

Background Paper
The Learning Generation

Domestic Tax and Education

This paper was prepared for the International Commission on Financing Global Education Opportunity as a background paper for the report, *The Learning Generation: Investing in education for a changing world*. The views and opinions in this background paper are those of the author(s) and are not endorsed by the Education Commission or its members. For more information about the Commission's report, please visit: report.educationcommission.org.

ActionAid Research Report
for
The International Commission on Financing Global Education
DOMESTIC TAX AND EDUCATION

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EXECUTIVE SUMMARY

INTRODUCTION

Globally there are some fundamental challenges in education –with 121 million primary or lower secondary age children out of school (EFAGMR 2015) and 250 million children who are in school but not learning. The new Sustainable Development Goal on education establishes ambitious targets and to finance the achievement of these we need a radical shift, a rebuilding of confidence in the capacity of the governments to finance public education that is of good quality – and that can only come from a substantial scaling up of investment. Fundamentally education is a long term investment that requires predictable financing. It is not a short term, one-off, quick win. The major returns to investment in education accrue over 10 or more years (when a child completes their education and contributes to their society). The biggest single costs are recurrent costs – especially for teacher salaries. Aid is seen as both too short term and too unpredictable to cover such costs. We need systemic solutions and sustainable financing – features that are most closely identified with tax.

Tax is presently the major source of financing government’s education plans– even in highly aid-dependent low income countries. Many countries are coming close to achieving the benchmarks of “4-6% of GDP” and “at least 15%-20% of public expenditure being spent on education but still lack sufficient revenue and this means we need to pay more attention to the size of government budgets overall. Tax-to-GDP ratios are a widely used measure of tax collection and to build a state that can credibly provide universal education is likely to require at least a ratio of 20% - which many low income countries fall short of. Focusing on tax as source of revenue has other benefits – as well as raising predictable revenue it is a key means of redistribution of resources and reducing inequality. There are also major benefits in terms of building accountability – strengthening relations between citizens and state and encouraging better governance. Some forms of tax are “progressive” (put simply, where those with more, pay more as a proportion of their income) and some “regressive” (where those with more pay less as a proportion of their income). Whilst a case can be made for expanding revenue for education by any means there is a particular virtue to use a progressive tax base for progressive spending on education as this doubles the dose of inequality-reduction at a time when everyone from the Pope to the IMF are concerned to achieve this.

This report focuses principally on **corporate taxation**, partly because this has become the focus of a lot of international attention in recent years as illustrated by the OECD’s Base Erosion and Profit Shifting (BEPS) process and the G20 political impetus behind it, by the Africa Union’s High Level Panel on Illicit Financial Flows and by the growing popular movement calling for companies to pay a fair share of tax. This is also an area of taxation where there is a huge impact from tax avoidance strategies in developing countries - and which therefore represents a potentially significant means for scaling up financing of education. The \$39 billion resource gap for education could be more than filled by coordinated action in this one area! Our principal focus is on multinational corporations because domestic businesses are not usually offered the same tax incentives or holidays (which are mostly used to attract foreign investment), because MNCs have particular opportunities to avoid tax due to their international nature, and because a tremendous amount of money at stake. A progressive intervention in the area of tax justice should rightly start where the inequality is greatest – and this is particularly so when supporting education which has such a powerful equalising potential. In focusing on corporate tax and multinational companies we recognise that there are many ways in which the scope for domestic action depends, in part, on better **coordinated international action**. The international dimensions are picked up more comprehensively in the report by Steve Klees and Alex Cobham (to which we have made active inputs).

Increasingly the **education community is waking up** to the importance of action on tax, particularly in relation to multinational companies – and the Education Commission could play a ground-breaking role in taking this to the next level. There are **four sections to this report** which pick up on four key areas where action on tax could make a massive difference to the financing of education in the coming years. First of all

we look at **tax incentives** – revealing the vast revenue that is foregone by governments under the illusion that they need to give tax breaks in order to attract investment. Secondly we look at aggressive **tax avoidance** – again revealing the huge sums that are lost to education and other public services by increasingly common but unethical practices. Thirdly we look at **tax treaties** – revealing the extent to which many treaties are profoundly imbalanced, depriving developing countries of desperately needed resources. Fourthly we touch on **earmarked taxes** linked to corporates – as one of the other areas where progress could be made. We then draw out some conclusions and recommendations for action by governments, civil society, donors and the of course the finance commission itself.

TAX INCENTIVES

Strategically targeted tax incentives can play a crucial role in supporting national development but many **tax incentives cause far more harm than good in developing countries**. First, and most importantly, they can massively reduce government revenues by removing the requirement for companies to pay fair levels of tax. Second, they can encourage corruption and secrecy when negotiated in highly discretionary ‘special deals’ with individual companies. Third, they mainly attract ‘footloose’ firms which move their investments from one country to another, and therefore do not encourage stable long term investments. Fourth, where they favour foreign investors, they can disadvantage domestic investors and deter them from entering markets or expanding. Finally, they often require large resources to administer and are rarely transparently implemented. The ostensible reason for governments providing tax incentives to business is to attract foreign direct investment (FDI), yet the evidence, including the academic literature, suggests that tax incentives are not needed to attract FDI. There are four types of incentives that are particularly problematic: discretionary incentives, tax holidays, tax incentives in free trade zones and stability agreements.

There are no official estimates of global revenue losses from tax incentives. In 2013, ActionAid estimated that developing countries lose **US\$139 billion a year** just from one form of tax incentive – corporate income tax exemptions, or nearly US\$3 billion each week. In just over two months, if channelled to where it is most needed, this could fill the annual global finance gap for basic education. The IMF, AfDB and other reports on individual countries have estimated revenue losses from tax incentives as exceedingly high as a proportion of GDP, for example in Ghana (6 per cent – enough to double the education budget), Kenya (3.1 per cent – could increase education budget by half), Uganda (2 per cent – could double education spending), and Rwanda (4.7 per cent – could double education spending). In **Ethiopia**, tax incentives amounted to around US\$1.3 billion (4.2 per cent of GDP) in 2008/09. If Ethiopia devoted just 10 per cent of these revenues to basic education, then the country would have an additional US\$133 million available, enough to get approximately 1.4 million more children into school. There is a compelling case for governments to be much more targeted in the use of tax incentives and to make specific pledges to end harmful incentives and invest the revenue that is gained in financing education and other national development priorities.

TAX AVOIDANCE AND EVASION

Tax evasion occurs when individuals or companies break the law of any of the countries they operate in and it is, by definition, an illegal practice. Because of this, it relies fundamentally on concealing the existence of taxable income from the authorities, whether by non-disclosure or by active steps such as placing the proceeds in a secrecy jurisdiction. **Tax avoidance** is a term that is used to capture practices that, while not clearly violating the letter of the law, violate the spirit or intentions of the law. This report advocates for countries to place less emphasis on the technical and often obscure distinction between tax evasion and tax avoidance and continue developing an ethical notion of tax compliance, where individuals and companies actively work to ensure that they pay taxation in accordance with the spirit and intention of the law. Various examples are provided of approaches used to avoid tax compliance, including **transfer pricing manipulation** (where goods or services traded among different companies within the same group can be manipulated in order to shift money from one jurisdiction to another with lower tax rates), **transfer mispricing** (where deliberate and illegal steps are taken to artificially shift income and/or profits), excessive **interest deductions and thin capitalisation** (where guarantees are used to create excessive debt or where excessive interest

rates are charged on intra company loans), **trade misinvoicing** (which involves deliberately misreporting the value of a commercial transaction on an invoice submitted to customs), **artificially channelling funds through tax havens** (attracted by low rates and high secrecy) and **hybrid mismatches** (which depend on differences in the tax treatment of an entity or instrument in two or more jurisdictions that, working together, result in double non-taxation).

It is generally agreed that **tax evasion and avoidance have a significant impact in developing countries**, but it is very difficult to provide a precise estimate. Lack of data and the opacity surrounding most of these mechanisms make it necessary to use approximations and indirect approaches to measure the problem. The very lowest estimated figure for tax losses is US\$ 100bn annually and if 20% of this was spent on education, it would be enough to cover half of the global resource gap to get all children into primary and lower secondary school, estimated at US\$ 39 billion. To achieve progress there is an urgent need to: strengthen tax rules and systems in developing countries;; to change rules in developed countries where they affect developing countries; increase transparency and information exchange; and revamp corporate taxation at an international level.

TAX TREATIES

Tax treaties are bilateral or, less often, multilateral agreements that are ostensibly designed to prevent the double taxation of income that originates in one territory and is paid to residents – both individuals and companies - of another. Tax treaties are thus seen as an important piece in ensuring a fair taxation of multinational companies and have become increasingly important with the surge of cross border investments over the last few decades. The evidence that they attract investment into developing countries is unconvincing. While tax treaties are not explicitly designed to facilitate tax avoidance that is nevertheless sometimes the effect they can have. Most often it arises as result of weaknesses in the agreement, out-dated clauses or biased negotiation processes. For example, some treaties are very old, which means they were not designed to deal with the increasingly globalised and digital economy and, in some cases, reflect a different balance of power (e.g. from colonial times) at the time of negotiation. There are challenges that arise owing to the allocation of taxing rights (especially where “resident based taxation” – taxing a company where it is based - is preferred over “source based taxation” – tax paid where the economic activity occurs), owing to reductions of withholding taxes and owing to the differences between treaties (e.g. around definitions about what constitutes a taxable permanent establishment) that can be exploited for tax avoidance purposes. The lack of or inadequate anti-abuse clauses also create problems for developing countries

The IMF has estimated that non-OECD countries lose around US\$ 1.6bn a year as a consequence of US treaty provisions - in relation to dividend and interest payments alone. Similar research conducted in the Netherlands estimates losses of EUR 770m for developing in 2011 as a result of Dutch tax treaties. More recently, ActionAid has estimated that restrictions on Bangladesh’s ability to levy withholding taxes on dividend payments alone results in a revenue loss of US\$85 million annually. These estimates do not take into account the potential increase of risk avoidance and other indirect effects resulting from lower withholding taxes. The aggregated impact on developing countries could amount to billions of dollars a year. Any measure aimed at reducing the negative impacts of tax treaties on developing countries requires a cancellation or renegotiation of some harmful treaties.

EARMARKED TAXES

Earmarking is the process of assigning revenue from specific taxes to particular objectives, in this case education. Under a full earmark, the earmarked revenue is the only source of finance for the programme, while a partial earmark means that other financing also contributes. Earmarking may also be wide – covering a whole spending programme – or narrow – for a specific project within the programme. A distinction can also be made between 'soft' earmarking, whereby government policy (but not legislation) decides to allocate certain taxes to education, and 'hard' earmarking, whereby such expenditures are enshrined in law.

There are some examples of taxes earmarked for education – such as the Ghana Education Trust Fund (funded by 2.5% of VAT collections), the Nigeria Tertiary Education Trust Fund (to which national companies pay 2% of assessable profits), the Brazilian Fund for Maintenance and Development of Basic Education (partly financed by earmarking 15% of VAT revenues), China’s Educational Surcharge levied on VAT taxpayers at 3% of Consumption and Business Taxes; and India’s flagship education programme that is funded partly by an ‘education cess’ (a ‘tax-on-tax’ introduced on all Union taxes at the rate of 2 per cent). In any scenario where earmarked taxes are used for education there is a particular need to ensure that they are only one source of funding and that they are supplementary to existing allocations - generating genuinely additional revenue that would not otherwise be raised. One option here is setting a benchmark on existing tax allocations or spending on education, before introducing a new earmarked tax - so that it can be clearly seen (and tracked) that the earmarked tax is providing additional revenues.

The global agreement of an ambitious education SDG offers a particular moment when earmarked taxes for education may make sense. For example, many countries will need to ratchet up spending on education over the coming years in order to scale up public provision or early childhood education or to universalise access to secondary education. In such a case, even if there are concerns about permanent earmarking, a case could be made to introduce an earmarked tax initially with a limited (say ten year) timeframe – on the understanding that at the end of that period the economic returns that emerge from such investment in education will, by the end of the period, have enabled the government to raise more revenue through normal forms of taxation.

CONCLUSIONS AND RECOMMENDATIONS

The Education Finance Commission needs to be able to recommend ways to raise both significant and sustainable new financing to help countries achieve full implementation of all the targets in the education SDG. Short-term, one-off solutions will not represent a breakthrough. An extra billion or two will not make a lasting difference. Placing a strong focus on how to expand the tax base for financing of education offers the best prospect for delivering what is urgently needed – tens of billions of dollars in sustainable funding, year on year. Crucially, this also offers a way to provide sustainable financing that deepens rather than undermines the accountability of national governments to deliver on the right to education. The sustainable financing that could potentially be raised include startling sums:

- US\$139 billion a year from persuading Ministries of Finance and Revenue Authorities to end harmful tax incentives.
- US\$100 to US\$200 billion a year from promoting effective action to end aggressive tax avoidance in developing countries.

If education receives 20% of these sums (the present, widely accepted benchmark) then this will represent a dramatic breakthrough for financing the Education 2030 agenda. There is also scope to raise many more billions through earmarked taxes raised for education – for example linked to natural resource extraction or the profits of certain categories of companies.

This is an issue whose time has come. The furore around the world following the Panama Papers showed the widespread public and political support for reform. The Education Finance Commission should champion action on tax as the most effective single means to mobilise the tens of billions of dollars that are urgently needed. It is time for the negative cycle of lost revenue and low investment in education to be replaced by a positive cycle of expanding domestic tax revenue to invest sustainably in education that will yield the long term economic growth - that in turn will expand revenues further.

Concretely we make the following **recommendations**:

Developing country governments

- Stop offering harmful tax incentives (the four types outlined in this report) and only use other tax incentives selectively to facilitate truly strategic national development.
- Strengthen tax systems, including the legal and regulatory frameworks and capacities in revenue authorities.
- Adopt measures to protect their corporate tax bases, such as for example disallowing excessive tax deductions for corporations and requiring them to use simpler methods of transfer pricing
- Increase tax collecting efforts and promote reforms to build more progressive tax systems.
- Cancel or renegotiate disadvantageous tax treaties.
- Consider the case for new earmarked taxes to raise revenue for strategic new investments in education if this is a more feasible route to increase revenue for the social sectors than un-earmarked increases in general revenue. Develop partial earmarking over full earmarking where that is a feasible choice.
- Collaborate with other countries in their region to harmonise corporate tax rates and policies so as to avoid a race to the bottom.

Multi-national corporations

- Pay fair taxes in the countries where they are invested
- Commit to full transparency in tax affairs by voluntarily adopting country-by-country reporting
- Companies linked to the Global Business Coalition for Education should set a positive example by committing to and adopting these measures

Developed countries / Aid donors

- Provide more aid to strengthen tax systems, including national revenue authorities
- Harmonise efforts behind sector support to national education sector plans (e.g. through the Global Partnership for Education)
- Conduct 'spillover analysis' of their own tax systems and tax treaties, making changes that both disincentivise tax avoidance by MNCs operating in developing countries (for example through strong CFC rules and regulation of thin capitalisation, or by barring non-complying companies from bidding for government contracts) and redistribute taxing rights back to developing countries.
- Review and renegotiate tax treaties that are disadvantageous to developing countries (which are otherwise undermining aid efforts from the same country).

Civil society organisations

- Link national education coalitions with tax justice, health and social protection campaigners to build strong broad-based, rooted alliances demanding tax justice and progressive spending.
- Build awareness of national citizens about the injustices involved when a small shopkeeper or landless labourer is paying tax but the largest multinational companies are not.
- Make the case for increasing 4 S's – the **share** of the budget for education, the **size** of the budget overall, the **sensitivity** of the budget (especially to equity concerns) and the **scrutiny** of the budget,

All governments

- Create a fully empowered, globally-inclusive and well-resourced inter-governmental body on tax – that is able to set and enforce fair global rules on tax avoidance, and consider new ways of doing corporate taxation such as a unitary system.
- Support international rules on tax transparency: public country by country report, public registries of beneficial ownership and automatic exchange of information among tax authorities.
- Support the creation of a global public registry of financial wealth.

1. INTRODUCTION

THE CHALLENGE OF PREDICTABLE FUNDING

- 1.1 Globally there are some **fundamental challenges in education** –with 121 million primary or lower secondary age children out of school (EFAGMR 2015) and 250 million children who are in school but not learning. The new Sustainable Development Goal on education establishes ambitious targets around universalising primary and secondary education of good quality, ensuring access to early childhood education, advancing technical and vocational education, youth and adult literacy. Current resources for education in developing countries are stretched and the effects of this include a decline in people confidence in public education, an increasing fragmentation of provision and the spread of for-profit fee-charging schools – with worrying impacts on equity and quality. This presents serious challenges for those who believe in the fundamental equalising power of education. Parents living in poverty around the world see education as the key passport to social mobility for their children. If we want to create more equal and fair societies, education is the bedrock. Today we need a radical shift, a rebuilding of confidence in the capacity of the governments to finance public education that is of good quality – and that can only come from a substantial scaling up of investment. Piecemeal change will not do.
- 1.2 Education is a **long term investment that requires predictable financing**. It is not a short-term, one-off, quick win. The major returns to investment in education accrue over 10 or more years (when a child completes their education and contributes to their society). This is a major challenge in a world that overwhelmingly makes short and medium term investment decisions, driven by Medium Term Expenditure Plans (supported by the IMF) and the political demands of electoral cycles. For some Ministries of Finance, education seems like a bottomless pit of spending which yields no returns as there is no mechanism in conventional finance projections to factor in longer term returns. *[We recommend that the Finance Commission explores ways to help Finance Ministers factor in long-term economic returns to education and the costs of inaction – but that is outside the scope of this paper.]*
- 1.3 Another fundamental reason why education requires predictable financing is that the biggest single costs are **recurrent costs** – especially for teacher salaries. To achieve the first target of the SDG, universalising access to primary and secondary education, will require the employment of millions more trained teachers. The quality of a country's education system depends on the extent to which the country has committed to ensuring all its teachers are trained, qualified and motivated. Multiple studies have demonstrated that teachers – and the level of teacher knowledge about their subject – are the most important determinant of education quality. UNESCO estimates indicate that around half of teachers in Africa, for example, have had no training, while other studies show that teacher salaries have approximately halved in real terms over the last 40 years. Data shows that in one-third of all countries, less than 75% of teachers have been trained according to national standards. But not all potential sources of finance are suitable for addressing the challenge of deploying more teachers; for example, aid budgets rarely cover teacher salaries – except in the case of general or sector budget support – because aid is seen as both too short term and too unpredictable. Governments are reluctant to employ a teacher with such funding as they are aware of need to continue paying the salary long after the end of a particular aid project. This is also a problem with many other innovative financing mechanisms which may offer short-term funding but struggle to guarantee sustainable financing over decades. There are of course additional challenges that arise with any innovative funding based on loans (given the renewed debt-repayment challenges faced by many developing countries) or funding that depends on charging fees (given the known impact these have on equity and exclusion in education) The big education challenges need systemic solutions and sustainable financing – features that are most closely identified with tax.

TAX: THE KEY SOURCE OF FINANCE FOR EDUCATION

1.4 The need for predictability means **tax is presently the major source of financing government education plans**– even in highly aid-dependent low income countries. In most countries, of course, it always has been. Interestingly, according to sample of government budgets in 2014, domestically raised revenues account for, on average, well over 86% of overall education sector spending in the budget, and 90% of spending on primary schooling – compared to only 74% of spending in health or 57% in agriculture, and only a quarter in the water and sanitation sector¹. This may be partly because other sectors attract more aid but it is also because other sectors are more able to absorb short term unpredictable funding, especially in more "capital heavy" sectors such as the water sector. It is also interesting to note that government spending on education as a proportion of the total education budget has risen between 2012 and 2014, whilst aid money has been falling. The fall in donor funding has been much larger in education than many others sectors over the same period. This suggests that governments are currently filling the gaps left as aid retreats from education. But the SDG commitments require much more than gap filling, and with no foreseeable increase of aid for education on the horizon, this is going to entail significant new domestic resource commitments.

1.5 When looking at domestic budgets, education advocates have spent many years focusing on the **share or percentage of national budgets** being spent on education. The Incheon Framework for Action recommends governments spend “at least 4-6% of GDP” and “at least 15%-20% of public expenditure to education”, with a recognition that developing countries “need to reach or exceed the upper end of these benchmarks if they are to achieve the targets”. Presently countries allocate an average of 5% of GDP and 11.7% of budgets - and so there are certainly many countries where allocating a greater share of existing revenue to education could make a significant difference. However, there are also many countries that are close to reaching these percentages but still far from having sufficient funding for education. Arguments could be made for allocating an ever higher share of budgets to education (especially given the extraordinarily high returns to education - that cross-cut the wider SDG agenda²) but there are always dangers of robbing Peter to pay Paul – taking money from another sector like health or water or agriculture to pay for education – which does not help with achievement of the full SDG framework. In this scenario the major problem is not shares spent on education but the overall size of budgets – governments simply do not have sufficient revenue to draw from.

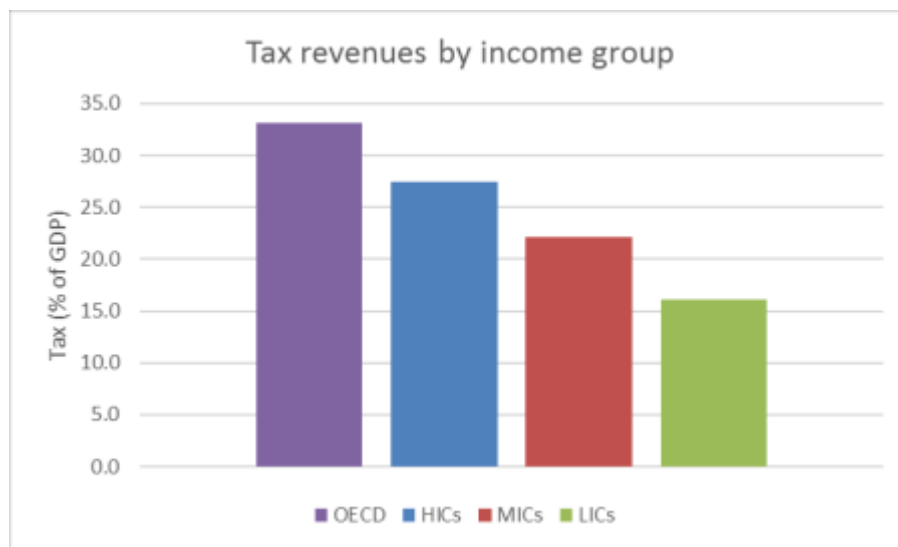
1.6 The key then is to look at the size of government budgets overall. **Tax-to-GDP ratios** are an imperfect but widely used measure of tax collection³, offering some indication of the potential for countries to raise more revenue. Thomas Piketty observes that countries with very low tax to GDP ratios are effectively “Regalian states” – only able to serve ceremonial functions – and that the vision of a “social state” depends on higher tax to GDP ratios. The UNDP suggests a benchmark of a minimum 20% for all

¹ This is drawn from Government Spending Watch - www.governmentspendingwatch.org/spending - 2014 planned government spending data. Government Spending Watch uses official government budget documents to track spending on education. The 2014 data includes governments planned spending in 56 developing countries, and includes the vast majority of LICs (90%) and most LIMCs (around 70%), and a lesser amount of UMICs. It should be noted that not all countries allow a breakdown of their education (or other sector) spending into government and donor splits, so this is only from a smaller sample of the data available for 56 countries. It should also be noted, as GSW analyses government budget documents this, therefore, only includes aid which is "on-budget" and planned for using government systems and sector plans (I.e. donor funding which is in support of government education plans and not in the form of GBS).

² See Global Partnership for Education : “17 ways education influences the new 17 global goals.” <http://www.globalpartnership.org/blog/17-ways-education-influences-new-17-global-goals>

³ GDP figures in some LICs are unreliable. There are dangers that simply setting targets to increase tax-to-GDP ratios may lead tax authorities to prioritise those taxes that are easier to collect (e.g. indirect taxes) in order to hit the target.

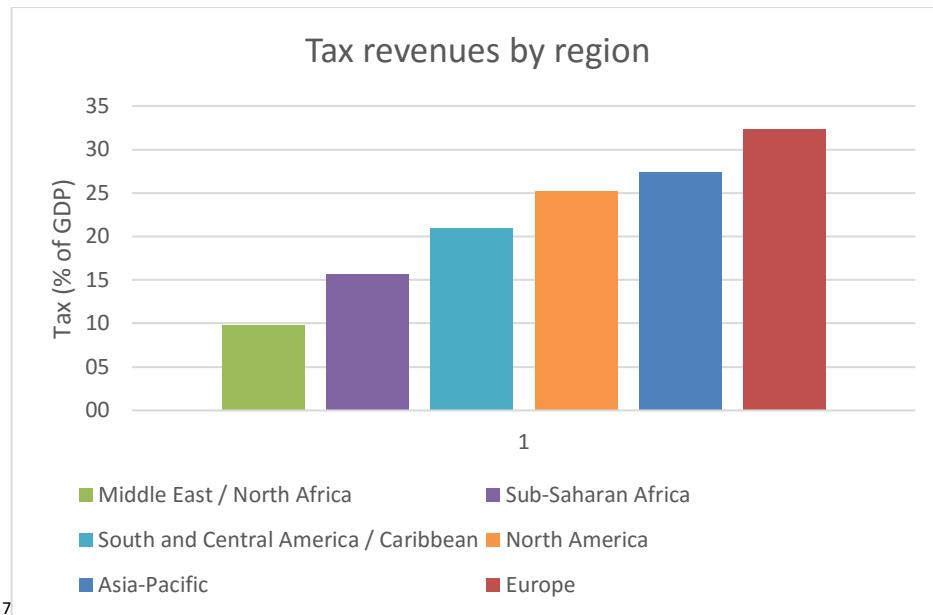
countries.⁴ Currently, tax revenues in low- and middle-income countries fall short of both what is needed and of the levels in richer countries. Indeed, higher-income countries tend to have higher tax ratios: the average tax-to-GDP ratio in OECD countries is 33% of GDP in taxation; compared to 16% of their GDP in low-income countries and 23.8% in lower-middle income countries.⁵ These differences are for clear reasons, the main one being related to the different structure of the economies. There are also regional contrasts (an average of 21% in Latin America and 16% in sub-Saharan Africa) but these regional and income groups also mask vast differences in overall levels across individual countries, with some countries having remarkably low rates, such as Bangladesh and Pakistan both collecting only around 10% of their GDP in taxes. The high levels of variability between countries⁶ show that government policies and practices can make a marked difference to the tax take.



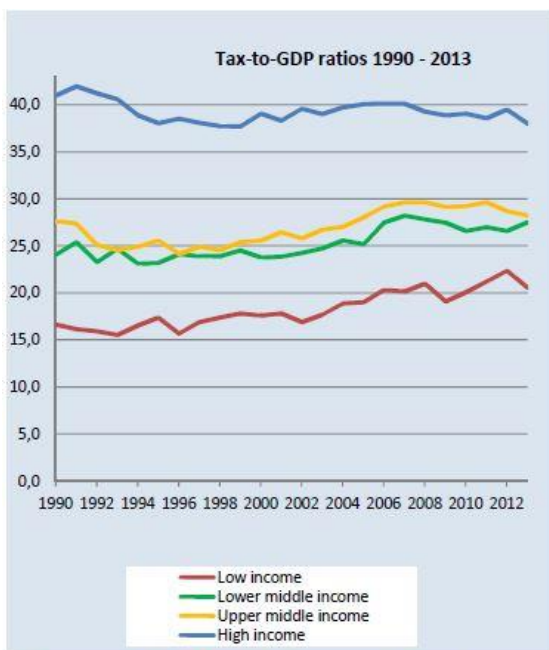
⁴ <http://www.oecd-ilibrary.org/docserver/download/4314031ec011.pdf?expires=1459000571&id=id&accname=guest&checksum=2901C0B5353D561BC02E764BB527D181>

⁵ All figures in this paragraph are based on the analysis of the Heritage Foundation online database. See: <http://www.heritage.org/index/explore?view=by-variables> Income groups as per the World Bank classification, see: <http://data.worldbank.org/about/country-and-lending-groups> There are other datasets like ICTD which use slightly different measures though overall patterns are similar <http://www.ictd.ac/datasets/the-ictd-government-revenue-dataset>

⁶ See for example figure 2 in "Global Taxation: Financing Education" the report by Klees et al for the Education Finance Commission, March 2016



It is also useful to look at trends. Though the table below⁸ is based on a different dataset it reveals an overall increase in tax to GDP in low income countries in the past twenty years, showing that there is scope for increases in revenue.



Source: FAD World Revenue Database

1.7 Focusing on **tax as source of revenue has other benefits** – as well as raising predictable revenue it is a key means of redistribution of resources and reducing inequality⁹. There are also major benefits in terms of building accountability – strengthening relations between citizens and state and encouraging better governance. This is particularly the case for education – as the school is often the most visible outpost of

⁷ Tables prepared by Javier Pereira based on Heritage Foundation data

⁸ From Fiscal Affairs Department of IMF – again a different dataset is used but the trend is clear

⁹ Arguably this is a definitive role of the state. Even the IMF who now acknowledge that severe inequality damages economic growth (see for example <https://www.imf.org/external/pubs/cat/longres.aspx?sk=42986.0>)

the State in rural communities and people's relationship with it is different if they feel that they are paying for it (through tax) than if they believe it is the produce of sheer benevolence by those in power. Indeed, there is a double accountability benefit – making citizens expect more in return for paying taxes and making governments feel they need to account to their citizens. Such a connection is not so easily achieved through aid or other financing mechanisms – and it is a real added value for education because there is a strong connection between accountability and quality in schools¹⁰. Part of this accountability benefit depends on citizens being aware of being taxpayers and this is not always universal, for although almost everyone is a tax payer, many are paying 'invisible taxes' such as value added tax. There are also benefits that come from funding through tax not aid for Ministries of Education at a national level - increasing the capacity for self-determination, enabling countries to determine their own education policies and not be vulnerable to the fads or (sometimes ideological) agendas of donors. Finally, there are two ways in which a positive cycle is at work when you use tax to finance education. Firstly, a more literate population¹¹ is linked to a widening of support for paying tax¹² and secondly, investing in education will yield, over time, significant economic growth (which will thus lead to a further expanded tax base).

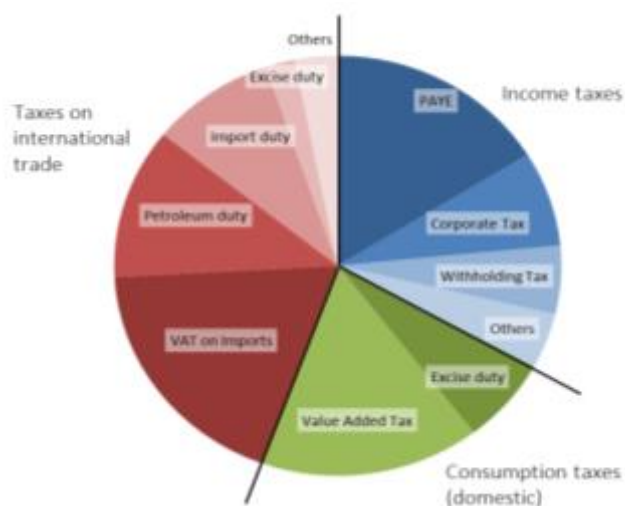
APPROACHES TO TAXATION IN DEVELOPING COUNTRIES

1.8 There are many different **types of tax**, some of which are direct (taxes of companies and individuals on their labour or investment income or wealth - which are paid directly) and some are indirect (on transactions or sales, like VAT - that are borne by the final consumer – or trade taxes like customs and excise linked to imports or exports). Another way of looking at this is that there are seven 'universal' types of taxation: on income, employment, consumption, profits, property, inheritance and industrial processes. There are also important non-tax revenues available for governments in some cases, particularly to natural-resource exporting countries, for example from mining royalties. These are not the subject of study in this research but this is another area where the Finance Commission may wish to explore. The pie chart below, for **Uganda**, illustrates the main elements in the tax base of one developing country (though of course there are different balances in different country contexts).

¹⁰ The role of accountability in education will be explored in full in the 2017 Global Education Monitoring Report: <https://gemreportunesco.wordpress.com/2016/03/09/consultation-now-open-for-the-2017-gem-report-accountability-in-education/>

¹¹ "As educational attainment rises, countries make greater use of taxes that require widespread literacy—individual income taxes and domestic goods and sales taxes—and rely less on payroll and trade taxes that have less demanding literacy requirements". <http://http-server.carleton.ca/~winers/papers/Kenny-Winer%20TAX%2013%202006.pdf>

¹² For the impact of literacy on tax revenues: <http://www.economics-ejournal.org/economics/discussionpapers/2013-63> There is also a reasonable hypothesis (to be fully tested) that more literate populations are more likely to work in more formal employment and thus be more easily taxed than those in the informal sector. There is little published material on this but for further work in this area see Asma Zubairi, formerly at EFAGMR and now at REAL in Cambridge.



1.9 Some forms of tax are “**progressive**” (put simply, where those with more, pay more as a proportion of their income) and some “**regressive**” (where those with more pay less as a proportion of their income). An income tax which is set in different bands (so high earners pay 60%, mid-level 40% and low earners pay 20%) is progressive, whereas VAT, if there are no exemptions made for basic goods, tends to be regressive.¹³ To some extent one might argue that any increase in tax, whether through progressive or regressive means, is acceptable, if the revenue is spent progressively on basic education. Indeed, expanding revenue through VAT might be considered acceptable if this is then spent on basic education as overall this would be powerfully redistributive¹⁴. This is especially worth considering when it is remembered that indirect taxes such as VAT raise revenue much more quickly than direct ones. But not all spending on education can be seen in this way. Investment in higher education sometimes benefits a privileged elite (unless equal access is promoted including at earlier levels of education) and thus can be seen as regressive. But ideally, progressive spending on education should be financed through progressive tax so there is a double dose of reducing inequality. This is particularly urgent given the growing concerns about the negative impact of inequality as expressed by everyone from the IMF to the Catholic Pope to Oxfam.¹⁵

1.10 The ‘**tax consensus**’ in developing countries for the last two to three decades has been dominated by the advice provided by the IMF and the World Bank and these agencies have paid little regard to what is progressive or regressive until recently¹⁶. The policy trend since the 1990s has been to liberalise trade, and therefore reducing trade taxes. The economies of many low-income countries have been built

¹³ Some exemptions can make VAT progressive. As education advocates there is a particular case we might make for VAT exemptions to go beyond traditional items like food and fuel to include school equipment and sanitary pads etc.

¹⁴ Imagine a population of 5 (or 5 million if you prefer) where the 5 individuals / quintiles earn 1,000, 2,000, 3,000, 4,000 and 10,000. The taxation is all from indirect taxation and all pay 20% of income (so the tax rate is flat not progressive). The total taxation revenue is 4,000 (20% of 20,000). The government then spends an equal amount on basic education (or other essential services) for each citizen amounting to 800 each (4,000 total tax divided by 5). The net effect is that income (including the financial benefit of services) after tax is:

- lowest earner 1,000 income - 200 tax + 800 education / services = 1,600
- highest earner 10,000 income - 2,000 tax + 800 education / services = 8,800

This shows simply that even a flat tax, spent progressively can reduce income inequality (an initial 1:10 ratio reduced to nearly 1:5). However, a progressive tax spent progressively would of course reduce income inequality even more rapidly (e.g. in this example if there was 40% tax on higher income then higher earner ends up with 6,800 - about 1:4).

¹⁵ See Global Taxation: Financing Education - Klees et al 2016 “*economic inequality represents a major threat to the achievement of the SDGs, imposing costs across a whole range of outcomes: from poorer physical and mental health (Pickett & Wilkinson, 2015), to worse prospects for sustained economic growth (Ostry et al., 2014), and worse outcomes for women and girls (Gonzales et al.2015).*”

¹⁶ Some recent work by the IMF recommends more attention to progressivity of tax e.g. Benedict Clements, Ruud Mooij, Sanjeev Gupta, and Michael Keen, (2015) *Inequality and Fiscal Policy*, International Monetary Fund, <http://dx.doi.org/10.5089/9781513531625>

on commodity exports, with a high ratio of exports to GDP, so trade taxes were previously an important source of revenue. The IMF particularly recommended replacing the lost revenue through indirect taxation, usually VAT, which is relatively easy to collect (partly because it depends on self-enforcement by traders and partly because it is less visible to those paying it). So, over the last few decades VAT has been introduced rapidly in a large number of low-income countries which has often added to the 'regressive' nature of many tax systems¹⁷ - although it is true that it is likely to have been the quickest way to replace the revenue. The fact that many people paying VAT are not conscious of paying taxes, potentially affects people's relationship with the State and their confidence (as tax payers) in holding public services to account. The IMF has not shown the same enthusiasm for expanding corporate tax or promoting progressive forms of income or wealth taxes, although they have recently started to explore these areas much more actively.¹⁸

TAX CHALLENGES IN DEVELOPING COUNTRIES

1.11 There are some **serious challenges in raising more tax revenue in developing countries**. First and foremost, the structure of the economy with many very poor people means there may be relatively few potential direct taxpayers. Many people are on incomes below the threshold to pay income tax, so that compared with a high income country the tax base simply does not exist in the same way. Furthermore, many earn their income in the **informal sector**. This sector appears to have potential as a source of tax revenue in developing countries as it represents, for example, an average of 38% of the GDP in Sub-Saharan Africa¹⁹ - a perception that is further reinforced by a strong negative correlation between tax revenue and informal activity.²⁰ However, the tax revenue potential of the informal sector in developing countries is likely to be significantly lower than what its contribution to the GDP of a country suggests. Average incomes in the informal sector are generally low and the costs of collection can be very high as a result of the number of actors to be controlled.²¹ Moreover, the informal sector comprises a large number of economic activities, some of which are harder or more appropriate to tax than others (and in some cases the cost of collecting the tax may exceed the returns). Some efforts to formalise or tax the informal sector can end up being highly regressive - and it is important to prioritise those parts of the sector that are most able to pay, such as unregistered businesses with multiple employees, rather than targeting of, for example, traders earning subsistence wages (many of whom are women).²² Positive incentives (such as increased access to credit or business services) are important in encouraging informal sector actors to register for tax - and one increasingly compelling reason for seeking to formalise / regulate the sector is that in some developing countries, high income companies and individuals may deliberately informalise their operations to avoid paying higher corporate or income taxes (as appears to have happened in Mozambique in 2002)²³.

¹⁷ The IMF have suggested that VAT, even without exemptions, is more progressive than trade taxes, since the incidence of tariffs on imports falls on the consumers of those imports. See for example Mick Keen, 2012, "Tax and development - Again", IMF working paper WP/12/220

¹⁸ IMF (2014) - Spillovers in International Corporate Taxation

¹⁹ Schneider, F.; Buehn, A. & Montenegro, C. E. (2010). Shadow Economies All over the World New Estimates for 162 Countries from 1999 to 2007. Policy Research Working Paper 5356, World Bank

²⁰ Woodruff (2013). Registering for Growth: Tax and the Informal Sector in Developing Countries. The CAGE-Chatham House Series, No. 7, July 2013

²¹ Joshi, A.; Prichard, W. & Heady, C. (2014). Taxing the Informal Economy: The Current State of Knowledge and Agendas for Future Research, The Journal of Development Studies, 50:10, 1325-1347

²² However, regulating the informal sector is still worth considering in some contexts as part of a carefully sequenced process of tax reforms (after the bigger actors are paying tax fairly). In addition to the modest revenues this could generate, it is also important to consider other effects, such as creating a culture of compliance. Other potentially positive effects of formalisation include better access to credit, which can in turn contribute to the company's growth, and improvements in labour contracts and relations. Formalisation is a difficult but not insurmountable task. Successful examples from developing countries already exist. Some examples include the development of 'associational' taxation in Ghana, the introduction of highly simplified tax regimes in Mozambique and Tanzania and the incentives offered to tax registered businesses in Malawi.

²³ See World Bank report from 2006

<https://www.google.co.mz/url?sa=t&rct=j&q=&esrc=s&source=web&cd=5&cad=rja&uact=8&ved=0ahUKEwiMg->

1.12 There are also challenges around **the politics of extending taxation**: it can be complex, challenging and take time. There are of course diverse ways of expanding the tax base, for example through progressive taxes on income, property or wealth. Indeed, there is particular potential in taxes on land and property which are tangible assets that it is difficult for anyone to hide – and we would recommend further research into this area, but it is not within the main scope of this report²⁴. Taxes on income or capital can be more challenging as the wealthy elite will often export their money out of the country, attracted by the low tax and high secrecy offered by the worryingly extensive market of tax havens around the world²⁵. Whist tax havens operate with impunity the more progressive an income or wealth tax is in a particular country, the greater the likelihood of money being hidden²⁶. It is estimated that \$189 billion is lost in annual tax revenues as a result of individual wealth being hidden offshore²⁷. This is an area where international cooperation and coordinated global action is required to prevent abuse (something picked up in the companion report by Alex Cobham and Steve Klees). There are of course other challenges associated with trying to introduce a progressive tax on income, wealth or property in many countries – arising from the capture of political power by the very same wealthy elites who one would seek to tax. This should not prevent attempts at reform – and some political contexts will indeed favour such reform – but it is important to acknowledge the challenges in other contexts.

1.13 Another serious challenge in developing countries is around the **capacity of tax revenue authorities and Ministries of Finance** – particularly their capacity to prevent avoidance (including by national elites). Often countries lack the technical and human resources to enforce existing regulations or develop new ones. External support to developing countries tax authorities is essential to make substantial advances in the fight against tax avoidance. Some estimates suggest that each US\$ 1 of aid invested in tax authorities in developing countries can generate up to US\$ 350 in tax revenues. But until very recently, only 0.1% of aid flows pursued this objective.²⁸ This is changing slowly: under the Addis Tax Initiative, donors commit to doubling their aid for tax capacity building and some donors such as DFID have set up capacity building units to support tax authorities in developing countries;²⁹ international initiatives such as the OECD’s Tax Inspectors Without Borders have been launched³⁰ and there are plans to introduce a new code for tax capacity building in OECD DAC reporting. Although these developments suggest the international community is taking steps in the right direction, information has yet to emerge as to the real scale and impact of such programmes³¹ and they do not in themselves address those problems in

[H6kdfLAhXHvBoKHXOnCygQFgg0MAQ&url=http%3A%2F%2Fwww.tipmoz.com/%2Flibrary/%2Fresources/%2Ftipmoz_media/%2Fcat3_link_1154956105.doc&usg=AFQjCNHGnX0WKqoaMCJWRTYTk_WXNSf7DA&sig2=YDPiHb0V1xOY6aLX3aeHew&bvm=bv.117218890,d.ZWU](http://www.tipmoz.com/%2Flibrary/%2Fresources/%2Ftipmoz_media/%2Fcat3_link_1154956105.doc&usg=AFQjCNHGnX0WKqoaMCJWRTYTk_WXNSf7DA&sig2=YDPiHb0V1xOY6aLX3aeHew&bvm=bv.117218890,d.ZWU) (page 8 on manufacturing, page 13 on registration),

²⁴ A recent OECD report observes “*recurrent taxes on immovable property [are] the least harmful tax*” .
<http://www.oecd.org/ctp/tax-policy/46617652.pdf>

²⁵ See Cobham, A.; Klees, S. (2016) Global Taxation: Financing Education and other SDGs – section 3.2 “Former African Development Bank chief economist Léonce Ndikumana and his co-author James Boyce have produced a series of estimates of the stock of African flight capital offshore since the 1970s, most recently for an important new volume produced by the African Economic Research Consortium. They estimate that the stock of flight capital built up between 1970 and 2010 for 39 African countries and held offshore is approximately \$1.3 trillion, or 82% of those countries’ 2010 GDP. In contrast, the stock of external debt stood at \$283 billion – so the scale of hidden African wealth offshore is estimated to exceed recorded external debt by a ratio of more than four to one.”

²⁶ Interestingly personal income tax is more widely used in more democratic countries , in part as it depends on some level of voluntary cooperation – see <http://http-server.carleton.ca/~winers/papers/Kenny-Winer%20ITAX%2013%202006.pdf>

²⁷ Cobham, A.; Klees, S. (2016) Global Taxation: Financing Education and other SDGs; p.16.

²⁸ OECD-DAC (2012). Tax and development: aid modalities for strengthening tax systems. OECD, Paris.

²⁹ See the following report from the UK Parliament: <http://www.parliament.uk/documents/commons-committees/international-development/GovernmentupdateIDCreportonTaxinDevelopingCountries.pdf>

³⁰ See: <http://www.oecd.org/tax/taxinspectors.htm>

³¹ There are however some reservations about recommending that aid from wealthy countries to low income countries should strengthen tax systems – as it can appear hypocritical. Many of the challenges that developing countries face arise from the fact that global tax rules and policies are out of date, unfair, unnecessarily complex and designed to benefit richer countries, facilitating systematic tax dodging by foreign companies that are often based in the richer countries

tax collection which arise not from lack of capacity within developing countries but from the complexity and opacity of international taxation.

BUILDING ON THE EDUCATION FOR ALL GLOBAL MONITORING REPORT³²

The Education for All Global Monitoring Report documented in 2014 that if governments in 67 low and middle income countries modestly increased their tax-raising efforts and devoted a fifth of their budget to education, they could have raised **an additional US\$153 billion for education** spending in 2015, or 72 per cent as compared to 2011, increasing the average share of GDP spent on education from 3 to 6 per cent by 2015. Spending in Africa would have increased by over US\$27 billion. These additions to domestic resources could have financed over half the US\$38 billion annual financing gap in basic and lower secondary education for 46 low and lower middle income countries. This increase would have more than doubled education spending per child, from US\$209 per year to US\$466 per year.³³

The example of Brazil and India is instructive here. **Brazil** has managed to go further in improving education quality and narrowing learning inequality in recent years, while India has done very little to improve terrible results in the public education sector. Brazil, the world's seventh largest economy, has made huge improvements in tax revenue collection in the past decade – in 2015 this stood at around 30 per cent of GDP – and the government has also prioritised education in the budget, spending 18 per cent. This has helped to raise expenditure for every primary school pupil to US\$2,218. By contrast, **India**, the ninth largest economy in the world, only collects 16 per cent of GDP in taxes, and devotes just 10 per cent of the government budget to education: therefore, it spends only US\$212 per primary school child.

Giving country examples, the Education for All Global Monitoring Report noted that, in **Pakistan**, tax revenue is just 10 per cent of GDP and education receives only around 10 per cent of government expenditure. If the government increased its tax revenue to 14 per cent of GDP by 2015 and allocated one-fifth of this to education, it could raise sufficient funds to get all of Pakistan's children and adolescents into school.³⁴

WHAT THIS REPORT IS ABOUT

1.14 This report focuses principally on **corporate taxation**. There are several reasons for this³⁵. Firstly, this has become the focus of a lot of international attention in recent years as illustrated by the OECD's Base Erosion and Profit Shifting (BEPS) process and the G20 political impetus behind it, by the Africa Union's High Level Panel on Illicit Financial Flows and by the growing popular movement calling for companies to pay a fair share of tax. This is also an area of taxation where there is a huge impact from tax avoidance strategies in developing countries - and which therefore represents a potentially significant means for scaling up financing of education - if the right attention is brought to the issues by the Finance Commission. The \$39 billion resource gap for education could be more than filled by coordinated action in this one area (even if education received just a 20% share of the increased revenues)! There is also added momentum to action on corporate taxation that arises from the sense of injustice that can be galvanised, for example in cases where a landless labourer may be paying more tax than a major multinational company. There was an overwhelming response to ActionAid's report on SAB Miller when campaigning focused on the story of a local woman running a bar in Accra, outside the largest brewery in

³² Now the Global Education Monitoring (GEM) Report

³³ Education for All Global Monitoring Report, 'Increasing Tax Revenues to Bridge the Education Financing Gap', *Policy Paper 12*, March 2014, pp.6-7, <http://unesdoc.unesco.org/images/0022/002270/227092E.pdf>

³⁴ Education for All Global Monitoring Report, 'Increasing Tax Revenues to Bridge the Education Financing Gap', *Policy Paper 12*, March 2014, p.1, <http://unesdoc.unesco.org/images/0022/002270/227092E.pdf>

³⁵ One reason not explored in detail here is that it is administratively cheaper for developing countries to raise corporation tax than other taxes See p 29 of <http://http-server.carleton.ca/~winers/papers/Kenny-Winer%20ITAX%2013%202006.pdf>

her country – and it was revealed that she paid more tax on selling the beer in her bar than the entire brewery did. That report, which revealed the same pattern across the continent, led to new coordination agreements between revenue authorities across 8 African countries - who woke up to the shocking scandals involved. Indeed there is a growing recognition of the ethical dimensions around corporation tax, especially relating to multinational companies: that foreign direct investment should not lead to a purely extractive relationship - and that generating increased tax revenues to invest in public services (which the companies themselves indirectly depend on) is one of the most important national benefits that should accrue.

1.15 The dominant focus of this report is on **multinational companies** rather than domestic industries. In general domestic businesses are not offered the same tax incentives or holidays (which are mostly used to attract foreign investment) – where there are particularly extreme anomalies. The domestic private sector also, generally cannot use cross-border loopholes to systematically shift profits and avoid tax³⁶. They may of course still evade tax – in which case there are laws that are being broken and action that can and should be taken. Multinational companies in general represent different challenges – being global and fleet-footed it is harder for national tax revenue authorities to take effective action. Indeed there is a profound imbalance in terms of staff and financial resources, with MNCs employing expert accountants and lawyers that tax authorities can rarely match. Furthermore, the international tax system is the product of global power inequalities, some of which can be traced back to the colonial era (in the case of some tax treaties). There is thus a particular urgency to redress the balance. Indeed a progressive intervention in the area of tax justice should rightly start where the inequality is greatest – and this is particularly so when supporting education which has such a powerful equalising potential.

1.16 In focusing on corporate tax and multinational companies we recognise that there are many ways in which the scope for domestic action depends, in part, on better **coordinated international action**. The international dimensions are picked up more comprehensively in the Global Taxation report for the Education Finance Commission by Steve Klees and Alex Cobham (to which we have made active inputs). These international dimensions are important as there are many areas where double standards are applied; for example it is not unusual for OECD countries to insist developing countries raise more of their own revenues whilst at the same time pursuing aggressive tax competition and defending global tax rules which makes this harder to achieve. Of course there are important areas when developing country governments can take action on corporate tax, and this report highlights some of these, but global action is also needed to negotiate new and fairer tax rules and norms. In particular there is a clear need to have a more inclusive and democratic body setting and enforcing global tax rules as the OECD, which currently dominates, excludes developing countries - so cannot be seen to fairly represent their interests.³⁷

1.17 There are of course some **arguments against focusing on corporate income tax**. Some analysts argue that corporate tax can actively undermine economic activity and that corporate tax is an anomaly as it should be people, not companies that pay tax – otherwise you risk taxing profits twice, at the level of the company and at the point when dividends are paid out to people. However, in developing countries most of the dividends will be going to people who are likely to be paying tax in other countries (or in tax havens). Developing countries lose out twice if there are bad corporation tax practices -

³⁶ Of course where domestic businesses do exploit loopholes and engage in similar practices to avoid tax compliance (as happens increasingly in countries like Nigeria, Kenya, Indonesia and Mexico) it is fair that they should also be affected by some of the reforms proposed. This is a worrying trend. For example, the largest domestic bread company in Kenya recently moved its headquarters to Mauritius, where it does no other business.

³⁷ . Indeed, in the recent BEPS process developing countries were frustrated at the lack of progress on many issues, including how international tax rules distribute the multinational corporate tax base between North and South; how to address capital gains tax avoidance by MNCs, how to make transfer pricing work when comparable data is not available in developing countries and how to address the pressure for governments to give away tax incentives.

because they can lose out both on the corporation tax they should receive and on taxing income on dividends³⁸.

1.18 Increasingly the **education community is waking up** to the importance of action on tax, particularly in relation to multinational companies – and the Education Commission could play a ground-breaking role in taking this to the next level. The Incheon Framework for Action, Education 2030, notes that increasing public funding for education “*requires widening the tax base (in particular, by ending harmful tax incentives), preventing tax evasion and increasing the share of the national budget allocated to education*”. The Education For all Global Monitoring Report (now the Global Education Monitoring report) did important work in 2014 documenting the profound gains that can be made in financing education through action on domestic tax (REF) and produced a specific policy briefing on this for African Ministers of Finance. The African Union recently endorsed the report of its High Level Panel on Illicit Financial Flows (chaired by former South African President Thabo Mbeki)³⁹, acknowledging that action to address these will yield much greater revenue than that which is received in aid. The new strategy (2016-2020) of the Global Partnership for Education also places domestic resource mobilisation and action on tax more prominently than ever before. This is an issue whose time has come and which the Finance Commission should champion as the most effective single means to mobilise the tens of billions of dollars that are urgently needed. It is time for the negative cycle of lost revenue and low investment in education to be replaced by a positive cycle of expanding domestic tax revenue to invest sustainably in education that will yield the long term economic growth that in turn will expand revenues further.

1.19 Of course it is worth noting the additional political and media momentum on these issues that arise from the release of the **Panama Papers**⁴⁰ (that came out days after the first draft of this report was submitted). There has never been a better time for action to redress some of these injustices and it is timely for the Education Finance Commission to make clear the important connections between coordinated action on tax and making serious progress on financing SDG4.

1.20 There are **four sections to this report** which pick up on four key areas where action on tax could make a massive difference to the financing of education in the coming years. First of all we look at **tax incentives** – revealing the vast revenue that is foregone by governments under the illusion that they need to give tax breaks in order to attract investment. Secondly we look at aggressive **tax planning and tax avoidance** – again revealing the huge sums that are lost to education and other public services by increasingly common but immoral practices. Thirdly we look at **tax treaties** – revealing the extent to which many treaties are profoundly imbalanced, depriving developing countries of desperately needed resources. Fourthly we touch on **earmarked taxes** linked to corporates – as one of the other areas where progress could be made. We then draw out some conclusions and recommendations for action by governments, civil society, donors and of course the finance commission itself.

³⁸ There are of course exceptions, where multinational companies are based in developing countries but this is the exception rather than the rule.

³⁹ <http://www.uneca.org/publications/illicit-financial-flows>

⁴⁰ <https://panamapapers.icij.org/>

2. TAX INCENTIVES

2.1 UNDERSTANDING TAX INCENTIVES AND WHEN THEY ARE HARMFUL

Strategically targeted tax incentives can play a crucial role in supporting national development. They have been widely promoted by governments, increasing significantly in recent years. Between 1980 and 2005, for example, the proportion of sub-Saharan African countries offering tax holidays to companies (i.e. exemptions from paying any corporate income tax for several years) rose from 40 per cent to 80 per cent.⁴¹ Most developing countries now offer not only income tax holidays but also other incentives such as exemptions from paying withholding taxes, VAT or import duties.⁴²

Yet **tax incentives frequently cause more harm than good**. First, and most importantly, they reduce government revenues by removing the requirement for companies to pay fair levels of tax. The revenue losses can be massive, as we detail below. Second, they can encourage corruption and secrecy when negotiated in highly discretionary special deals with individual companies or investors. Third, some kinds of incentives tend to attract ‘footloose’ firms which move their investments from one country to another, and therefore do not encourage stable long term investments. Fourth, by often favouring foreign investors, they can disadvantage domestic investors and deter them from entering markets or expanding. Finally, they often require large resources to administer and are rarely transparently implemented.⁴³

A recent joint report by the IMF, OECD, UN and the World Bank notes:

‘Incentives, including corporate income tax (CIT) exemptions in free trade zones, continue to undermine revenue from the CIT; where governance is poor, they may do little to attract investment—and when they do attract foreign direct investment (FDI), this may well be at the expense of domestic investment or FDI into some other country. Tax-driven investment may also prove transitory... Studies also suggest that tax -driven investment does not provide a stable source of investment in the recipient country.’⁴⁴

The ostensible reason for governments providing tax incentives to business is to attract foreign investment (FDI). Yet the evidence, including the academic literature, suggests that **tax incentives are not needed to attract FDI**. The IMF has noted that ‘investment incentives – particularly tax incentives – are not an important factor in attracting foreign investment’.⁴⁵ Indeed the same joint report by the IMF, World Bank, OECD and UN quoted above concludes “Tax incentives generally rank low in investment climate surveys in low-income countries, and there are many examples in which they are reported to be redundant—that is, investment would have been undertaken even without them”⁴⁶. The IMF has also observed: ‘Reduced tax rates and incentives can attract foreign investment, but only where other business conditions are good.

⁴¹ IMF, *Revenue Mobilization in Developing Countries*, March 2011, para 53, <http://www.imf.org/external/np/pp/eng/2011/030811.pdf>

⁴² A tax incentive is defined as ‘a deduction, exclusion or exemption from a tax liability, offered as an enticement to engage in a specified activity such as investment in capital goods for a certain period’. <http://www.businessdictionary.com/definition/tax-incentive.html>, accessed 19 February 2016.

⁴³ IMF, *Kenya, Uganda and United Republic of Tanzania: Selected Issues*, 1 December 2006, p.10

⁴⁴ *Supporting the Development of More Effective Tax Systems: A report to the G-20 Development Working Group by the IMF, OECD, UN and World Bank*, 2011, p.19, 24 <http://www.imf.org/external/np/g20/pdf/110311.pdf>

⁴⁵ IMF, *Kenya, Uganda and United Republic of Tanzania: Selected Issues*, 1 December 2006, p.11

⁴⁶ Report to the G20 Development Working Group by the IMF, OECD, UN and World Bank “Options for Low Income Countries’ Effective and Efficient Use of Tax Incentives for Investment” Oct 2015

Business surveys repeatedly find that while taxation matters for foreign investors, other considerations—infrastructure, rule of law, labor—matter more.⁴⁷

Studies show that **more important factors in attracting FDI** are good quality infrastructure, low administrative costs of setting up and running businesses, political stability and predictable macro-economic policy. A 2010 study by the University of Nairobi found that the main reasons for firms investing in Kenya were access to the local and regional market, political and economic stability and favourable bilateral trade agreements. Tax concessions offered in special economic zones were mentioned by only 1 per cent of the businesses sampled.⁴⁸ Similarly, in the World Bank's recent Investor Motivation Survey for the East African Community, 93 per cent of investors said that they would have invested anyway, had tax incentives not been on offer; tax incentives ranked 17th, behind a host of factors including exchange rates, utility and transport infrastructure, and the other benefits of free zones.⁴⁹

Not all tax incentives are necessarily bad for development and some may be used to correct market failures or achieve aims that cannot be achieved through other policies. Tax incentives could, for example, help domestic companies grow and/or help promote strategically important sectors of the economy.⁵⁰ Further, the academic literature identifies another broad area of incentives as being useful (though often with conditions) – these are investment incentives, such as tax credits, which reduce the cost of investing.⁵¹ By contrast, there are several types of tax incentives which are near-universally harmful for developing countries (see box) – but it is these which are more often provided by governments.

The worst tax incentives

Four types of incentives should generally be avoided:

Discretionary incentives give companies special deals in individual agreements. They are often awarded behind closed doors, kept secret and therefore vulnerable to corruption. Since they often go beyond the general legislation in offering companies massive tax reductions, they distort the market in favour of investors with the most political influence. The IMF notes: 'Any incentives must be in the law and available to all investors on the same terms and not subject to administrative discretion.'⁵²

Tax holidays can give companies a period of many years when they pay no taxes, or at least no corporate income taxes, and tend to apply for a fixed period at the start of an investment. The IMF has noted that 'tax holidays [are] generally agreed to be the worst form of incentive... They are widely

⁴⁷ IMF, *Revenue Mobilization in Developing Countries*, March 2011, para 54, <http://www.imf.org/external/np/pp/eng/2011/030811.pdf>

⁴⁸ Bethuel Kinuthia, 'Determinants of Foreign Direct Investment in Kenya: New Evidence', University of Nairobi, August 2010, p.13, <http://bit.ly/16ngfd6>

⁴⁹ Edward Mwachinga, 'Results of investor motivation survey conducted in the EAC', World Bank presentation, 2013, <http://bit.ly/14B0AqE>

⁵⁰ ActionAid (2016) – *What a way to make a living*

⁵¹ For example, an IMF working paper notes: 'There are good reasons to suppose...that measures which directly reduce the cost of investing are more effective than tax holidays...Such investment-related incentive measures include: investment allowances, which are deductions for investment in addition to depreciation allowances (so that more than 100 percent of an asset's value is written off for tax purposes over its lifetime); investment tax credits, typically a percentage of the cost of the investment that directly reduces the CIT liability; and accelerated depreciation, which allows for a more rapid deduction from the CIT base of capital consumption, relative to its true economic depreciation—that is, wear and tear and obsolescence. All of these measures have the effect of directly reducing the after tax cost of making an investment.' Michael Keen and Mario Mansour. 'Revenue Mobilization in Sub-Saharan Africa: Challenges from Globalization', *IMF Working Paper*, July 2009, p.13, <http://www.imf.org/external/pubs/ft/wp/2009/wp09157.pdf>

⁵² IMF, *Revenue Mobilization in Developing Countries*, March 2011, Appendix XI, <http://www.imf.org/external/np/pp/eng/2011/030811.pdf>

regarded as a particularly ill-designed form of investment incentive, and one that poses considerable dangers to the wider tax system'.⁵³ The reason is that, while depriving countries of revenues, they tend to attract footloose investments that move on once the preferential terms end, rather than making long-term commitments that bring new skills and technology to the local economy. They encourage businesses to 'close down' and reinvent themselves under a different name to benefit from a new tax holiday.⁵⁴

Tax incentives in free zones offer all businesses operating in particular geographical locations large tax reductions as well as infrastructure, business support and proximity to other firms. But such tax incentives encourage businesses to stay within the 'bubble', reducing interaction with domestic businesses that would otherwise benefit from forward and backward linkages. Since free zones offer low taxes, they can also put pressure on policymakers to provide similar incentives to firms outside the zones.⁵⁵

Stability agreements between investors and governments freeze the tax terms applied to the former, making it harder for governments to change them in future. This means that while other businesses have no option but to comply with future changes that might increase their tax bills, favoured investors are allowed to continue with special treatment, sometimes permanently. Thus future governments are locked in by such agreements, reducing their options to democratically change tax rates to bring in more revenues.⁵⁶

2.2 REVENUE LOSSES FROM TAX INCENTIVES

There are no official estimates of global revenue losses from tax incentives. In 2013, ActionAid estimated that **developing countries lose US\$138 billion a year**^{57 58} just from one form of tax incentive – corporate income tax exemptions, or nearly US\$3 billion each week. This could comfortably fill the global finance gap for basic education: the EFA Global Monitoring Report team in 2013 estimated the annual global financing gap for basic education as US\$26 billion for primary school and US\$38 billion if lower-secondary education is included.⁵⁹

The IMF, African Development Bank (AfDB), ActionAid and other organisations have in recent years produced **country studies of revenue losses** from tax incentives. These are documented below and include how education could be supported by the use of these revenues. The table shows that IMF, AfDB and other reports on individual countries have estimated revenue losses from tax incentives as exceedingly high as a proportion of GDP, for example in Ghana (6 per cent), Tanzania (around 4 per cent), Kenya (3.1 per cent), Uganda (2 per cent), and Rwanda (4.7 per cent). In several countries, the revenues from tax incentives could more than double education budgets.

⁵³ IMF, *Revenue Mobilization in Developing Countries*, March 2011, para 55 and Appendix X, <http://www.imf.org/external/np/pp/eng/2011/030811.pdf>

⁵⁴ Alexander Klemm, 'Causes, Benefits, and Risks of Business Tax Incentives', *IMF Working Paper*, January 2009, p.14, <https://www.imf.org/external/pubs/ft/wp/2009/wp0921.pdf>

⁵⁵ Michael Keen and Mario Mansour. 'Revenue Mobilization in Sub-Saharan Africa: Challenges from Globalization', *IMF Working Paper*, July 2009, p.21, <http://www.imf.org/external/pubs/ft/wp/2009/wp09157.pdf>

⁵⁶ ActionAid, *Give Us a Break: How Big Companies Are Getting Tax-Free Deals*, June 2013, p.5, http://www.actionaid.org/sites/files/actionaid/give_us_a_break_-_how_big_companies_are_getting_tax-free_deals_2.pdf

⁵⁷ ActionAid, *Give Us a Break: How Big Companies Are Getting Tax-Free Deals*, June 2013, http://www.actionaid.org/sites/files/actionaid/give_us_a_break_-_how_big_companies_are_getting_tax-free_deals_2.pdf

⁵⁸ Of this \$139 billion, \$30 billion is lost by low and lower-middle income countries.

⁵⁹ Education for All Global Monitoring Report, 'Education for All is affordable – by 2015 and Beyond', Policy Paper, February 2013, <http://unesdoc.unesco.org/images/0021/002199/219998E.pdf>

Tax incentives revenue losses and how they could fund education: Select countries

Country	Revenue losses from tax incentives	The education it could fund
Ghana ⁶⁰	US\$2.27 billion in 2014 The IMF stated in an April 2015 report that discretionary tax treatments, in the form of exemptions, special regimes and tax holidays may amount to 'perhaps 6 per cent of GDP'. This would amount to around GC 6,806 million or US\$2.27 billion.	The revenues could more than double the education budget. (The 2014 budget allocated GC 5,816 to education).
India ⁶¹	Around US\$112 billion in 2012/13 (5.7% of GDP) (mainly from excise/customs duty exemptions, also from corporate income tax incentives) .	Could double the education budget (around US\$56 billion in 2012/13)
Kenya ⁶²	KShs 100 billion (US\$ 1.1 billion) from all tax incentives in 2011 (3.1% of GDP). The government has estimated revenue losses from all tax incentives at KShs 100 billion (US\$ 1.1 billion) a year. This would amount to around 3.1% of GDP. Of these, trade-related tax incentives were at least KShs 12 billion (US\$ 133 million) in 2007/08 and may have been as high as US\$ 566.9 million.	Could increase education spending by over half. Could more than double the primary education budget, which stood at US\$924.15 million in 2012/2013. It could pay for the training and salaries of the 50,000 additional teachers that Kenya still needs to provide primary education for every child, for 100,000 new classrooms, and for two new textbooks for every child of primary and lower secondary school age – and still leave more than US\$10 million in change.
Nicaragua ⁶³	US\$415.6 million in 2008.	Could fund 2.5 times the amount currently spent on primary education. Just over a quarter of the value of the tax exemptions could pay for two years of pre-service training for 5,000 new primary school teachers, five years of in-service training for all current primary school teachers, and "Paquetes Solidarios" (backpacks including school materials and shoes) for every primary and secondary school aged child in the country.
Nigeria ⁶⁴	At least US\$2.9 billion a year. According to IMF figures, Nigeria is losing 0.5 per cent of its GDP in corporate income tax incentives given to companies with "Pioneer status" (which provides a 3 year corporate income tax holiday) alone; this would amount to around US\$2.6 billion a year. According to government figures, Nigeria is	The revenues could more than double the education budget.

⁶⁰ See ActionAid, *The West African Giveaway: Use and Abuse of Corporate Tax Incentives in ECOWAS*, July 2015, p.13, http://curtisresearch.org/the_west_african_giveaway_2-1.pdf

⁶¹ Education for All Global Monitoring Report, 'Increasing Tax Revenues to Bridge the Education Financing Gap', *Policy Paper 12*, March 2014, p.4, <http://unesdoc.unesco.org/images/0022/002270/227092E.pdf>; Centre for Budget and Governance Accountability, 'Tax Exemptions in India', undated, http://www.cbgaindia.org/files/recent_publications/TAX%20EXEMPTIONS.pdf.

⁶² Tax Justice Network Africa / ActionAid, *Tax Competition in East Africa: A Race to the Bottom?*, May 2012, p.11, http://www.actionaid.org/sites/files/actionaid/eac_report.pdf. Kenya allocated KShs 190 billion education in 2010/11 (Institute of Economic Affairs, Budget 2010/11, <http://www.ieakenya.or.ke/publications/bulletins/budget-2010-11-more-spending-better-controls>)

⁶³ Global Campaign for Education, *A Taxing Business: Financing Education for All Through Domestic Resources*, 2013, p.12, http://www.campaignforeducation.org/docs/reports/GCE_A%20TAXING%20BUSINESS.pdf. Based on a calculation used in Deborah Itriago, *Owning Development: Taxation to Fight Poverty*, September 2011, Oxfam Intermon, p.6, <https://www.oxfam.org/sites/www.oxfam.org/files/rr-owning-development-domestic-resources-tax-260911-en.pdf>

⁶⁴ See ActionAid, *The West African Giveaway: Use and Abuse of Corporate Tax Incentives in ECOWAS*, July 2015, pp.13-14, http://curtisresearch.org/the_west_african_giveaway_2-1.pdf

	further losing around US\$327 million a year on import duty exemptions.	
Rwanda ⁶⁵	Rwf 94 billion (US\$156 million) in 2008 (3.6% of GDP and Rwf 141 billion (US\$234 million) in 2009 (4.7% of GDP in 2009).	Could nearly double the education budget.
Sierra Leone ⁶⁶	Le 840.1bn (US\$199m) average over the three years 2010-12	Tax incentives provided in 2012 could have increased the education budget seven-fold
Tanzania ⁶⁷	TShs 458.6 billion (US\$288 million) per year during 2008/09 – 2010/11 (tax incentives given to corporations only)	Could fund a quarter of the education budget
Uganda ⁶⁸	US\$ 690 billion (US\$272 million) in 2009/10. The African Development Bank estimates that losses from tax incentives are 'at least 2%' of GDP. ⁶⁹ This amounts to around US\$ 690 billion (US\$272 million) in 2009/10. ⁷⁰	Could more than double Uganda's education spending. (Uganda's allocation to education in 2008/09 was Shs 786 billion. ⁷¹ US\$272 million is equivalent to almost the total primary education budget in 2012; it is more than enough for the government to meet its pay commitments to existing teachers (which they currently say they cannot afford) and pay salaries for more than 80,000 new primary school teachers, bringing the total to more than 250,000, and the average number to one for every 34 children, with every child in school.

In addition to the countries above, figures for revenues lost from tax incentives have emerged in other countries in recent years:

- **Bangladesh** only published figures once, for 2005, which showed revenue losses from corporate income tax incentives alone amounted to US\$113.1 million.⁷²
- Analysis of 15 **Caribbean** countries in 2008 put the revenue cost of corporate income tax incentives at an average of 5.5 per cent of GDP.⁷³
- In **Zambia**, a 2012 analysis by the International Monetary Fund noted that a combination of improvements in Zambia's tax administration, the introduction of new taxes and a reduction in tax

⁶⁵ Tax Justice Network Africa / ActionAid, *Tax Competition in East Africa: A Race to the Bottom?*, May 2012, p.11, http://www.actionaid.org/sites/files/actionaid/eac_report.pdf

⁶⁶ Budget Advocacy Network, *Losing Out, Sierra Leone's Massive Revenue Losses from Tax Incentives, April 2014*, <http://curtisresearch.org/Losing%20Out.%20Final%20report.%20April%202014.pdf>

⁶⁷ Estimates by the African Development Bank, IMF and others are that Tanzania loses between 2.9 - 6 per cent of its GDP in tax incentives. Norwegian Church Aid, *The One Billion Dollar Question: How Can Tanzanian Stop Losing So Much Tax Revenue?*, June 2012, <http://curtisresearch.org/ONE%20BILLION%20DOLLAR%20QUESTION.Final%20text.%20June%202012.pdf>; Tax Justice Network Africa / ActionAid, *Tax Competition in East Africa: A Race to the Bottom?*, May 2012, p.11, http://www.actionaid.org/sites/files/actionaid/eac_report.pdf

⁶⁸ Tax Justice Network Africa / ActionAid, *Tax Competition in East Africa: A Race to the Bottom?*, May 2012, p.11, http://www.actionaid.org/sites/files/actionaid/eac_report.pdf

⁶⁹ African Development Bank, *Domestic Resource Mobilisation for Poverty Reduction in East Africa: Uganda Case Study*, November 2010, p.20

⁷⁰ Based on figures in IMF, *Uganda: Second Review under the Policy Support Instrument and Request for Waiver of Assessment Criteria, Country Report No.11*, October 2011, p.24. Nominal GDP in 2009/10 of US\$ 34.5 trillion

⁷¹ Republic of Uganda, *Approved Estimates of Revenue and Expenditure, 2009/10*, Table 4, www.finance.go.ug

⁷² M. Golam Mortaza and Lutfunnahar Begum, 'Tax expenditures in Bangladesh: an introductory analysis', Bangladesh Bank, Policy Note, 2006. <http://bit.ly/14AZnj9>

⁷³ Luis Cubeddu et al, 'Tax Incentives and Foreign Direct Investment: Policy Implications for the Caribbean', in Andreas Bauer ed, *The Caribbean: Enlarging Economic Integration*, 2008, cited in IMF, *Revenue Mobilization in Developing Countries*, March 2011, para 53, <http://www.imf.org/external/np/pp/eng/2011/030811.pdf>

incentives would together increase Zambian government revenues by 4 per cent of GDP.⁷⁴ This would mean an increase in revenues of around US\$752 million a year.⁷⁵

- In **Ethiopia**, tax incentives amounted to around US\$1.3 billion (4.2 per cent of GDP) in 2008/09. If Ethiopia devoted just 10 per cent of these revenues to basic education, then the country would have an additional US\$133 million available, enough to get approximately 1.4 million more children into school.⁷⁶

2.3 CONCLUSION

Given their huge costs and potential for meeting the education financing gap, governments must **subject tax incentives to rigorous scrutiny** and cancel or phase out those incentives that cannot be clearly shown to provide benefits that outweigh the costs. There is significant scope to act unilaterally – it was governments that decided to provide tax incentives, thus they can remove them. Indeed, many governments, notably Tanzania, are committed to reviewing and reducing some tax incentives and have already taken some steps to do so. Some forms of incentives, such as tax holidays, discretionary special deals and fiscal stability agreements, must be ruled out altogether.⁷⁷ There is also scope for regional collaboration: for example the Southern African Development Community has drafted guidelines for greater cooperation⁷⁸ and the East Africa Community⁷⁹ has started to explore coordinated actions to eliminate tax incentives.

Thus governments must:

- Provide tax incentives only on the basis of a thorough cost-benefit analysis, including an assessment of impact on the poor and vulnerable groups. The analysis must be made subject to public debate, scrutiny and parliamentary oversight
- Create a public policy framework for granting tax incentives so that any incentives given are based on clear rules that are transparently applied
- Ensure that tax incentives, if granted, are subject to systematic monitoring and evaluation, and are revocable if the company fails to reach the agreed development objectives
- Avoid granting any discretionary tax incentives (not least as these encourage corrupt practices)
- Publish an annual overview of the costs of tax incentives.
- Deepen regional collaboration to prevent a race to the bottom on tax incentives.

There are of course **challenges** in making progress on tax incentives. Once given it is hard to remove them as they are often linked to clear contractual commitments. Those that are given in discretionary ways are often linked to corruption, in one form or another, which may involve senior political figures who have a serious vested interest in preventing anything coming to light. It is thus easier to focus on transparency around future practices than demanding a review or cancellation of past ones. However, it is also clear that actions at national, regional or global levels to end harmful tax incentives ought to receive much more prominence than they presently do. Globally they do not get the same attention as actions to address tax avoidance and evasion – which we explore in the following section.

⁷⁴ IMF, *Zambia: Staff Report for the 2012 Article IV Consultation – Debt Sustainability Analysis*, p.4, <https://www.imf.org/external/pubs/ft/scr/2012/cr12200.pdf>

⁷⁵ The IMF gives a total GDP figure of US\$18.8 billion in 2011. IMF, *Zambia: Staff Report for the 2012 Article IV Consultation – Debt Sustainability Analysis*, p.4, <https://www.imf.org/external/pubs/ft/scr/2012/cr12200.pdf>.

⁷⁶ Education for All Global Monitoring Report, 'Increasing Tax Revenues to Bridge the Education Financing Gap', *Policy Paper 12*, March 2014, p.4, <http://unesdoc.unesco.org/images/0022/002270/227092E.pdf>

⁷⁷ ActionAid, *Levelling Up: Ensuring a Fairer Share of Corporate Tax for Developing Countries*, July 2015, p.20, https://www.actionaid.org.uk/sites/default/files/publications/levelling_up_final.pdf; ActionAid, *Give Us a Break: How Big Companies Are Getting Tax-Free Deals*, June 2013, p.11, http://www.actionaid.org/sites/files/actionaid/give_us_a_break_-_how_big_companies_are_getting_tax-free_deals_2.pdf

⁷⁸ <http://www.sadc.int/themes/economic-development/investment/tax-coordination/>

⁷⁹ http://www.actionaid.org/sites/files/actionaid/eac_report.pdf

3. TAX AVOIDANCE AND EVASION

This chapter provides an overview of key concepts, practices and impacts of corporate tax evasion and avoidance in developing countries. It starts by discussing, the legal and moral dimensions of tax minimisation strategies. This provides a conceptual framework for the rest of the chapter. The following four sections describe and provide a typology of the main instruments and strategies that allow multinational companies to avoid or evade tax payments. The fifth section provides a summary of different estimates of the impact of these practices on tax revenues in developing countries and what this could mean for education. The chapter concludes by discussing a range of different solutions that could be implemented by developing countries in order to minimise tax avoidance and evasion and increase tax collection.

3.1 LEGAL, ILLEGAL, UNETHICAL?

Tax evasion occurs when individuals or companies break the law of any of the countries they operate in and it is, by definition, an illegal practice. Because of this, it relies fundamentally on concealing the existence of taxable income from the authorities, whether by non-disclosure or by active steps such as placing the proceeds in a secrecy jurisdiction. **Tax avoidance** is a term that is used to capture practices that, while not clearly violating the letter of the law, do violate the spirit or intentions of the law.

The precise boundaries of the concept of tax avoidance can be hard to define. In this chapter there are plenty of examples of multinational companies that pay little or no tax as a result of avoidance strategies to the detriment of developing countries. These examples leave little room to doubt, but it is not always easy to draw a clear line between what is acceptable and what is not. Different concepts, such as 'aggressive' tax avoidance / tax planning have tried to bring some nuance, but they remain hard to define.

General anti-abuse rules (GAARs) illustrate government's efforts to capture some of these legal, but harmful practices. EU law, for example, recognises the concept of 'artificial arrangements' that result in tax advantages, when they are not justified by "valid commercial reasons which reflect economic reality" and allow the suspension of legislation aimed at preventing double taxation.⁸⁰ Conceptually, this approach is quite similar to the idea of 'economic substance' enshrined in US Law and that considers as void transactions which are exclusively conducted in order to minimise tax payments.⁸¹

Most importantly, GAARs capture some of these ethical issues. In practice GAARs render illegal any advantages gained through legal practices but pursued to defeat the spirit of the law. This report strongly advocates for countries to place less emphasis on the technical and often obscure distinction between tax evasion and tax avoidance, and instead to continue developing **an ethical notion of tax compliance**, where individuals and companies actively work to ensure that they pay taxation in accordance with the spirit and intention of the law.

3.2 TRANSFER PRICING MANIPULATION

The prices of goods or services traded among different companies within the same group can be manipulated in order to shift money from one jurisdiction to another with lower tax rates. The growing domination of multinational companies in the global economy has brought a significant increase in the volumes of trade between companies of the same group (intra-group trade). Estimates suggest that intra-

⁸⁰ See EU Anti-abuse measures in the area of direct taxation (<http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=URISERV%3A131062>), and the Council Directive (EU) 2015/121 of 27 January 2015 amending Directive 2011/96/EU on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States

⁸¹ <https://www.irs.gov/Businesses/Codification-of-Economic-Substance-Doctrine-and-Related-Penalties>

group trade represents 48% of all trade in France and a similar figure in the US (47%).⁸² This gives an idea of the potential of transfer mispricing as a tool to minimise tax payments.

There are legal tools to prevent the manipulation of transfer prices, but they can be extremely difficult to implement, especially in developing countries. Many jurisdictions have adopted legislation that requires that transactions between related companies take place at market value, as if the transaction took place between unrelated companies. This concept is known as the ‘**arm’s length principle**’. However, implementation can be very challenging. Firstly, the burden of proof usually falls on the tax authorities.⁸³ Secondly, proving manipulation relies on establishing what the real price of a particular product or service would have been on an open market. This may be hard or nearly impossible due to a lack of comparable products and services being traded on the open market (particularly in developing countries). The table below provides a list of different types of transactions and illustrate some of the challenges they entail from a regulatory perspective. Thirdly, tax authorities require substantial amounts of information and technical capacity and resources to perform the analysis. Developing countries in particular tend to struggle with the implementation of the ‘arm’s length principle’ because they have fewer technical and human resources and their legal frameworks are sometimes less sophisticated.⁸⁴

The **concept of arm’s length principle is continually being developed**. Most countries in the world have adopted the standard developed by the OECD, which was updated most recently within the context of the OECD’s BEPS process.⁸⁵ – but these changes are unlikely to get rid of the problems. Ultimately, the increasing complexity of the arm’s length principle and the challenges faced in its implementation (e.g. lack of comparable transactions) only makes regulation more difficult and expensive to implement in developing countries with limited resources. The inherent weaknesses of the ‘arm’s length principle’ suggest that new and alternative approaches would be preferable.⁸⁶

Table X. Examples of transactions used in transfer pricing manipulation

Transaction	Description	Challenges	Example
High value added services	Management support, legal expertise, IT services, etc.	Difficult to value accurately without a first-hand knowledge of the internal affairs of the company	A sugar company in Zambia reportedly paid US\$ 8m a year in management and other fees to a Irish based company with no registered employees ⁸⁷
Intangible assets	Royalties for the right to use intellectual property such as patents, copyrights, brands. A separate category is goodwill	Value of intellectual property is extremely difficult to estimate with precision and can change overtime	Use of royalty payments by a large brewery company cost 6 African countries an estimated GBP 10m a year ⁸⁸

⁸² Altomonte, Carlo and di Mauro, Filippo and Ottaviano, Gianmarco I.P. and Rungi, Armando and Vicard, Vincent, Global Value Chains During the Great Trade Collapse: A Bullwhip Effect? (February 2012). Banque de France Working Paper No. 364.

⁸³ Jelic, D. (2013) Allocation of burden of proof that the arm’s length principle was(not) breached under the TFEU Fundamental Freedoms. Lund University, School of Economics and Management, Master Thesis in European and International Tax Law

⁸⁴ ActionAid (2010) Calling time on tax avoidance,

⁸⁵ OECD (2015). Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports. OECD, Paris

⁸⁶ Influential countries like Brazil and China have created their own alternative systems – but it takes a powerful country to do so given the potential backlash from companies.

⁸⁷ ActionAid (2013). Sweet nothings. The human cost of a British sugar giant avoiding taxes in southern Africa. ActionAid

⁸⁸ ActionAid (2010). Calling time: Why SABMiller should stop dodging taxes in Africa. ActionAid

3.3 TRANSFER MISPRICING

Multinational companies tend to exploit the indeterminacy of the arm's length principle or, perhaps more often, genuine disagreements between taxpayers and tax authorities who naturally apply complex rules in a manner that produces the best result for them. Sometimes, multinational **companies may also deliberately and illegally use transfer prices** that are not based on an attempt to comply with the arm's length principle to shift profits. This particular practice is referred to as transfer mispricing.

3.4 INTEREST DEDUCTION AND THIN CAPITALISATION

The UK tax authority defines thin capitalisation as the practice of a company (generally part of a group) taking on excessive debt when compared to its borrowing capacity as a standalone entity.⁸⁹ **Debt can be used for tax avoidance purposes** because interest payments are generally deductible for tax purposes and thus provide an opportunity to reduce the taxable income in the jurisdiction where the indebted company is registered and transfer income, in the form of interest, elsewhere. Even in the absence of intra-group loans, thin capitalisation can still take place in instances where the company receives guarantees from other companies in the group in order to secure excessive levels of external debt. Thin capitalisation can result in significant tax losses, especially where withholding taxes are not applied. The use of this practice by an extractive company in Malawi resulted in over USD 7.3m in tax losses.⁹⁰

In addition to the amount of debt, the rate of interest is also an important factor in assessing the existence of thin capitalisation.⁹¹ **Higher interest rates result in higher interest payments.** The interest rate of intra-group loans is subjected to transfer pricing rules such as the arm length principle (see above) in order to minimise the risk of profit shifting through artificially inflated interest payments.

3.5 TRADE MISINVOICING

Trade misinvoicing is a method for moving money across borders which involves deliberately **falsely misreporting the value of a commercial transaction** on an invoice submitted to customs. This practice can be used for different purposes, including shifting profits abroad, evading customs taxes or laundering money. The use of misinvoicing is thus not restricted to the minimisation of tax payments. Independently of the motivation for engaging in trade misinvoicing, this practice generally results in tax losses for the state.⁹²

Although conceptually similar to transfer pricing based schemes, there are substantial differences between the two approaches. Misinvoicing relies on the fact that transactions are conducted or appear to be conducted among unrelated parties in order to avoid arm's length regulations. To achieve this effect, misinvoicing generally uses the secrecy provided by certain jurisdictions to hide the real ownership or beneficiary of the company involved in the trade. In comparison, transfer pricing manipulation relies on the technical difficulty of demonstrating the real price of the good and service. These differences have some implications in the way both techniques are used. Transfer pricing manipulation is more likely to be used in transactions involving intellectual property or other services which are difficult to value accurately or objectively. Trade misinvoicing is more complex and requires more infrastructure than trade mispricing: requiring intermediaries and complex transactions to make the transaction appear to have taken place between unrelated parties.

⁸⁹ <http://webarchive.nationalarchives.gov.uk/+http://www.hmrc.gov.uk/manuals/intmanual/INTM541010.htm>

⁹⁰ An extractive affair

⁹¹ Ibid

⁹² Baker, R.; Clough, C.; Kar, D.; LeBlanc, B. & Simmons, J. (2014). Hiding in Plain Sight: Trade Misinvoicing and the Impact of Revenue Loss in Ghana, Kenya, Mozambique, Tanzania, and Uganda: 2002-2011. Global Financial Integrity

Misinvoicing can be very difficult to detect because it often involves small variations in the price, quantity or quality of the good or service. Discrepancies can be difficult to identify by customs authorities, especially when the sheer volume of international trade and the need to keep goods in transit are taken into account. Sometimes though misinvoicing is more obvious. In one notable case an American company invoiced for plastic buckets at \$972 each.⁹³

The impact of misinvoicing in developing countries may be massive. Estimating trade misinvoicing accurately is very difficult, but some recent research suggests it could reach US\$ 800bn a year for developing countries alone.⁹⁴ If this sum were to be taxed at 30% this would yield \$240 billion in new tax revenue for developing countries. A recent study commissioned by the Danish Trade Minister from Global Financial Integrity showed that *“More than \$60bn has been illegally moved in and out of Uganda, Ghana, Mozambique, Kenya and Tanzania over ten years, with most of it passing through tax havens”*⁹⁵. Even if the methodology used in these studies overestimates the real figure, the scale of the numbers suggests misinvoicing is having a large impact on tax revenues in developing countries.

3.6 JURISDICTIONS THAT ENABLE TAX AVOIDANCE – HAVENS

Many jurisdictions have enacted regulation and signed agreements that can be used or exploited by multinational companies to avoid taxes in developing countries. In some cases, the tax avoidance opportunities generated by these jurisdictions are the result of government policy while in others it could be considered as an unintended effect. This section explores three different features that can play a role in tax avoidance strategies.

Low rates

Low tax jurisdictions are key for any avoidance strategy that involves the shifting of profits, such as transfer pricing manipulation (see above). The main rationale behind these strategies is to **localise profits in jurisdiction with low or zero tax rates** in order to reduce the overall tax burden. Low tax jurisdictions often separate their real economies from the tax beneficial structures that foreign actors might set up. This helps protect the real economic activity that takes place within the jurisdiction and the taxes it generates. If all taxes were low or nil, it would be very difficult to run or govern a jurisdiction since there would be little money for public services and investments. This is generally achieved through a combination of the following two features:⁹⁶

- No or low rates tend to apply to income taxes and not to other types of taxes (e.g. property tax, consumption taxes, etc.). In many cases, the reduction of income tax rates is often restricted to foreign income only.
- The advantages are only granted to non-resident entities, often without requiring that substantial economic activity takes place within the jurisdiction.

Another interesting feature of low tax jurisdictions is that some of them offer **advance tax rulings** so that individuals and corporations can verify whether the suggested arrangements would work and their tax impact. Moreover, low tax jurisdictions that play an important role in international tax avoidance schemes tend to be well governed.⁹⁷ The most plausible explanation is that only well governed countries can attract significant foreign investment by providing regulatory and economic stability.⁹⁸ The same rationale can

⁹³ See <http://www.theguardian.com/world/2014/may/11/african-invoice-fraud-tax-havens-development>

⁹⁴ Kar, D, & Spanjers, J. (2016). Illicit Financial Flows from Developing Countries: 2004-2013. Global Financial Integrity

⁹⁶ Tax Justice Network (2007). Identifying tax havens and offshore financial centres. Briefing paper

⁹⁶ Tax Justice Network (2007). Identifying tax havens and offshore financial centres. Briefing paper

⁹⁷ Dharmapala, D. & Hines Jr., J. R. (2009). Which countries become tax havens? Journal of Public Economics, vol. 93(9-10), pages 1058-1068

⁹⁸ Ibid

probably be extended to the next section below, since good governance does remain important in gaining the trust of companies and accountants.

Opacity/secretcy

Opacity allows entities to escape the laws or oversight of other jurisdictions and usually plays a key role in illegal tax strategies such as trade misinvoicing. Without it, companies⁹⁹ using artificial structures to minimise tax payments would be vulnerable either to tax authorities in other countries, which could challenge the most aggressive or illegal practices, or to reputational risk associated with media or public scrutiny. Opacity can be defined as the adoption of legislative, legal or administrative provisions in one or more of the following areas, resulting in:¹⁰⁰

- **Limitations to the effective exchange of information** for tax purposes with other governments. Exchange of information refers to international agreements aimed at facilitating cooperation between tax authorities in tax investigations.¹⁰¹
- **The non-disclosure of basic information**, such as corporate structure, accounts, stock, directors, etc.) for one or more types of legal entities (including trusts, charities, foundations, holding companies, etc.).
- **The non-disclosure of the ownership and beneficial ownership** of entities, assets or rights. The term beneficial owner refers to the people who are ultimately in control of company/entity even if their legal ownership is diluted or non-existent.

Some countries, such as Switzerland, enforce banking secrecy by law.¹⁰² In some other cases, the authorities might refuse external access to it, or more conveniently, are not required to collect certain information so there is nothing substantial they could grant access to.

Treaty networks

Tax treaties are **bilateral or multilateral agreements designed to avoid double taxation of income** arising in one territory and paid to residents of another. Tax treaties and the mechanisms through which they can facilitate tax avoidance are discussed in greater depth in the following chapter. The reason that tax treaties are mentioned in this section is that several jurisdictions have created large networks of tax treaties that provide opportunities for channelling income through them while minimising corporate tax payments. As a result, many of these jurisdictions are used as conduits by multinational companies, especially when they offer some form of tax advantage. In some occasions, the term 'treaty havens' have been used to define some of these countries such as the Netherlands.¹⁰³

3.7 HYBRID MISMATCHES

Hybrid mismatches are essentially **differences in the tax treatment of an entity or instrument in two or more jurisdictions that, working together, result in non-taxation**.¹⁰⁴ Mismatches can emerge as a result of provisions contained in the tax code, regulations or tax treaties. The most common example is the existence of hybrid financial instruments that combine features of both debt and equity investments. Their hybrid nature has resulted in some jurisdictions treating some of these instruments as debt, while others consider

⁹⁹ Or wealthy individuals – who may also prize secrecy / opacity

¹⁰⁰ The discussion builds on: the Financial Secrecy Index methodology, <http://www.financialsecrecyindex.com>;

Articles 22 and 23 of the Brazilian Law nº 11.727, adopted on 23 June 2008; and Tax Justice Network (2007). Identifying tax havens and offshore financial centres. Briefing paper

¹⁰¹ Convention on Mutual Administrative Assistance in Tax Matters, available at: <http://www.oecd.org/ctp/exchange-of-tax-information/ENG-Amended-Convention.pdf>

¹⁰² Swiss Banking Law of 1934.

¹⁰³ van Os, R. & Knottnerus, R. (2011). Dutch Bilateral Investment Treaties: A Gateway to 'Treaty Shopping' for Investment Protection by Multinational Companies, SOMO

¹⁰⁴ OECD (2015). Neutralising the Effects of Hybrid Mismatch Arrangements. OECD/G20 Base Erosion and Profit Shifting Project. Action 2: 2015 Final Report, OECD, Paris

them as equity.¹⁰⁵ This difference can be exploited by companies to avoid taxation altogether (double non-taxation).¹⁰⁶ The term ‘hybrid mismatches’ also applies to hybrid entities. These are entities that, because of their legal form, some countries consider as non-existent (transparent) for tax purposes, while others treat them as normal entities. The different treatment of the entity in different jurisdictions, results in discrepancies in the treatment of deductible expenses that can lead to double non-taxation.¹⁰⁷

Solutions to the problem of hybrid mismatches generally rely on giving jurisdictions the possibility to tax income if they can ascertain that the money has not or will not be taxed by the other jurisdiction.¹⁰⁸ The OECD’s BEPS process has come up with some recommendations to deal with certain mismatches,¹⁰⁹ but some concerns have been raised about the document not being comprehensive enough.¹¹⁰ In addition, implementation of many provisions might take some time. For example, those related to tax treaties would require their renegotiation, which could significantly delay its impact.

3.8 THE IMPACT ON TAX REVENUES IN DEVELOPING COUNTRIES

It is generally agreed that **tax evasion and avoidance has a significant impact in developing countries**, but it is very difficult to provide a precise estimate. Lack of data and the opacity surrounding most of these mechanisms make it necessary to use approximations and indirect approaches to measure the problem. The table below summarises some of the most common global estimates about the impact of tax avoidance and evasion on tax revenues and provides a summary of the scope of mechanisms that are included in the figure. In addition to estimates of tax losses it also includes other estimates about the overall size of the flows that gives a useful idea of the extent of the problem.

Table: Estimates of tax avoidance/evasion in developing countries

Source	Volume	Focus countries	Tax avoidance/evasion mechanisms
Estimates of tax losses:			
IMF (2015)	US\$ 200 bn / year	Non-OECD countries	Focus on profit shifting using ‘tax havens’ ¹¹¹
UNCTAD (2015)	US\$ 100 bn / year	Developing countries	Methodology means the scope is limited geographically. It focuses on the use of ‘tax havens’ and a few other jurisdictions.
Estimates of capital flows (without assumptions relating to tax revenue):			
GFI (2015)	US\$ 800 bn / year	Developing countries	Trade misinvoicing. In addition to avoiding taxes includes other motivations such as money laundering and moving income from criminal activities.
Africa Union High Level Panel on Illicit Financial Flows (2015)	US\$ 50 bn annually (at least) in illicit financial flows	Sub-Saharan Africa	Commercial tax evasion, trade misinvoicing and abusive transfer pricing; (Also includes the drug trade, human trafficking, illegal arms dealing, smuggling, bribery, theft by corrupt officials.)
Cobham & Jansky (2015)	US\$ 650 bn in 2012	Worldwide, activities of US companies only	Profit shifting of US-headquartered multinationals likely resulted in around \$130 billion of revenue losses in 2012 (compared to just \$12 billion in 1994). Global figure is an extrapolation on the basis of the US share of world FDI

¹⁰⁵ Johannesen, N. (2014). Tax Avoidance with Cross-border Hybrid Instruments’, 112 Journal of Public Economics 4

¹⁰⁶ OECD (2012). Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues. OECD, Paris

¹⁰⁷ For an example, see page 9, in OECD (2012). Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues. OECD, Paris

¹⁰⁸ Ibid

¹⁰⁹ OECD (2015). Neutralising the Effects of Hybrid Mismatch Arrangements. OECD/G20 Base Erosion and Profit Shifting Project. Action 2: 2015 Final Report, OECD, Paris

¹¹⁰ Harris, P. (2014). Neutralizing Effects of Hybrid Mismatch Arrangements. UN DESA

¹¹¹ The list of tax havens is based on Gravelle, J. (2013). Tax Havens: International Tax Avoidance and Evasion. CRS Report for Congress, Congressional Research Service, United States.

Sources in table above¹¹²

The **sheer scale of these figures makes it difficult to grasp** the actual implications for developing countries. If 20% of the very lowest figure for tax losses reported in the table above (US\$ 100bn) was spent on education, it would be enough to cover half of the global resource gap to get all children into primary and lower secondary school, estimated at US\$ 39 billion.¹¹³ If the \$660b in the final figure (Cobham and Jansky) was taxed at 30% it would generate \$198billion – and if 20% of this was spent on education it would **generate just over the \$39billion needed to finance the global education resource gap.**

3.9 SOLUTIONS

It is not possible to provide detailed technical options to prevent tax avoidance and evasion through each individual mechanism described above. Instead, this section provides a list of broad types of measures and discusses their implications for different types of avoidance strategies. Measures need to be implemented in developing countries, in developed countries and also internationally.

Strengthening tax rules and systems in developing countries

A significant share of tax avoidance and evasion could be prevented by developing countries if they developed improved regulatory frameworks and sufficient resources to enforce them. For example, countries can ensure they have adequate rules on transfer pricing, perhaps adopting an approach to the arms-length principle better suited to their needs than the standard OECD one. Once corporate transparency is improved, it will also be possible for individual countries to choose to adopt a unitary approach to taxing multinational companies.¹¹⁴ Countries can also adopt rules about the level of debt financing (thin capitalisation) permitted. They can tighten up enforcement of laws against fraud, thus clamping down on trade misinvoicing. And so on.

While not substituting the need for reforms of international tax rules and norms, strengthening the regulatory frameworks and the tax authorities of developing countries should be a priority in the global fight against tax avoidance. However, because the rules are complex, it requires more capacity than currently exists in some countries. Some estimates suggest that each US\$ 1 of aid invested in strengthening taxation systems in developing countries can generate up to US\$ 350 in tax revenues, but until very recently, only 0.1% of aid flows pursued this objective.¹¹⁵

Changing rules in developed countries that affect developing countries

Some domestic tax rules affect other countries, either deliberately or inadvertently – and this can include developed country rules affecting developing countries. For example, **controlled foreign company (CFC) rules** are measures adopted by a country to prevent its resident companies from artificially minimising tax payments by shifting income to low tax jurisdictions. (They are sometimes known as anti-tax-haven rules.) At

¹¹² Crivelli, E.; De Mooij, R. & Keen, M. (2015). Base Erosion, Profit Shifting and Developing Countries. IMF Working Paper, WP/15/118. Also AU panel - http://www.uneca.org/sites/default/files/PublicationFiles/iff_main_report_26feb_en.pdf
UNCTAD (2015). World Investment Report 2015: Reforming International Investment Governance. United Nations, Geneva;
Kar, D. & Spanjers, J. (2015). Illicit Financial Flows from Developing Countries: 2004-2013. Global Financial Integrity;
Boyce, J. K. & Ndikumana, L. (2012). Capital Flight from Sub-Saharan African Countries: Updated Estimates, 1970 – 2010. Political Economy Research Institute, University of Massachusetts,

Amherst; and

Cobham, A. & Jansky, P. (2015). Measuring Misalignment: The Location of US Multinationals' Economic Activity Versus the Location of their Profits. ICTD Working Paper 42

¹¹³ UNESCO (2015). Education for All Global Monitoring Report 2015. UNESCO, Paris

¹¹⁴ The case for a unitary approach to taxation of MNCs (to replace separate accounting) is elaborated further in the relate report for the commission by Cobham and Klees.

¹¹⁵ OECD-DAC (2012). Tax and development: aid modalities for strengthening tax systems. OECD, Paris

least 33 countries have adopted some form of CFC rules, including some developing and emerging countries such as Brazil, South Africa, Peru and Indonesia.¹¹⁶

Put very simply, CFC rules generally require funds that arise in tax havens to be taxed in the residence country. If CFC rules are weak, MNCs resident in the relevant country have an inadvertent incentive to shift profits from developing countries (or any countries) into tax havens, as the profits will not be taxed in the residence country because of the weak CFC rules. Strong CFC rules can also cover profits shifted out of third countries, which helps increase their impact.¹¹⁷

Another way developed-country rules can affect developing countries is through limits on thin capitalisation, through limits in the debt levels of companies which are based on the ratio of debt to equity, or through a ceiling in the amount of interest that can be deducted from company earnings. Research conducted in the US suggests that thin capitalisation rules effectively reduce the use of intra-company debt to artificially minimise tax payments.¹¹⁸ Yet another is to review unfair tax treaties – covered in depth in the next section.

Increasing transparency and information exchange

Most of the mechanisms discussed above rely to a significant extent on a thick veil of opacity in order to escape scrutiny by public authorities or the wider public / media. In particular, tax havens thrive on opacity. The three following measures would be particularly powerful in reducing tax avoidance and evasion.¹¹⁹ These measures can be implemented at the domestic level, though they would only be fully effective if implemented in a coordinated manner by a large number of countries. The third one, in particular, requires the participation of other countries.

- Public country-by-country reporting
- Public registries of beneficial ownership
- Automatic information of exchange among tax authorities, instead of the prevalent regime of exchange of information upon request.¹²⁰

We strongly recommend clear statutory measures to improve transparency rather than depending on voluntary initiatives (such as the Extractive Industries Transparency Initiative¹²¹) which are inevitably limited in scope – though lessons can be drawn from such efforts.

Revamping corporate taxation at international level

In the longer term, there are many changes at international level needed, in addition to the crucial transparency measures listed above. To implement these, an intergovernmental body to deal with tax matters, inclusive of all countries, is essential. This intergovernmental body might deal with matters such as:

- Reviewing international standards designed to reduce corporate tax avoidance and evasion, but in a more inclusive manner, more beneficial to all countries, than has been possible in the OECD BEPS process.
- Working towards a global system of unitary taxation, ensuring that formulas used do not unfairly disadvantage poorer countries.

¹¹⁶ Deloitte (2014) Guide to Controlled Foreign Company Regimes. Deloitte, UK

¹¹⁷ OECD. Public Discussion Draft. BEPS Action 3. Strengthening CFC Rules. 12th May 2015. Page 12

¹¹⁸ Blouin, J., Huizinga, H., Laeven, M. L., & Nicodème, G. (2014). Thin capitalization rules and multinational firm capital structure. International Monetary Fund.

¹¹⁹ For more information on these three areas see: Cobham, A. (2016) Global Taxation: Financing education and the other Sustainable Development Goals. A report to The International Commission on Financing Global Education Opportunity

¹²⁰ These are also key recommendations from the related Commission report by Cobham and Klees 2016

¹²¹ See <https://eiti.org/> and the EITI Standards 2016

4. TAX TREATIES

This chapter focus on the role of tax treaties in tax avoidance schemes. It starts by introducing the rationale for signing tax treaties. The following sections discuss when and how tax treaties can become an instrument to avoid taxes. The chapter ends by looking at the impact of tax treaties on developing countries and the implications for the education sector. It concludes with some different options that could help to minimise the impact of tax treaties on tax revenues in developing countries, thereby releasing potential funds for investment in education.

4.1 WHY TAX TREATIES EXIST AND THEIR CONSEQUENCES

Tax treaties are bilateral or, less often, multilateral **agreements ostensibly designed to prevent the double taxation of income** that originates in one territory and is paid to residents – both individuals and companies - of another. Tax treaties are thus seen as an important piece in ensuring a fair taxation of multinational companies and have become increasingly important with the surge of cross border investments over the last few decades. However, many legal scholars argue that changes in developed countries' tax systems since the Second World War make tax treaties largely unnecessary for this purpose.¹²² The evidence that they attract investment into developing countries is also unconvincing.

Tax treaties are usually based on one of two models and the **choice of model has implications for tax revenues in developing countries**.¹²³ Most treaties signed by OECD countries are based on the OECD model, which as discussed below tends to favour the richer country. The UN has also developed its own model, which proposes a fairer distribution of tax rights between signatory countries.

While tax treaties are not explicitly designed to facilitate tax avoidance that is nevertheless sometimes the effect they can have. Most often it arises as result of weakness in the agreement, out-dated clauses or biased negotiation processes. For example, some treaties are very old, which means they were not designed to deal with the increasingly globalised and digital economy and, in some cases, reflect a different balance of power. For example, the UK-Malawi tax treaty dates from 1955, nine years before the country became independent.¹²⁴ But how old a tax treaty is, is not the only factor at play. Recent research conducted by Martin Hearson for ActionAid shows that the negative impacts of tax treaties on low income countries have increased over time.¹²⁵ The specific mechanisms through which tax treaties can enable tax avoidance and some examples are discussed in greater depth in the sections below.

The harmful effects of treaties can be amplified through spill over effects. Treaty shopping is one such mechanism. Imagine that jurisdiction A signs a tax treaty with jurisdiction B and that the treaty offers significant tax advantages (e.g. lower rates on certain income) compared to another treaty (or no treaty) in existence between jurisdictions B and C. If tax savings are high enough, many companies from C or operating through C and with investments in jurisdiction B will restructure in order to channel income through jurisdiction A. This means that income that previously flowed from B to third countries will now be taxed at a lower rate, thereby increasing tax losses to the State.

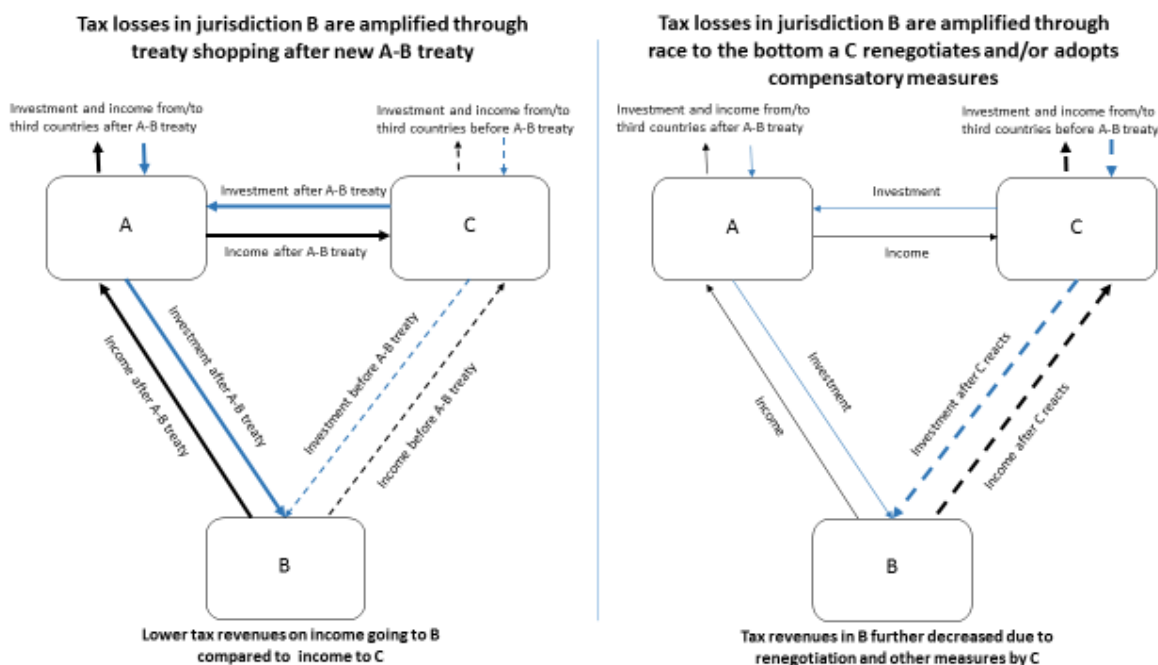
¹²² Two classic examples are Dagan T (2000) The Tax Treaties Myth. New York University Journal of International Law and Politics 32: 939 and Thuronyi V (2010) Tax Treaties and Developing Countries. In: Lang M, Pistone P, Schuch J, et al. (eds), Tax treaties: building bridges between law and economics, Amsterdam: IBFD, pp. 441–458.

¹²³ DAURER, V., & KREVER, R. (2012). Choosing between the UN and OECD tax policy models: An African case study. EUI Working Papers, RSCAS 2012/60

¹²⁴ ActionAid (2015) The UK's tax treaty with Malawi is out-dated and unfair: It's time Malawi got a better deal. ActionAid

¹²⁵ ActionAid (2016) Mistreated: The tax treaties that are depriving the world's poorest countries of vital revenue. ActionAid International, Johannesburg

A second amplification mechanism is through a race to the bottom. Following the example above, it is possible that a jurisdiction C, which has a treaty with B and used to receive or channel a lot of income from it, seeing a decrease in flows to the benefit of country A. In this situation country C would probably be inclined to redress the situation either by renegotiating the treaty or by adopting other compensatory measures.



4.2 ALLOCATION OF TAXATION RIGHTS

In order to avoid double taxation, **tax treaties distribute the rights of taxing income among the two participating countries.** These rights can be distributed on the basis of two different principles. Income can be taxed in the country where the company makes money. This approach is called 'source based taxation'. The second approach is to tax income where the company is headquartered for tax purposes and this is called 'residence based taxation'.

Tax treaties are neutral in the sense that the same provisions apply to both parties, but their **impact can be highly asymmetric**, especially in the case of treaties signed between developed and lower income developing countries. From a developing country perspective, 'source based taxation' usually results in much larger tax revenues compared to 'residence taxation' because developing countries tend to headquarter fewer multinational corporations compared to developed countries.

Tax treaties signed between developed and developing countries tend **to restrict 'source based taxation' and favour 'residence based taxation'**.¹²⁶ As a result, many tax treaties deprive developing countries of tax revenues and confer taxing rights on developed countries, who may benefit from most of the taxes, or allow their multinational firms to benefit from a lower effective tax rate. The asymmetry and unfairness of this approach is especially clear in industries where a lot of value is generated within the developing country such as factory production, extractive industries, agricultural production, etc.

¹²⁶ For this reason, tax treaties are "aid in reverse": Irish CR (1974) International Double Taxation Agreements and Income Taxation At Source: International and Comparative Law Quarterly 23(2): 292–316.

As more and more developed countries have tended to reduce or eliminate taxes on foreign income,¹²⁷ the predominance of ‘residence based taxation’ in tax treaties means that they are increasingly transfers of tax revenue from developing countries to multinational firms, rather than redistribution of tax revenue to developed countries.

4.3 REDUCTION OF WITHHOLDING TAXES

Withholding taxes apply to income that is transferred abroad (i.e. paid to non-residents abroad). In addition to raising tax revenues, withholding taxes can be used to discourage companies from shifting money to avoid taxes (see for example the section on transfer mispricing). In general, withholding taxes apply to payment of e.g. dividends, interest payments, royalties and service fees (management and consultancy fees, etc.). Withholding taxes can have different rates for different types of income and as a result tax treaties tend to adopt a differentiated approach to different types of income.

Concerns about the **impact of treaties on tax revenues can emerge when tax treaties reduce or eliminate withholding taxes**. This not only reduces the actual income from withholding taxes, but also increases the risk of avoidance because the deterrent effect is smaller. These effects can be substantially amplified through treaty shopping and other indirect effects (see above).

4.4 EXPLOITING WEAKNESSES AND DIFFERENCES BETWEEN TREATIES

When tax treaties allocate taxation rights they do so on the basis of certain definitions, conditions or rules that are outlined in the document. **Some of the definitions in existing tax treaties present weaknesses that can be exploited for tax avoidance purposes**. In other cases, definitions differ between tax treaties signed with different countries and can create inconsistencies that offer similar opportunities.

An example of the first mechanism is the definition of ‘**permanent establishment**’. In general, unless it has an incorporated subsidiary, tax treaties allow the taxations of the profits of a foreign corporation only if it has a ‘permanent establishment’ in the country. If the operations of multinational companies in the country can be structured in a way that circumvents the definition of ‘permanent establishment’ they can avoid taxes on profits. Although the definitions of permanent establishments in treaties signed by developing countries seem to have improved over the years, there are still examples such as the treaties signed by China with Mongolia, Laos and Ethiopia that severely restrict the ability of these countries to tax the profits of unincorporated Chinese companies.¹²⁸

Inconsistencies in the definition of tax residence from one treaty to another can also result in non-taxation and are an example of the second mechanism described above. Google is one of the companies that exploit this inconsistency in tax treaties signed by Ireland as part of a tax avoidance strategy known as the ‘double Irish Dutch Sandwich’.¹²⁹ A key part of this strategy is that inconsistencies in the definition of tax residence allow a company to be considered as Irish for tax purposes by the US, but as Bermudian by Ireland. This results in a form of stateless income that is not taxed anywhere.

4.5 LACK OF OR INADEQUATE ANTI-ABUSE CLAUSES

Many tax treaties fail to prevent abuse by foreign actors, thereby expanding the opportunities for benefiting from the tax advantages and avoidance opportunities that they provide. Strengthening the

¹²⁷ PWC (2013) Evolution of Territorial Tax Systems in the OECD

¹²⁸ ActionAid (2016) Mistreated: The tax treaties that are depriving the world’s poorest countries of vital revenue. ActionAid International, Johannesburg

¹²⁹ Discussion based on Zucman, G. (2014). Taxing across borders: Tracking personal wealth and corporate profits. The Journal of Economic Perspectives, 121-148

conditions for qualifying for the relevant treaty and its benefits while disallowing artificial arrangements set up to benefit from a tax treaty to do so can be a powerful tool to tackle treaty shopping.

Tax treaties are open to abuse in many different ways. One example is the failure of many treaties to prevent avoidance of capital gains tax. For example, only 51% of the 519 tax treaties examined in a recent ActionAid report include a clause that prevents the avoidance of capital gains tax on immovable assets through share sales.¹³⁰ Such a clause is becoming more common, though it is still remarkable that some countries continue to sign treaties without it.¹³¹

A range of different issues related to the inappropriate access to benefits granted by tax treaties has been discussed as part of the OECD BEPS process, but it will take some time before the impact of these solutions can be adequately assessed. As recognised by the OECD, many of the proposals still need to be further developed and the role of specific investment instruments and entities better defined.¹³²

4.6 WORLDWIDE IMPACT AND SOLUTIONS

Research studies point to the significant impact of tax treaties on tax revenues in developing countries, to the tune of billions of dollars a year. The IMF has estimated that non-OECD countries lose around US\$ 1.6bn a year as a consequence of US treaty provisions - in relation to dividend and interest payments alone.¹³³ Similar research conducted in the Netherlands estimates losses of EUR 770m for developing in 2011 as a result of tax treaties.¹³⁴ More recently, ActionAid has estimated that treaty restrictions on Bangladesh's ability to levy withholding taxes on dividend payments alone results in a revenue loss of US\$85 million annually. These estimates do not take into account the potential increase of risk avoidance and other indirect effects resulting from lower withholding taxes.

A study looking at the broader effects of tax treaties, such as treaty shopping, shows that tax treaties decrease the overall corporate tax rate on income from 21% to 12% as a result of the reduction in withholding taxes, with treaty shopping contributing to a further 6% reduction so that companies end up paying an effective rate of just 6%.¹³⁵ At this point there is not enough available data to allow a credible estimate to be made about the lost tax revenues arising from unfair tax treaties, but this is clearly an area where further research is warranted. Sub-Saharan Africa collected an average of US\$ 31bn in corporate taxes a year between 2008 and 2010¹³⁶ and it is clear that action on tax treaties could see this rise significantly.

To reduce the negative effects of tax treaties, efforts should be made to renegotiate treaties so as to impose fewer restrictions on the ability of developing countries to collect tax revenues.¹³⁷ Nigeria, Rwanda, South Africa, Zambia, Malawi and Mongolia have all recently either cancelled or renegotiated tax treaties¹³⁸. In the case of Rwanda they renegotiated a treaty with the tax haven of Mauritius and the new treaty allowed the Rwandan government (for the first time) to tax dividends sent to Mauritius, tax international interest

¹³⁰ ActionAid (2016) *Mistreated: The tax treaties that are depriving the world's poorest countries of vital revenue*. ActionAid International, Johannesburg

¹³¹ Hearson, M. (2015) *Measuring Tax Treaty Negotiation Outcomes: the ActionAid Tax Treaties Dataset*. ICTD Working Paper 47

¹³² OECD (2015) *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*. OECD/G20 Base Erosion and Profit Shifting Project, Action 6 - 2015 Final Report. OECD, Paris

¹³³ Keen, M et al, (2014). *Spillovers in international corporate taxation*. IMF Policy Paper, p. 24.

¹³⁴ McGuaran, K. (2013). *Should the Netherlands sign tax treaties with developing countries?* SOMO

¹³⁵ van't Riet, M. & Lejour, A. (2014). *Ranking the stars: network analysis of bilateral tax treaties* (No. 290). CPB Netherlands Bureau for Economic Policy Analysis, p 16.

¹³⁶ Calculations based on the World Bank online database and the dataset in: Mansour, M. (2014) *A Tax Revenue Dataset for Sub-Saharan Africa: 1980-2010*. Fondation pour les Études et Recherches sur le Développement International, working paper I19

¹³⁷ ActionAid (2016) *Mistreated: The tax treaties that are depriving the world's poorest countries of vital revenue*. ActionAid International, Johannesburg

payments and tax royalty payments. In the case of taxation rights, the UN model should be adopted as the minimum standard¹³⁹, to ensure that developing countries are given a chance to tax multinationals more fairly in the future.¹⁴⁰ Increased public scrutiny of the negotiation process can also help to identify and prevent weaknesses in the wording of the treaties.

Since there is no obligation to sign new or keep existing tax treaties, **it is also important that developing countries weigh the potential benefits of signing a tax treaty against its costs.** The relationship between treaties and investment has repeatedly been questioned, and the evidence suggests that any potential benefits that tax treaties might bring cannot be taken for granted.¹⁴¹ Developing countries need to consider whether treaties are likely to encourage sufficient additional foreign investment, or other positive impacts such as cooperation between tax authorities, to compensate for the potential losses.¹⁴² It seems appropriate for developing countries to conduct impact assessments before the negotiation or finalisation of any treaty and to review treaties after a few years in order to account for any unexpected effects. In some cases countries should consider cancelling or withdrawing from treaties where the negative effects are clear. Equally developed countries should take responsibility to review and renegotiate treaties that are clearly disadvantageous to developing countries. Indeed, any existing tax treaty that contradicts a developing country's national development goals should be open for renegotiation.

¹³⁸ ActionAid (2016) Mistreated - page 13

¹³⁹ As opposed to the OECD model which is not so helpful for developing countries. Indeed, low and middle income countries could helpfully formulate their own model treaties that go beyond the UN model (using the UN rates as a minimum not an upper limit).

¹⁴⁰ ActionAid (2016) Mistreated: The tax treaties that are depriving the world's poorest countries of vital revenue. ActionAid International, Johannesburg

¹⁴¹ Keen, M et al, (2014). IMF policy paper, spill-overs in international corporate taxation, ; and Brooks, K & Krever, R 2015. The troubling role of tax treaties. Tax design issues worldwide, series on international taxation, 51, pp. 159-17, 168.

¹⁴² Cooper, G. S: (2014) Preventing Tax Treaty Abuse. Papers on Selected Topics in Protecting the Tax Base of Developing Countries. UN Department on Social and Economic Affairs

5. EARMARKING TAXES TO EDUCATION

5.1 THE PROS AND CONS OF EARMARKING

Earmarking is the process of assigning revenue from specific taxes to particular objectives, in this case education. Under a full earmark, the earmarked revenue is the only source of finance for the programme, while a partial earmark means that other financing also contributes. Earmarking may also be wide – covering a whole spending programme – or narrow – for a specific project within the programme.¹⁴³ A distinction can also be made between '**soft**' earmarking, whereby government policy (but not legislation) decides to allocate certain taxes to education, and '**hard**' earmarking, whereby such expenditures are enshrined in law.

There has long been a debate about the **pros and cons** of earmarking. On the positive side, earmarking can encourage people to pay for better services and reduce resistance to paying taxes when people know they are being allocated for good causes (and education works well for this purpose, usually attracting people's support).¹⁴⁴ Earmarking can also increase revenues for a programme by providing an extra revenue stream that might not otherwise be available. It thus can avoid the periodic haggling that takes place within bureaucracies over appropriate levels of funding.¹⁴⁵ Earmarking can help ensure a minimum and stable source of funds to particular programmes.

However, opponents of earmarking often argue that it can lead to a misallocation of resources, with too much (or too little) being given to ear-marked activities and not enough to others. Earmarking can infringe on the powers and discretion of the legislative and executive branches of government and introduces inflexibility into budgets.¹⁴⁶ Earmarking is also open to criticism if programmes are not subject to evaluation since they may be diverted to lower-priority projects. Orthodox public finance theorists argue that public spending should be determined by policy decisions, not by the amount raised by an earmarked tax.¹⁴⁷ This raises the issue that education funding should clearly not be *solely* (or even *mainly*) funded by particular earmarked taxes but should be based on need and effective policy-making.

5.2 EXAMPLES OF EARMARKED TAXES FOR EDUCATION

Very few developing countries promote earmarked taxes for education. Some of those that do are outlined below.

Ghana has promoted a special fund for education - the Ghana Education Trust Fund (known as the GETFund) – since 2001, which is funded by 2.5 per cent of VAT collections. GETFund's mission is 'to support the delivery of quality education to the citizens of Ghana from the basic to tertiary level through dynamic funding policies aimed at ensuring equitable provision of essential resources for all levels of education to all

¹⁴³ Margaret Wilkinson, 'Paying for Public Spending: Is There a Role for Earmarked Taxes?', *Fiscal Studies*, 1994, <http://onlinelibrary.wiley.com/journal/10.1111/%28ISSN%291475-5890>

¹⁴⁴ Margaret Wilkinson, 'Paying for Public Spending: Is There a Role for Earmarked Taxes?', *Fiscal Studies*, 1994, <http://onlinelibrary.wiley.com/journal/10.1111/%28ISSN%291475-5890>

¹⁴⁵ William McCleary, 'The Earmarking of Government Revenue: A Review of Some World Bank Experience', *World Bank Research Observer*, 1991, [http://www-](http://www-wds.worldbank.org/servlet/WDSContentServer/IW3P/IB/2000/01/06/000178830_98101911461915/Rendered/PDF/multi_page.pdf)

[wds.worldbank.org/servlet/WDSContentServer/IW3P/IB/2000/01/06/000178830_98101911461915/Rendered/PDF/multi_page.pdf](http://www-wds.worldbank.org/servlet/WDSContentServer/IW3P/IB/2000/01/06/000178830_98101911461915/Rendered/PDF/multi_page.pdf)

¹⁴⁶ William McCleary, 'The Earmarking of Government Revenue: A Review of Some World Bank Experience', *World Bank Research Observer*, 1991, [http://www-](http://www-wds.worldbank.org/servlet/WDSContentServer/IW3P/IB/2000/01/06/000178830_98101911461915/Rendered/PDF/multi_page.pdf)

[wds.worldbank.org/servlet/WDSContentServer/IW3P/IB/2000/01/06/000178830_98101911461915/Rendered/PDF/multi_page.pdf](http://www-wds.worldbank.org/servlet/WDSContentServer/IW3P/IB/2000/01/06/000178830_98101911461915/Rendered/PDF/multi_page.pdf)

¹⁴⁷ Margaret Wilkinson, 'Paying for Public Spending: Is There a Role for Earmarked Taxes?', *Fiscal Studies*, 1994, <http://onlinelibrary.wiley.com/journal/10.1111/%28ISSN%291475-5890>

segments of the Ghanaian population'.¹⁴⁸ However, much of GETFund's focus is on tertiary education.¹⁴⁹ In the 2016 budget GETFund is reportedly contributing 14 per cent of the allocation to education.¹⁵⁰

Nigeria has a 'tertiary education tax' under which all Nigerian resident companies (but not foreign companies) pay 2 per cent of their assessable profits.¹⁵¹ The Tertiary Education Trust Fund, established in 2011, manages and disburses the education tax funds to public tertiary institutions in Nigeria, and focuses on promoting physical infrastructure for teaching and learning, instructional material and equipment, research and publications and academic staff training and development.¹⁵² The tax was previously called an Education Tax, which began in the 1990s and was disbursed to education at all levels in the country. In 2011, the tertiary education tax collected N128 billion in revenues.¹⁵³ It was reported in late 2015 that the government was considering increasing the allocation to the TETFund from 2 per cent to 4 per cent.¹⁵⁴

Brazil has at least two earmarked education taxes. In August 2013, the Brazilian Congress passed a bill to ensure that royalties from newly discovered oil fields go to education and healthcare. According to the bill, 75 per cent of royalties paid to the government from oilfields in the so-called 'pre-salt' layer (where the oil and gas lies beneath several thousand metres of water, rock and salt off the Brazilian coast) are to be invested in education and 25 per cent in health. This oil revenue is projected to contribute more than US\$75 billion to public education over the next 10 years.¹⁵⁵ In addition, Brazil has another fund for promoting basic education which utilises a certain proportion of taxes collected. Previously, the Fund for the Maintenance and Development of Basic Education (FUNDEF), which came into effect in 1997 to finance sub-national spending on primary and lower-secondary education, was partly financed by earmarking 15 per cent of revenues from state collections of VAT. Its present configuration, known as FUNDEB (Fund for the Development of Basic Education and Appreciation of the Teaching Profession) is funded by an allocation of 20 per cent of state and federal taxes.

India's flagship programme for ensuring elementary education for all is the Sarva Shiksha Abhiyan (SSA) programme, which is partly financed through an 'education cess'; the cess is a 'tax-on-tax' introduced in 2004 on all Union taxes at the rate of 2 per cent, which is kept in a separate fund called the Elementary Education Fund and can only be used for the purpose of funding the SSA and the Mid-day Meal scheme. The cess has funded around 60 per cent of the SSA programme during 2006-13, the rest of the finance coming from general government budgetary allocations. The government also introduced in 2009-10 the Rashtriya Madhyamik Shiksha Abhiyan (National Secondary Education Mission, RMSA) with a mandate to provide universal secondary education by 2020. The education cess was raised by one percentage point from 2 to 3

¹⁴⁸ 'GETFund's mission', <http://www.getfund.gov.gh/index.php/2013-05-09-10-08-27/2013-05-09-10-38-32>

¹⁴⁹ 'History', <http://www.getfund.gov.gh/index.php/2013-05-09-10-08-27/2013-05-09-10-39-06>. GETFund states that a key aim is 'Provision of financial support to the agencies and institutions under the Ministry of Education, for the development and maintenance of essential academic facilities and infrastructure in public educational institutions, particularly, in tertiary institutions'.

¹⁵⁰ Ama Amankwah Baafi, 'UNICEF, two others push for more funds for education', 16 February 2016, <http://www.graphic.com.gh/news/education/58437-unicef-two-others-push-for-more-funds-for-education.html#sthash.olPhx5q6.dpuf>

¹⁵¹ 'Nigeria Corporate - Taxes on corporate income', <http://taxsummaries.pwc.com/uk/taxsummaries/wwts.nsf/ID/Nigeria-Corporate-Taxes-on-corporate-income>

¹⁵² 'About TETFUND', <http://www.tetfund.gov.ng/index.php/about-tetfund>

¹⁵³ Innocent Oweh, 'Education tax: A collaboration that may salvage education in Nigeria', undated, <http://dailyindependentnig.com/2012/10/education-tax-a-collaboration-that-may-salvage-education-in-nigeria/>

¹⁵⁴ Amina Mohammed, 'Nigeria to raise tertiary education tax to 4%', 19 August 2015

¹⁵⁵ Brazilian Campaign for Education (<http://www.campanhaeducacao.org.br/?idn=117>), cited in Global Campaign for Education, A *Taxing Business: Financing Education for All Through Domestic Resources*, 2013, p.15, http://www.campaignforeducation.org/docs/reports/GCE_A%20TAXING%20BUSINESS.pdf

per cent in April 2009 to provide earmarked funds for RMSA.¹⁵⁶ The programme aims to increase secondary school enrolment to 75 per cent as compared to 52 per cent in 2006.¹⁵⁷

China has since 1986 had an Educational Surcharge levied on all taxpayers who pay VAT, Consumption Tax (CT) and Business Tax (BT) at a rate of 3 per cent of these taxes. Previously applying only to domestic enterprises, in 2011 the surcharge was extended to foreign companies.¹⁵⁸

5.3 THE PERFORMANCE OF EARMARKED TAXES

There have been a few studies of some of the earmarked taxes for education and these suggest that they have usefully contributed to improving education spending and quality. However, these studies rarely elucidate on whether earmarked taxes specifically (as opposed to other forms of funding) have made decisive differences in the quality of the programmes.

Brazil's FUNDEF programme was associated with a rapid increase in enrolment rates in primary and lower-secondary education. Studies carried out in the 1990s showed that enrolment rates rose 2 per cent per year faster after the introduction of FUNDEF.¹⁵⁹ Similarly, **India's Sarva Shiksha Abhiyan** (SSA) programme has recorded impressive achievements in terms of mobilization and allocation of resources, creation of infrastructure, hiring and training of teachers and participation of community groups in delivering education. Some studies suggest that the cess has contributed to increasing spending on education by Union and State governments.¹⁶⁰ By 2011, over 350,000 schools were constructed and nearly 1.12 million teachers were recruited; the dropout rate declined by half from 40 to nearly 20 per cent between 2001-02 and 2009-10. The SSA also involves strong community participation with the setting up of Village Education Committees and School Management Committees to try to ensure accountability and provide oversight on fund utilization and school functioning.¹⁶¹

Ghana's GETFund has generated millions of dollars each year nationally for educational sector infrastructure and student assistance programmes and is considered by some analysts as one of the most transformative pieces of legislation in Ghana's education history.¹⁶² The major concerns have been over the timely allocation of resources. In January 2016, for example, the Public Accounts Committee of Ghana's Parliament accused the Ministry of Finance of delaying the release of money to the GETFund, saying that from 2005 to

¹⁵⁶ Anit Mukherjee, "Targeting Education Financing on the Marginalized: Lessons from Implementation of Sarva Shiksha Abhiyan and Right to Education in India", Background Paper for UNESCO, 2013, <http://unesdoc.unesco.org/images/0022/002259/225951E.pdf>

¹⁵⁷ 'Overview', <http://mhrd.gov.in/rmsa>

¹⁵⁸ Dan Harris, 'China's Tax System: When "Equal" Is A Very Bad Thing', 19 December 2010,

http://www.chinalawblog.com/2010/12/chinas_tax_system_when_equal_is_a_very_bad_thing.html; Josh Silverman, 'Reminder to Account for Urban Construction Tax and Education Surcharge from Dec. 1', 1 December 2010, <http://www.china-briefing.com/news/2010/12/01/reminder-to-account-for-urban-construction-tax-and-education-surcharge-from-dec-1.html>

¹⁵⁹ OECD, *Territorial Reviews: Brazil*, 2013, p.164,

https://books.google.es/books?id=oiUcSuaUbjlC&pg=PA164&lpg=PA164&dq=brazil+fundef+vat&source=bl&ots=QVC9pi6EpT&sig=PqbxX1ZAay_v75gblc0A33CwFN0&hl=en&sa=X&ved=0ahUKEwiulJLs4o3LAhWHUHQKHbG0B_kQ6AEIjAB#v=onepage&q=brazil%20fundef%20vat&f=false

¹⁶⁰ Anit Mukherjee, "Targeting Education Financing on the Marginalized: Lessons from Implementation of Sarva Shiksha Abhiyan and Right to Education in India", Background Paper for UNESCO, 2013, <http://unesdoc.unesco.org/images/0022/002259/225951E.pdf>

¹⁶¹ Anit Mukherjee, "Targeting Education Financing on the Marginalized: Lessons from Implementation of Sarva Shiksha Abhiyan and Right to Education in India", Background Paper for UNESCO, 2013, <http://unesdoc.unesco.org/images/0022/002259/225951E.pdf>

¹⁶² Francis Atuahene, 'Financing Higher Education through Value Added Tax: A Review of the Contribution of the Ghana Education Trust Fund (GETFund) in Fulfilment of the Objectives of Act 581', JHEA/RESA, 2009,

https://www.researchgate.net/publication/228451354_Financing_Higher_Education_through_Value_Added_Tax_A_Review_of_the_Contribution_of_Ghana_Education_Trust_Fund_GETFund_in_Fulfillment_of_Act_581

2013 monthly disbursement into the fund was usually in arrears between two and nine months, compared to the one month mandated by law.¹⁶³

Nigeria's TETFund has also received mixed reviews. One study of the Fund's impact on one university – Ebonyi State University – concludes that the programme has impacted positively on the infrastructural and human development of the institutions, by boosting finances to improve infrastructure and the quality of teaching. However, the study also notes that, despite the TETFund, tertiary institutions in Nigeria still lack the funds necessary to upgrade the institutions to international standard, partly since 'even the funds approved by TETFund are not always fully accessed by the beneficiary institutions'.¹⁶⁴ A study of the TETFund in Imo state concluded that it has not impacted significantly on the quality of tertiary education since the latter remains bedevilled with dilapidated infrastructure, insufficient classrooms, obsolete textbooks in libraries and inadequate student accommodation. It also found numerous cases of fraud in the allocation of the funds, a lack of a sound internal financial control system and a lopsided allocation of funds.¹⁶⁵

5.4 THE POTENTIAL OF EARMARKED TAXES

Earmarked taxes have the potential to both raise more revenue for education and increase the transparency of the tax system – because if a government commits to earmark a tax for education then the funds raised should be more easily monitored by citizens. In practice, earmarking is **more common in health policy** than in education policy. Some 64 countries use earmarked payroll tax revenues to fund contributions for coverage of formal sector workers in a public health insurance scheme. Some 24 countries allocate a proportion of revenues from tobacco taxes to health, while 10 do so for sales of alcohol.¹⁶⁶ However, a recent analysis argues that, even with health policy, there is limited convincing evidence on whether earmarking revenues for health actually leads to more stable, predictable, and flexible sources of funding. Additionally, while there has been some sector specific work undertaken, such as a recent WHO examination of tobacco earmarks, there is almost no practical evidence on the 'how' of earmarking that focuses on real country experience.¹⁶⁷

Certainly education passes the first test for any earmarked tax – that it is **something which people are happier to contribute to than some other areas of spending**. Indeed, evidence from existing earmarking programmes for education suggest that they have the potential to contribute to increased education spending and therefore should be seriously considered by governments. This is important, but more research and evaluation is needed on the specific contribution of earmarked taxes to the success of these programmes.

In any scenario where earmarked taxes are used for education there is a particular need to ensure that they are only one source of funding and that they are **supplementary to existing allocations** - generating genuinely additional revenue that would not otherwise be raised. One option here is **setting a benchmark on existing tax allocations** or spending on education, before introducing a new earmarked tax - so that it can be clearly seen (and tracked) that the earmarked tax is providing additional revenues. In a scenario where no

¹⁶³ Musah Yahaya Jafaru. 'Ministry of Finance delays release of GETFund – PAC', 27 January 2016, <http://www.graphic.com.gh/news/general-news/57130-ministry-of-finance-delays-release-of-getfund-pac.html#sthash.jh8tVTqx.dpuf>

¹⁶⁴ Larry Udu and Joseph Nkwede, 'Tertiary Education Trust Fund: Interventions and Sustainable Development in Nigerian Universities: Evidence from Ebonyi State University, Abakaliki', *Journal of Sustainable Development*, 2014, <http://www.ccsenet.org/journal/index.php/jsd/article/viewFile/39128/21755>

¹⁶⁵ 'The Impact of Education Tax Fund on the Tertiary Institutions in Nigeria', undated, https://www.academia.edu/8881003/THE_IMPACT_OF_EDUCATION_TAX_FUND ETF_ON_THE_TERTIARY_INSTITUTIONS_IN_NIGERIA

¹⁶⁶ Cheryl Cashin and Danielle Bloom, 'Earmarking — A Safe Bet to Finance Health?', 28 January 2016, <http://www.jointlearningnetwork.org/news/earmarking-a-safe-bet-to-finance-health>

¹⁶⁷ Cheryl Cashin and Danielle Bloom, 'Earmarking — A Safe Bet to Finance Health?', 28 January 2016, <http://www.jointlearningnetwork.org/news/earmarking-a-safe-bet-to-finance-health>

such benchmark is in place there is a danger that public support for education is simply being used to justify new taxes, without education itself benefiting – and this should be avoided.

There may be particular scope to advocate for earmarked taxes on **natural resource extraction** – as these might be seen to be part of the natural capital of a country and it makes sense to exchange this form of capital for investment in human capital through education – which brings such long term gains for the nation. There may also be a case for earmarked taxes on corporate profits, perhaps in particular sectors such as IT and mobile phones - as education is key to bridging the digital divide and the market for such products is dramatically expanded through the spread of literacy.

Different countries may choose different positions on whether to use **soft earmarking** (based on policy) or **hard earmarking** (based on law). The IMF tends to discourage hard earmarking (as it imposes too much rigidity and limits the space for government manoeuvre) but in some political contexts this may be the favoured route. In practice, unless allocations to education from the existing tax base are explicitly benchmarked (as noted above) then an apparently hard earmarking may in practice be soft (as there is scope for the government to allocate other revenue upwards or downward based on their policy preferences). In this case there are dangers that having a tax earmarked for education just helps to legitimate (or reduce opposition to) the new tax collection without necessarily leading to new revenue for education. To avoid this scenario there is a case for stronger benchmarking and harder earmarking. However, it is worth noting that most governments do not radically revise general fund financing allocations annually to different sectors – the empirical norm is for allocations to proceed in an incremental manner year on year rather than for allocations to be adjusted in the light of serious re-evaluation of tax and spending needs year on year. So long as this holds true a new earmarked tax for education may indeed generate more revenue for education.

The **Education SDG offers a particular moment** when earmarked taxes for education may make sense. For example, many countries will need to ratchet up spending on education over the coming years in order to scale up public provision or early childhood education or to universalise access to secondary education. In such a case, if it fits the national government's development priorities, even if there are concerns about permanent earmarking, a case could be made to introduce an earmarked tax initially with a limited (say ten year) timeframe – on the understanding that at the end of that period the economic returns that emerge from such investment in education will, by the end of the period, have enabled the government to raise more revenue through normal forms of taxation. The Education Finance Commission could helpfully call for such earmarked taxes so long as there is a clear commitment to benchmark pre-existing tax allocations to education – so as to ensure that the new taxes raised are truly leading to additional investment.

6. CONCLUSIONS: WHAT CAN BE DONE

AN EXAMPLE OF WHAT CAN BE DONE: TRANSFORMATION IN TANZANIA

In 2016, ActionAid Tanzania and the Tanzania Tax Justice Coalition are seeing the remarkable fruition of years of campaigning - as the government develops a more progressive tax system and commits to increasing spending on education. Following campaign pressure, the government introduced and then parliament enacted a new VAT Act 2014 and Tax Admin Act 2014, both of which entered into law in February 2015. These new laws have provisions in which all multinationals must now pay VAT, all discretionary powers of the ministers in granting tax incentives were removed; all multinationals seeking incentives will be subject to a full cost benefit analysis; and all tax incentives will go through parliamentary scrutiny first.

Civil society pressure, including by ActionAid Tanzania and the Tanzania Tax Justice Coalition, strongly contributed to this through

- Publishing research into tax incentives in 2012¹⁶⁸;
- Supporting analysis and discussion of the draft bills including attending parliamentary sessions with MPs;
- Funding capacity building for parliamentarians so they could debate the issue in parliament from an informed perspective;
- Training journalists and raising the profile of tax issues through print and electronic media,
- Undertaking advocacy and lobbying initiatives targeting the Ministry of Finance, the Tanzania Revenue Authority and the President;
- Engaging in informal face to face meetings with the revenue authority;
- Mobilising students from secondary, tertiary and university level around Dar Es Salaam and youth and community members from surrounding suburbs to sign a petition on tax and public services that was handed to the Ministry of Finance;
- Engaging with all political parties on the eve of the 2015 elections to include manifesto commitments on tax justice and spending on public services.

After the elections the increased political will by the new government has seen the restructuring of the revenue authority leadership including those involved in suspected corruption and theft as well as those involved in shoddy deals that led to multinational companies not paying taxes on their products to the revenue authority at the port. These measures have resulted in government significantly increasing tax collection (a monthly record of \$1.7 trillion shillings was raised in December 2015¹⁶⁹. This has enabled the government to increase the budget for education from 3,465 billion t-shillings (2014/15 FY) to 3,870 billion t-shillings (2015/16 FY) - that is from US\$1.58 billion to \$1.77 billion in a single year. There are prospects of much greater increases if the same trajectory is followed in the coming years.

CONCLUSION

The Education Finance Commission needs to be able to recommend ways to raise both significant and sustainable new financing to help countries achieve the full education SDG. Short-term, one-off solutions will not represent a breakthrough. An extra billion or two will not make the difference. **Placing a strong focus on how to expand the tax base for financing of education offers the best prospect for delivering what is urgently needed – tens of billions of dollars in sustainable funding, year on year.**

¹⁶⁸ Tax Competition in East Africa : A Race to the Bottom? http://www.actionaid.org/sites/files/actionaid/eac_report.pdf

¹⁶⁹ See <http://www.thecitizen.co.tz/News/TRA-collections-hit-a-record-Sh-1-4-tr-since-establishment/-/1840340/3024280/-/2vuokuz/-/index.html> and <http://www.thecitizen.co.tz/News/-/1840340/3110436/-/kpcb2p/-/index.html>

Crucially, this also offers a way to provide sustainable financing that deepens rather than undermines the accountability of national governments to deliver on the right to education.

The sustainable financing potentially available is indicated by the following estimates:

- \$139 billion a year from persuading Ministries of Finance and Revenue Authorities to end harmful tax incentives.
- \$100 to \$200 billion a year from promoting effective action to end tax avoidance in developing countries.

If education were to receive 20% of these sums (the present, widely accepted benchmark) then this would represent a dramatic breakthrough for financing the Education 2030 agenda. Of course, the full amounts will not be recovered – but the figures show just how much corporate taxation alone could contribute. There is also scope to raise many billions more through earmarked taxes for education – for example linked to natural resource extraction or the profits of certain categories of companies – so long as existing funding is clearly benchmarked so the new taxes raise genuinely additional resources for education.

Making progress on tax reform is not without challenges. There are strong **vested political and commercial interests**. Individual politicians may see they have more to gain (from ribbon cutting, job-creation, positive publicity and sometimes even backhand payments) from agreeing incentives than from blocking them. The increase public revenue that will be gained does not bring such immediate personal benefit or profile. Of course MNCs themselves are always likely to champion the benefits of tax incentives, tax treaties or tax arrangements from which they benefit. There is a need therefore to look beyond individual interests to the collective interest and the public good that can be gained from reform. This requires public awareness, citizen pressure and high level championing at both global and national levels if we are to make a breakthrough.

This is an issue whose time has come. The furore around the world following the Panama Papers showed the widespread public and political support for reform. The Education Finance Commission is ideally positioned to champion action on tax as the most effective single means to mobilise the tens of billions of dollars that are urgently needed. It is time for the negative cycle of lost revenue and low investment in education to be replaced by a positive cycle of expanding domestic tax revenue to invest sustainably in education that will yield the long term economic growth - that in turn will expand revenues further

RECOMMENDATIONS

Concretely we make the following recommendations:

Developing country governments

- Stop offering harmful tax incentives (the four types outlined in this report) and only use other tax incentives selectively to facilitate truly strategic national development.
- Strengthen tax systems, including the legal and regulatory frameworks and capacities in revenue authorities.
- Adopt measures to protect their corporate tax bases, such as for example disallowing excessive tax deductions for corporations and requiring them to use simpler methods of transfer pricing
- Increase tax collecting efforts and promote reforms to build more progressive tax systems.
- Cancel or renegotiate disadvantageous tax treaties.
- Consider the case for new earmarked taxes to raise revenue for strategic new investments in education if this is a more feasible route to increase revenue for the social sectors than un-earmarked increases in general revenue. Develop partial earmarking over full earmarking where that is a feasible choice.

- Collaborate with other countries in their region to harmonise corporate tax rates and policies so as to avoid a race to the bottom.

Multi-national corporations

- Pay fair taxes in the countries where they are invested.
- Commit to full transparency in tax affairs by voluntarily adopting country-by-country reporting.
- Companies linked to the Global Business Coalition for Education should set a positive example by committing to and adopting these measures.

Developed countries / Aid donors

- Provide more aid to strengthen tax systems, including national revenue authorities.
- Harmonise efforts behind sector support to national education sector plans (e.g. through the Global Partnership for Education).
- Conduct 'spillover analysis' of their own tax systems and tax treaties, making changes that both disincentivise tax avoidance by MNCs operating in developing countries (for example through strong CFC rules and regulation of thin capitalisation, or by barring non-complying companies from bidding for government contracts) and redistribute taxing rights back to developing countries.
- Review and renegotiate tax treaties that are disadvantageous to developing countries (which are otherwise undermining aid efforts from the same country).

Civil society organisations

- Link national education coalitions with tax justice, health and social protection campaigners to build strong broad-based, rooted alliances demanding tax justice and progressive spending.
- Build awareness of national citizens about the injustices involved when a small shopkeeper or landless labourer is paying tax but the largest multinational companies are not.
- Make the case for increasing 4 S's – the **share** of the budget for education, the **size** of the budget overall, the **sensitivity** of the budget (especially to equity concerns) and the **scrutiny** of the budget,

All governments

- Create a fully empowered, globally-inclusive and well-resourced inter-governmental body on tax – that is able to set and enforce fair global rules on tax avoidance, and consider new ways of doing corporate taxation such as a unitary system.
- Support international rules on tax transparency: public country by country reporting, public registries of beneficial ownership and automatic exchange of information among tax authorities.
- Support the creation of a global public registry of financial wealth.

