What if developing countries could finance poverty eradication from their own public resources?

Global Policy Forum Europe
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For decades development cooperation has been based on the assumption that countries of the global South need to be *helped* in their development with monies coming from the rich North. A symbol of this "partnership" (a euphemism for what are too frequently paternalistic donor-recipient relationships) is the 35-year-old unfulfilled promise by developed countries to allocate 0.7% of their gross domestic product (GDP) to official development assistance (ODA).[2] Since the time this pledge was made, the discourse about development financing has concentrated on the question of how to mobilize more money for the South, whether through an increase in ODA or through new financial instruments like global taxes.

Yet, however useful, "aid" is not the solution. It is not sufficient and, in the long term, Southern countries can only overcome their dependency on rich donors when their governments are able to mobilize enough domestic resources to guarantee universal access to reasonable quality essential public goods and services. New perspectives are needed.

The basic starting points for achieving this goal include, among others, an effective tax system that enables governments to raise the necessary resources, and transparent and democratic ("participatory") budgets that focus on the financing of key development tasks. The most urgent of those tasks are outlined in the so-called Millennium Development Goals (MDGs), and they address issues such as education, health, nutrition, safe water provision and social security.

However, up to now the mobilization of domestic resources and the strengthening of fiscal policies for the purposes of poverty eradication and social redistribution has been met by several internal and external obstacles.

Billions lost through tax evasion

Southern countries lose billions of dollars of potential income every year. Some of the main causes of those *leaks* are the following:

- Ineffective tax systems fail to reach landowners, foreign corporations and wealthy individuals. This comes hand in hand with a corrupt financial administration that is not in a condition to actually stop tax revenue from falling.
- Through tax cuts and frequent tax exemptions for foreign investors, developing countries forego revenues without ensuring the corresponding development benefits of the investments thus promoted. This is particularly true in the more than 3,000 currently existing export processing zones (sometimes called "special economic zones"), where workers' rights and environmental regulations are frequently abolished. The competition to attract foreign investment becomes a "race to the bottom" in tax terms. Transnational corporations profit from this practice, but the local populations seldom see the benefits.
- The globalization of corporate activities allows firms with a transnational presence to manipulate the prices of their internal transactions so that the profits are accounted for in the countries where the taxes are lower, in a move known as "transfer pricing". While markets and production are globalized and money can circulate around the world in seconds, tax policy is confined within national borders.
- Even countries with properly functioning tax systems lose billions of dollars every year due to capital flight to tax havens.
- Finally, the pressure towards trade liberalization and tariff reduction deprives many countries in the South of vital income. In Africa in particular, customs revenues provide an important percentage of government income. Dropping tariffs and providing no replacement leaves a gap in the budget.

  The resources that are actually lost through capital flight, tax avoidance and tax fraud can only be estimated, as there are no official statistics on these phenomena. The dimension of the problem, however, can be assessed from the following figures:

- If low-income countries were to revise their taxes, strengthen their financial administrations and abolish tax exemptions for transnational investors so that the proportion of public revenues within gross domestic product (which was 12.0% in 2003) was brought to the average level of the rich countries (25.7% in 2003), their governments' income would increase by approximately USD 140 billion per year.[3]
- The tax income of the developing countries would increase by over USD 285 billion per year if the informal economy could be integrated completely into the formal economy and taxed accordingly. Even if this is unrealistic, partial integration would already bring in many billions in additional income.
- Manipulating the accounting of the prices of intra-firm transactions or falsely declared import or export prices led to shortfalls in revenue of USD 53 billion in one year in the USA alone. For developing countries no numbers are available so far, but the tax losses for public budgets are considerable in any case.
- On a worldwide level, capital flight to tax havens results in losses to governments of an estimated USD 255 billion a year due to uncollected income and property taxes. Of this total, roughly 20% – or approximately USD 50 billion – would most likely correspond to the countries of the South (Cobham, 2005a, p. 10).

In contrast to these numbers, the United Nations Millennium Development Project has estimated that in order to achieve the MDGs, low-income countries should be spending USD 180 billion in 2006 on essential services, or USD 43 billion more than in 2002. Those domestic expenditures would still need to be supported by an increase in ODA by USD 73 billion (between 2002 and 2006). Thus the fulfilment of the MDGs requires both a substantial increase in development assistance and substantial additional tax revenues in the countries of the South. In other words, only if the tax loopholes are plugged and tax evasion is drastically reduced in the countries of the South can the MDGs still be achieved.

Nevertheless, functioning tax systems, the reduction of capital flight and the effective taxation of the rich elites and transnational corporations do not guarantee that governments will actually use the additional revenues for the fight against poverty and the development of their countries. And that is because parallel to the obstacles on the income side, there are various problems on the expenditure side which can prevent the use of public revenues in a way that actually contributes to development.

Reallocation in budgets would bring in billions for social development

Many governments of the South do not spend a substantial portion of public income on measures that fight poverty. Instead, a major part of the usually meagre public revenues flow into debt servicing,

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2 Resolution A/RES/2626 (XXV) of the UN General Assembly (1970).

3 For the poorest countries, however, in which the majority live at the margins of minimum acceptable standards of living, an increase in the proportion of tax revenues within GDP to the level of the industrialised countries is hardly probable.

into subsidies that do not help development and harm the environment, and into military budgets. This is partially due to the pressure from foreign creditors (including the IMF and World Bank) or hostile neighbour states. But part of the responsibility for the misuse of resources lies with the governments of these countries themselves. The sums at stake are enormous:

- In 2004 the governments of Africa, Asia, Latin America and the CIS (former Soviet Union) spent USD 333.7 billion on servicing their foreign debts.
- The subsidies of non-OECD countries to agriculture, water, energy, forestry, fishery and other environmentally relevant sectors have been estimated at USD 340 billion per year.
- The annual military expenditure of the countries of the South reached a volume of USD 193 billion in 2004.
- At the same time, public expenditures on education and health remain stagnant in many developing countries. Costs are being transferred, particularly in the area of health, from the public to private budgets. This affects the poor above all.

A reform of government budgets would set billions free for poverty eradication and social development programmes. The cost estimates of the implementation of the MDGs entail that public budgets for essential services must more than double between today and 2015. This can only be possible in the countries of the South if, along with higher tax income, they also reduce their debt service payments, cut harmful subsidies, and lower their military expenditure. The possibility of reforming the resource allocation in the national budgets of developing countries should not however obscure the fact that in the budgets of the rich countries there are far larger possibilities of savings and better utilization of funds. Some USD 725 billion per year is spent on subsidies, which are problematic for both social and environmental reasons. The military expenditure of the rich countries was USD 842 billion in 2004, which is more than four times greater than the defence budgets of all of the countries of the South put together. The Bush administration spends USD 10 billion *per month* on the war in Iraq and Afghanistan alone, more than what the United Nations and all their development programmes and funds spend in an entire year.

Steps toward global tax justice and eco-social fiscal reforms

In recent years, NGOs, social movements and international expert committees have formulated comprehensive recommendations for global tax justice and eco-social fiscal reforms. Realizing these requires a paradigm shift in the international discourse on development financing and the implementation of the MDGs, which lies along the following lines:

1. *Build efficient and fair tax systems*. A basic condition for the strengthening of public revenues is a broadly based tax system. The rich and the large landowners should pay more. Capital and resource consumption should be taxed more than labour. A flat value added tax is regressive and burdens the poor. The governments and parliaments of the countries concerned carry the responsibility for undertaking this kind of tax reform. Development cooperation should actively support these reforms through capacity building and technical assistance.

2. *Strengthening of tax administration and public financial management*. A tax system is only as effective as the administrative machinery that implements it. In many countries such tax administration still needs to be built, or at least strengthened. This involves the legal framework, the staff and the technical infrastructure. Only in this way can the untaxed shadow economy be reduced, tax avoidance overcome and tax evasion prevented. Development cooperation can provide crucial technical and financial support here.

3. *Effective taxation of transnational companies*. Tax exemptions or tax incentives for transnational investors in export processing zones are counterproductive in this regard. They should be abolished, if possible in an internationally coordinated way (see below). Furthermore, laws against manipulative transfer pricing should be introduced and the necessary technical capacities must be created. In view of the rapid technological development, international support and cooperation are urgently necessary here.

4. *Tax compliance as part of corporate responsibility*. The debate on corporate social responsibility and accountability has concentrated so far on fundamental environmental and social standards, human rights and corruption. Taxation questions have so far played a minimal role in this debate. Only the OECD Guidelines for Multinational Enterprises demand in chapter X: "It is important that enterprises contribute to the public finances of host countries by making timely payment of their tax liabilities. In particular, enterprises should comply with the tax laws and regulations in all countries in which they operate and should exert every effort to act in accordance with both the letter and spirit of those laws and regulations. This would include such measures as providing to the relevant authorities the information necessary for the correct determination of taxes to be assessed in connection with their operations and conforming transfer pricing practices to the arm's length principle." These norms should apply to all corporations, particularly those participating in the UN-promoted Global Compact. A company that evades taxes through accounting tricks should not be labelled as "socially responsible".

5. *Binding rules on the transparency of payment flows*. Taxes and royalties from foreign investments in the oil, natural gas and mining sectors are of great importance to commodity-rich countries. These taxes are frequently not published by the governments nor by the companies involved. But lack of transparency facilitates corruption and tax evasion. Since the disclosure of information could create a competitive disadvantage to an individual company, it does not make sense to rely on voluntary initiatives, and governments should make it mandatory for a corporation quoted on the stock market – in particular oil and mining firms – to disclose all information about the taxes and royalties they pay, as well as fees and other financial flows between them and public institutions in all countries.

6. *Fight against corruption and bribery*. In order to reduce the losses due to fraud, corruption and bribery, stronger rules and procedures are necessary both in the countries concerned and at the international level. The United Nations Convention Against Corruption plays an important role here. It came into force on 14 December 2005 and has been signed by 140 countries and ratified by 60 (as of August 2006). It must now be ratified as rapidly as possible by more countries and then converted into national law. A monitoring mechanism needs to be established in order for the Conference of States Parties to be able to examine its implementation country by country.

7. *Strengthening international tax cooperation*. The success of national tax reforms depends on improved international cooperation between governments, since the freedom of transnational capital movement limits the possibilities of success of a government acting alone. In the global tax race to

the bottom, governments that compete alone in this race are inevitably the losers. In contrast, a better coordinated tax policy would benefit the large majority of countries (with the exception of some of the more aggressive tax havens).

8. *Improved information exchange among revenue offices*. A first step in the fight against tax evasion would be the introduction of an automatic information exchange between revenue offices and the different countries in which an investor operates. Countries and territories which are not prepared to participate should be properly sanctioned by the United Nations.

9. *Introduction of an international minimum tax on corporate profits*. A minimum of harmonization and a new basis for taxing corporations are necessary in order to counteract the harmful tax competition to attract foreign investors. Different principles can be put into practice, such as, for example, the principle of "unitary taxation" or the universal application of the residence principle. The introduction of a minimum tax on corporate profits or a special tax for transnational companies would be politically meaningful, but it requires a harmonization of the tax systems.

10. *Establishment of an international tax organization*. As of now there is no intergovernmental forum on a global level to deal with questions of taxation. The OECD carried out pioneer work with its activities against harmful tax competition, tax havens and manipulated transfer prices. However, the activities against tax havens are at best moderate and the countries of the South are not equal partners in the OECD. In order to close this global governance gap, the creation of an International Tax Organization was proposed in 2002 by the Zedillo panel in its report in preparation for the Monterrey Conference on Financing for Development. So far it has only succeeded in upgrading the United Nations ad-hoc committee of tax experts into the Committee of Experts on International Cooperation in Tax Matters in 2004. Further steps toward an intergovernmental tax forum under the auspices of the United Nations are still pending.

11. *No more pressure to liberalize in international trade negotiations.* As long as the budgets in many countries, particularly in Africa, depend on customs revenues, forced trade liberalization leads to substantial income losses. The governments of the affected countries cannot compensate for these cuts in the short term. The European Union and the USA should therefore stop pressuring these countries to reduce their tariffs in the negotiations of the World Trade Organization or in regional or bilateral trade agreements. Instead, the countries concerned (in accordance with the principle of "Special and Differential Treatment" for poor countries) should be able to determine the speed and the range of further liberalization steps independently.

12. *Abandon flawed fiscal policy conditionalities*. The IMF usually demands indebted countries to reduce their public expenditures and privatize public services, such as water provision, for example. At the same time, it requires the reduction of tariffs and the uniform introduction of the value added tax to compensate for the income losses. The neoliberal policies of the IMF have been weakening the income basis and thus the political space of governments and have contributed to the increased gap between rich and poor in many countries. The IMF and other donors should draw the proper conclusions from these experiences and abandon this interference into the fiscal policy of recipient countries. At the same time, a comprehensive independent evaluation should assess the concrete consequences of the interventions of the IMF and World Bank on the budgetary policy of individual countries of the South.

13. *Debt sustainability should depend on ability to reach the MDGs*. In many countries substantial parts of the national budget must be used for debt servicing and are therefore not available for the fight against poverty and the financing of the MDGs. An independent evaluation of the sustainability of the debt of these countries is urgently needed to replace the notoriously unreliable evaluations of the IMF and World Bank. The UN Secretary-General demanded in his report to the Millennium+5 Summit in 2005 that debt sustainability be defined in such a way that a debtor country has to service its debt only after having secured the resources needed to achieve the MDGs. Domestic indebtedness of the state has to be considered in this regard together with the external debt.

14. *Eliminate harmful subsidies - also in the South*. Every year subsidies devour several hundred billion dollars in the countries of the South. A huge part of them serve environmentally or socially damaging purposes, such as financial incentives for transnational companies or the lowering of oil prices. In the context of an eco-social fiscal reform, such subsidies must be diminished. Development cooperation can promote this process, for example, by providing support for the introduction of energy-saving technologies.

15. *Reduce military expenditure and strengthen peacebuilding*. Large sums for expenditure on education and health could be freed up by the reduction of the military budget in many countries. A condition for this, however, is stronger support for these countries in the context of civilian conflict prevention, peacekeeping and peacebuilding measures. The new UN Peacebuilding Commission can play an important role, if it is equipped with the necessary financial resources. At the same time, the largest weapons-producing countries (in particular the five permanent members of the Security Council) have a responsibility to improve the regulation and control of their arms exports and to support a global arms trade treaty.

16. *Transparent budgets and gender budgeting*. Free access to all budget information and effective controls (e.g. by audit offices) are basic conditions in order to increase the accountability of governments in the use of public funds. Only in this way can it be guaranteed that additional public revenues are actually used for the purposes of the fight against poverty and the implementation of the MDGs. Governments should therefore ensure the effective participation of civil society in budgetary planning, especially in the context of national strategies for the implementation of the MDGs. With the help of gender budgeting analysis it should be determined in particular whether and to what extent governments comply with their commitment to promote gender equality. Similarly, it should be determined if budgets comply with the obligation for the fulfilment of economic, social and cultural human rights.

17. *Budget support.* The provision of ODA in the form of direct budget support can strengthen the institutions and the political responsibility (and *ownership*) of the recipient governments. In this way, transaction costs can be reduced, "projectitis" overcome, and donor coordination improved. Budget support is only meaningful, however, if the criteria of transparency specified above are fulfilled, if citizens have a democratic say, and if independent control of the utilization of funds is ensured. In addition, the capacities must be present for the effective use of the additional budget resources, or they should be built. Finally, it must be guaranteed that budget support is assured on a long-term basis, so that the recipients can plan their budgets

with the certainty that the funds will be available, and are not bound to harmful political conditionalities.

The implementation of this and further steps to global tax justice and eco-social fiscal reforms will not be easy and can only result from social and political mobilization. Although the majority of the population will benefit from the outlined reforms, they will adversely affect those who are the beneficiaries of the present system. These include corrupt elites in some countries of the South as well as wealthy individuals who place their fortunes in tax havens and those transnational companies that maximize their profits through manipulative transfer pricing and production outsourcing in export processing zones. On the other side of the spectrum stand many millions of people whose living standards would improve noticeably through increased government expenditure on public education and health care, active social policies and more national investments in public infrastructure. Whether the necessary paradigm shift in international economic, financial and development policy takes place will depend considerably on the pressure exerted by civil society groups, particularly in the face of the political influence wielded by powerful lobbyists acting on behalf of the wealthy and the transnational corporations who benefit from the current status quo. With civil society campaigns and networks, such as the Tax Justice Network, Publish What You Pay, and the initiatives on participatory, gender and human rights budgeting, the first important steps toward this direction have been made. ■

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