dipping’).

**II. Analysing existing solutions at a global level**

**Tax treaties between developed and developing countries**

Lost tax revenues can also be exacerbated by tax treaties, a key part of international tax regulation. Aiming at avoiding double-taxation, bilateral treaties allocate taxing rights between the two signing countries. As regards bilateral tax treaties between developed and developing countries, there is a general concern that developed countries manage to protect their interests better than developing countries. Secondly, because tax treaties have been used to lower taxation in cross-border financial transfers, they have become a key tool for transnational enterprises shifting their profits out of the countries where the profits have been earned, to jurisdictions where MNCs can pay little or no taxes.

Most of the world’s tax treaties are based on the OECD Model Tax Convention, which sets a framework for how to divide taxing rights between governments for companies that are based in one country (the residence country, most often a developed country) and operating in another country (the source country, often a developing country). Since the OECD Model Tax Convention was seen as favouring residence countries (i.e. OECD countries), another Model
Tax Convention was developed under the auspices of the UN, to ensure a more balanced approach to the allocation of taxing rights. However, many developed countries still insist on using the OECD Model when negotiating with developing countries.

**Action at the global level: the OECD - BEPS Action Plan**

The Action Plan on Base Erosion and Profit Shifting (BEPS) proposed by the OECD and approved by the G20 seeks to redefine international tax rules to curb profit-shifting activity, and ensure that companies pay taxes where economic activity takes place and value is created. Given the heavy dependence of developing countries on corporate taxation, the process could be highly beneficial to them. However, there are several reasons why this process, in its current state, will not deliver an outcome that leads to more progressive tax systems worldwide, or will not benefit developing countries:

- **BEPS is too narrow in scope**, and concentrates too heavily on rich country interests (OECD members). Its 15-actions plan fails to address a number of their key concerns (the problem of tax incentives for example) and progress on the actions most relevant to developing countries is still slow.

- Being **designed especially for developed countries**, developing countries lack the necessary legislative measures needed to address base erosion and profit shifting. They face difficulties in building the capacity needed to implement highly complex rules and to challenge MNCs, and their action is often hindered by a lack of information.

In terms of governance, the OECD is only accountable to its members, and the BEPS process fails to ensure appropriate representation and accountability. Developing countries have been consulted, but consultations on the side-lines cannot compensate for the lack of opportunity to participate on an equal footing.

**The need for an Action plan in the fight against tax avoidance and tax evasion in developing countries**

Given the importance of better mobilisation of domestic resources and the problems that developing countries face in tackling tax evasion and tax avoidance, the rapporteur suggests a list of strong recommendations that the EP should support, in view of the FfD Conference to be held in Addis Ababa and the range of existing international initiatives to reform the global tax system.

Among them, strengthening financial and technical assistance to developing countries and regional tax administration frameworks; the adoption of strong solutions to enhance transparency and cooperation in the fight against tax dodging, such as an Automatic Exchange of Information mechanism and country-by-country reporting, taking into consideration developing countries needs and constraints; the conduction at EU and Member States’ level of an impact assessment of tax policies on developing countries; the preservation of source countries’ taxation rights when negotiating tax treaties and the creation of a truly intergovernmental body where developing countries could participate on an equal footing in the global reform of existing international tax rules.