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Chapter VII

FISCAL SPACE FOR STABILITY AND DEVELOPMENT: CONTEMPORARY CHALLENGES

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A. Introduction

An appropriate macroeconomic environment and industrial policies aimed at production upgrading and diversification need to be permanent elements of a long-term national development strategy, but they have become even more critical as economies are forced to adapt to the new economic landscape emerging from the global financial crisis (*TDR 2013*). Previous chapters of this *Report* have shown how current international arrangements in trade and capital flows can inhibit the national policy space needed for countries to adapt; they have also suggested ways for encouraging different patterns of economic integration that would open up new opportunities both for developing countries and their trading partners. Yet this is only one part of the story: even if governments were allowed, within the framework of multilateral, regional and bilateral agreements, to pursue their desired development strategy, they would still need to finance it. In the context of preserving policy space, strengthening fiscal revenues is key, as these are not only more sustainable than other sources of long-term finance, but also less constrained by restrictions and conditions that impose limits on policy space.

As noted in previous UNCTAD reports, strategies for boosting public finances have been essential underpinnings of developmental States, and are also critical for macroeconomic stability (UNCTAD, 2009). However, the globalized economy poses serious challenges to increasing fiscal revenues. This chapter examines how fiscal space has been affected by tax competition among countries and by tax avoidance by international firms and wealthy households, as well as by the specific challenges facing countries that are heavily dependent on natural-resource rent. It explores some ways of addressing these problems concentrating on issues related to the domestic collection of taxes and other current public revenues. Development assistance and debt financing can provide alternative sources of revenue and are of particular significance to some developing countries. The different challenges these flows pose for fiscal and policy space have been discussed in greater detail in *TDRs 2008, 2010, 2011* and *2013*, and therefore are not discussed at length in this *Report*.

Fiscal space refers to the ability of a government to use fiscal instruments to pursue various economic, development and social policy objectives. An increase in public revenues can enhance the possibilities of using particular instruments, such as differential tax rates, subsidies and social transfers, to meet social and developmental goals. Fiscal space has a quantitative or budgetary dimension, which can be roughly approximated by measuring the share of public revenue in GDP. But the notion of fiscal space

should not be restricted to current levels of public revenue. In particular, it should not be seen as being equivalent to fiscal balance; a government may be in deficit, and yet be able to finance additional desired expenditures if these generate growth, or it may incur debt if this does not threaten stability and other policy goals. Fiscal space also refers to the potential for increasing public expenditure, including for measures in support of structural transformation, and for variations in that expenditure as an instrument of demand management.

Fiscal space also has a qualitative dimension, related to the level and compositions of public revenues and expenditures. Decision-making on this can be constrained, de jure, by international arrangements and agreements, by externally imposed conditionalities and by legal rules such as those relating to deficit ceilings; but it can also be constrained de facto, for example by the perceived requirements of global investors and financial markets, or by the power of domestic interest groups.

> Fiscal space is an essential element of the policy space needed for development, and at the same time fiscal space increases with development.

Fiscal space is a dynamic concept, since changes in public spending have an impact on the economy, and consequently on government revenues. In the short run, it can be expanded through the multiplicative effects of pro-growth policies. In particular, in a recessionary setting, when countercyclical stimulus may be required, fiscal space can be created by augmenting revenues through various short-term measures, in addition to increasing public borrowing (*TDR 2011*). However, from a longer term, development perspective, fiscal space means having the capacity to finance spending requirements that increase and change over time. Indeed, during the process of development, public spending as a share of GDP grows, particularly for financing infrastructure, social transfers and basic services, and in parallel, so do the revenues to finance it. Fiscal space is an essential element of the policy space needed for development, and at the same time fiscal space increases with development.

Section B of this chapter examines current trends in the fiscal revenues of different groups of countries, and the challenges faced by governments that are seeking to improve the volume and composition of those revenues. It presents the long-term trends of fiscal space, and shows that it is a constitutive part of the development process. It also discusses how globalization and related policy choices have been altering the composition of fiscal revenues.

The subsequent sections focus on the ways in which global governance and international actors greatly affect the fiscal space of developing and developed countries alike. Section C examines how tax havens, secrecy jurisdictions and illicit financial flows erode the tax base, undermine the fairness of the tax system, and distort trade and investment patterns. It evaluates the amount of tax leakages caused by those mechanisms, and describes some national and multilateral initiatives taken to tackle this problem. Section D analyses issues relating to the extractive industries that are of particular relevance for many developing countries. Given the boom in commodity prices, these industries offer huge potential to boost fiscal revenues. However, this potential is not always well exploited due to inadequate tax rules or to difficulties in enforcing them, since TNCs in these industries frequently resort to tax avoidance techniques. The section also analyses how the rent from natural resources is distributed in selected countries, and explains how the rules affecting this distribution have been changing in recent years. Finally, section E summarizes the main findings and presents some policy orientations aimed at improving the fiscal space for development strategies.

B. Developmental States and their fiscal space

1. Developmental States

Successful developmental States have had the foresight and capacity to encourage private sector development, including by increasing profits and investment above the level likely to have been possible by relying on market forces alone. They have also been able to design effective mechanisms to discipline private investors and direct their resources to areas where the economic and social returns might be particularly high (*TDRs 1996, 1997, 2003* and *2009*). From this perspective, Adelman (2000) has identified essential elements for a successful developmental State. These include a substantial degree of autonomy, capacity and credibility to set policies in the national interest, leadership commitment to economic development, good economic policies, and a necessary degree of economic autonomy with respect to the international environment.

Previous chapters have focused, in particular, on the last of these elements in securing the requisite degree of policy space. But developmental States are also in the business of mobilizing and allocating resources, which are likely to be key to their success in the long term. These are needed to support infrastructure development by investing in both physical and human capital, where the private sector, particularly in developing countries, is likely to be weak, or absent, and dependent on good infrastructure for its own profit-making activities. However, the basic bargain between the State and business goes well beyond providing only good infrastructure; at various times and to varying degrees, it also requires the State to assume other functions as well, such as increasing the supply of investable resources, socializing long-term investment risks, and providing support services in such areas as technology, training and exporting. State-sponsored accumulation and technological progress is likely to involve, variously, the transfer of assets from less to more productive sectors, control of the financial system, the obtaining of foreign technologies and their adaptation to local conditions, and direct public investments in some activities along with selected priority investments to encourage diversification and upgrading.

These activities can only be pursued within an integrated strategy based on a shared vision of a country's development, and they depend on building broad social consent, supported by institutional arrangements for continuous dialogue and coordination with key stakeholders. Public finance, including the mobilization of tax revenues, is a key component in legitimizing the role of the State and establishing the areas of government responsibility in the economic and social spheres. Ocampo (2007) identifies five components of this "fiscal covenant" that are essential for effective State mobilization of resources: clear rules of fiscal discipline, accompanied by adequate tax revenues to finance the functions that society assigns to the State; transparency of public expenditure; the design of efficiency criteria for the management of State resources; acknowledgement of the central role of the public budget in the provision of "goods of social value", and, more generally, in the distribution of income; and the design of balanced and democratic fiscal institutions which are open to citizens' participation.

The challenge is particularly demanding at lower levels of income and development when the potential sources of revenue are limited, and even more so for countries that are heavily dependent on natural resources for their initial development drive. Most extractive industries have a limited local market and seek to maximize their revenues from exports. This can generate significant profits and valuable foreign-exchange earnings, which, if properly

managed, can ease a number of constraints on faster growth. However, this is easier said than done: the problem of "Dutch disease", whereby an expanding mining sector triggers a real currency appreciation and a fall in output and employment in other tradable sectors, can introduce serious macroeconomic imbalances and increase exchange rate volatility and economic vulnerability. However, a large body of evidence suggests that this is manageable provided policymakers have the requisite policy space (IMF, 2003; UNCTAD, 2005).

More damaging to long-term prospects is when this kind of expansion generates a pattern of lopsided internal integration through the creation of enclave economies. The structure of international commodity markets is such that when policymakers invite TNCs to develop this sector, they find themselves in a weak negotiating position, as these very large firms have at their disposal better information than their hosts as well as greater financial, technological and market strengths, including the threat of capital flight. Moreover, unpredictable rents associated with price volatility can seriously distort the wider incentive structure, adding a speculative dimension to investment planning in both the private and public sectors. The solution is not one of either State or foreign ownership of natural resources; it has to do with how best to manage resource rents with long-term development goals in mind. In recent years, as discussed in previous chapters, the pendulum has swung towards trying to attract FDI to this sector, with insufficient attention given to strengthening the bargaining position of host governments to obtain better returns from their natural-resource base and stimulate the upgrading and diversification of national output. Refocusing on long-term development will require changes in existing fiscal and legislative arrangements in order to increase revenues and ensure that a greater proportion of value added remains in the host economy, as discussed further below.

2. *Long-term fiscal trends*

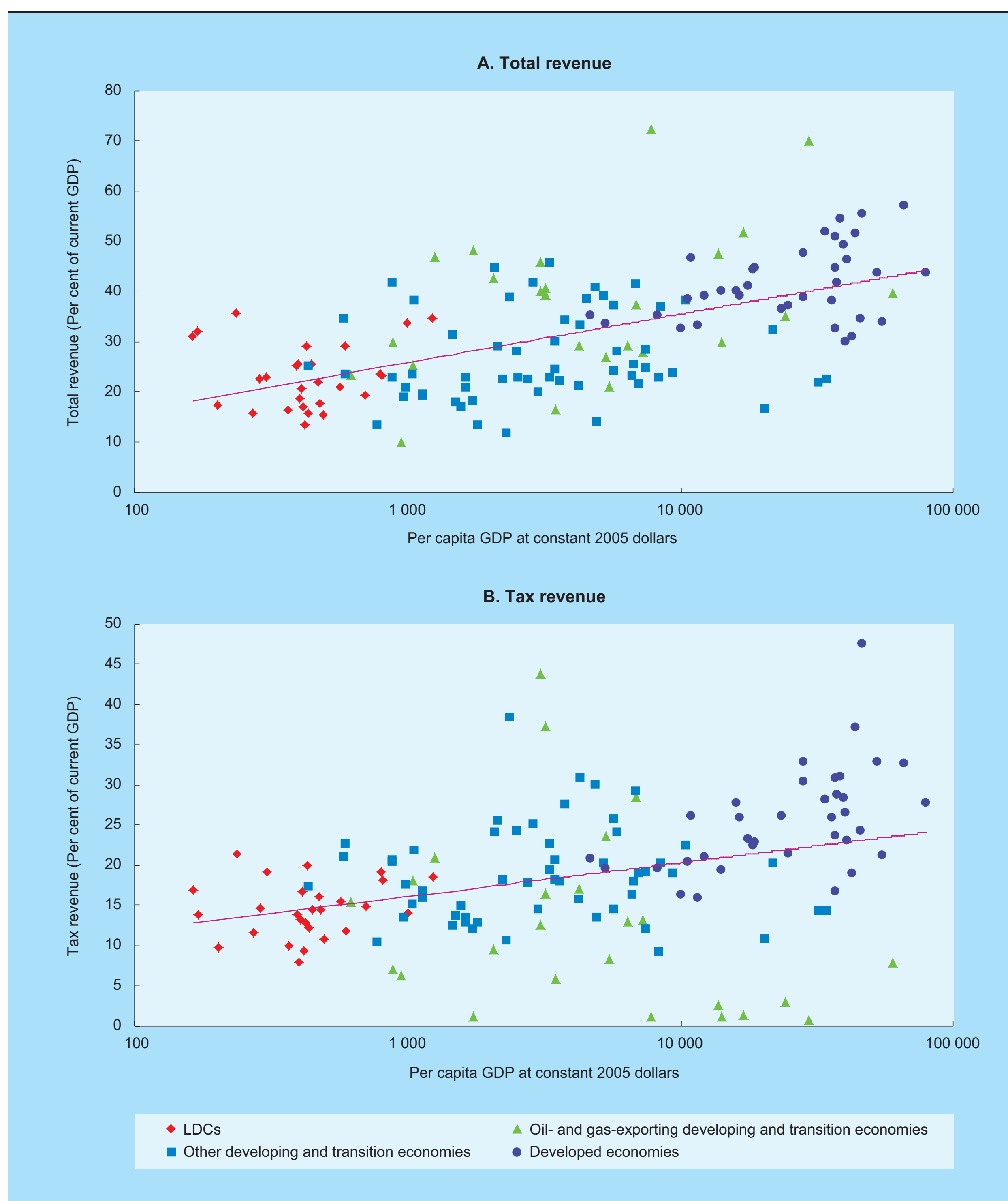
In general, developed countries tend to have greater fiscal space than developing countries, as they collect larger revenues as a share of GDP. This is the result of a long historical process: in the early 1900s, revenues collected by the Government in the United Kingdom amounted to 15 per cent of GDP, compared with 40 per cent one century later (Clark and Dilnot, 2002); in the United States, government revenues rose from below 10 per cent of GDP to 30 per cent during the same period (Maddison, 2001). This enlargement of the tax base was the result not only of the growth of the modern (and formal) sector of the economy, but also of adjustments in legislation, the introduction of new taxes and other fiscal charges, and their variation over time, as well as considerable efforts to strengthen tax administration and enforcement (Besley and Persson, 2013). Greater revenue collection capacity, in turn, provided the means for meeting the demands of citizens for publicly provided goods and services based on the concept of a welfare State. More generally, it permitted financing higher growth-enhancing public spending, which generated a positive interrelationship between development and fiscal space. In the period 2011−2012, developed countries, on average, collected public revenues totalling 41.5 per cent of GDP, with tax revenues alone amounting to 25.5 per cent. In contrast, during that period the total revenues and tax revenues of general government in LDCs amounted to 23 per cent and 14.5 per cent of GDP, respectively.

Despite this broad association between levels of income and fiscal revenues, there is no benchmark for the ratio of public revenue to GDP. The latter depends as much on an economy's capacity to furnish public revenues − and the administrative capability to collect them − as on political choice. There are significant differences in this ratio across countries at similar levels of per capita income, reflecting historical circumstances, dissimilar revenue-generating capacities and socially accepted policy choices about the role of the State. Those policy choices concern its redistributive role and the extent to which both socially important services should be delivered by the public sector, and instruments of public finance are used for macroeconomic management and to support policies for structural transformation.

There is a positive relationship between government revenues as a share of GDP and per capita GDP across a wide range of developed, developing and transition economies, but also a significant dispersion within these groups (chart 7.1). For example, government revenues in most high-income European countries, including (in decreasing order) Norway, Denmark, Finland, Sweden, France, Belgium, Austria, Italy, the Netherlands and Germany, are above or

Chart 7.1

RELATIONSHIP BETWEEN GOVERNMENT REVENUES AND PER CAPITA GDP, 2012



Source: UNCTAD secretariat calculations, based on ECLAC, *CEPALSTAT*; Eurostat, *Statistics Database*; *OECD.StatExtracts* database; European Commission, *Annual macro-economic* database (*EC-AMECO*); and IMF, *World Economic Outlook* and *Government Finance Statistics* databases.

Note: Data refer to 2012 or latest year available. Revenue data refer to general government revenue, except for Argentina, the Plurinational State of Bolivia, Colombia, Ecuador, El Salvador, Mexico, Panama, Paraguay, Uruguay and the Bolivarian Republic of Venezuela, for which data refer to the non-financial public sector. Per capita GDP data are shown in logarithmic scale.

close to 50 per cent of GDP; while in Japan, the United States and Australia, government revenues are around 30 per cent of GDP. This difference illustrates diverse models of social coverage and the welfare State. At the other end of the income hierarchy, LDCs also show some heterogeneity, with government incomes ranging from around 15 per cent of GDP (in ascending order) in Haiti, Sierra Leone, Uganda, Ethiopia, Guinea-Bissau and the Central African Republic, to close to 30 per cent in Malawi, Burundi, the Democratic Republic of the Congo and Mozambique. The latter two countries are exporters of mineral ores and metals, which provide revenues to their governments independently of the average income of the population.

The capacity for raising public revenue from the extractive industries, largely unrelated to per capita income, is clearly apparent in oil- and gas-exporting developing countries and transition economies. Whereas in most other countries, income tax collection contributes around two thirds of government revenues, in oil-exporting countries that share is close to only one third (compare charts 7.1A and 7.1B). Government revenues of Angola, the Plurinational State of Bolivia, Iraq, Kuwait, Libya, Oman and Saudi Arabia are close to or over 50 per cent of GDP, despite the fact that these countries range from lower-middle-income to high income levels. Most of their government revenues come directly from dividends of State-owned extractive firms, royalties or production-sharing agreements, while income tax contributes a lower share. However, exporting minerals or hydrocarbons does not guarantee high levels of government income, as indicated by the data from Peru, Turkmenistan and Zambia. It depends largely on domestic policies related to the distribution of the rents from natural resources, as discussed in section D of this chapter.

Non-oil-exporting developing and transition economies, mostly middle-income countries, have an intermediate level of public revenues, with a non-weighted average of 26.8 per cent of GDP. In this heterogeneous group, transition economies have clearly above-average public revenue levels (most notably Bosnia and Herzegovina, Serbia, Ukraine and Uzbekistan), partly due to the significance of social contributions. This is also the case for a number of Latin American countries with strong redistributive policies, and where the social security and pension system have remained the State's responsibility (e.g. Argentina, Brazil and Cuba). By contrast, public revenue levels are comparatively low in several Central American countries (e.g. Guatemala and Honduras) and South Asia (e.g. Pakistan and Sri Lanka).

The gap between a number of developing and developed countries in terms of public revenue shares in GDP has narrowed over the past two decades, as a result of growing domestic resource mobilization in most developing and transition economies. In Latin America and Africa, total tax revenues as a percentage of GDP rose significantly, bolstered by stronger economic growth and a broadly favourable macroeconomic environment (chart 7.2).[1] Increased public earnings from commodity exports also contributed, reflecting higher commodity prices, and in some cases, changes in the terms of contracts agreed with oil and mining corporations. In Latin America, lower unemployment, higher real wages and a larger share of formal jobs also raised social contribution levels. The resulting progressive reduction of inequality was accompanied by a rise in consumption and indirect taxes. Furthermore, revenues benefited from the introduction of new taxes alongside advances in tax administration (ECLAC, 2014a). In Africa, overall growth of public revenues was smaller, in part due to the lower contribution of border taxes, which remain an important component of total tax revenues. Total government revenues also increased significantly in West Asia and in the transition economies, largely due to gains from rising oil prices. In general, in all developing regions and transition economies the share of government revenue in GDP increased, with the exception of East, South and South-East Asia. The low rates of growth of taxes relative to GDP in parts of Asia and the Pacific, despite years of rapid economic growth, has been attributed to the region's low levels of personal income tax and heavy reliance on value added tax (VAT) (ESCAP, 2013). On the other hand, in developed countries, the share of government revenues in GDP declined slightly, from an average of 43 per cent in the period 1991−1995 to 41.5 per cent in 2011−2012.

Output growth has broadly positive effects on fiscal space. In most developing and transition economies, government revenues have tended to increase faster than GDP, especially in middle-income countries. A study of 17 Latin American and 6 South-East Asian countries suggests that during the period 1990−2012, a 1 per cent rise in

Chart 7.2

GOVERNMENT REVENUES BY SOURCE, SELECTED COUNTRY GROUPS, 1991–2012

(Per cent of GDP)

Source: UNCTAD secretariat calculations, based on ECLAC, *CEPALSTAT*; IMF, *World Economic Outlook* and *Government Finance Statistics* databases; Eurostat, *Statistics Database*; *OECD.StatExtracts* database; and *EC-AMECO* database.

Note: Data refer to the five-year average of the mean observation of general government revenue, except for Argentina, the Plurinational State of Bolivia, Colombia, Ecuador, El Salvador, Mexico, Panama, Paraguay, Uruguay and the Bolivarian Republic of Venezuela, for which data refer to the non-financial public sector. Data for China refer to budget revenue only; they do not include extra-budgetary funds or social security funds. Other revenues include capital revenues.

GDP caused a 1.15 per cent increase in government revenues (Weeks, 2014). This can partly be explained by structural transformations taking place in parallel with output growth, mainly resulting from the enlargement of the modern sector of the economy, and an increase in the proportion of the labour force employed in medium and large enterprises. This in turn provides a larger tax base, including for direct taxation. On the other hand, in developing countries with low per capita incomes and high levels of informal employment, governments have fewer entry possibilities through which to capture more revenues from private incomes. Consequently their growth of fiscal revenues as a percentage of GDP is weaker than that of middle-income developing countries. A major exception may be in countries where revenues are augmented by various taxes on large firms in the extractive industries, as discussed in section D.

3. *Composition of public revenue and fiscal space*

The composition of taxes matters because of its distributive implications and its role in generating incentives for particular elements of demand and supply. For example, applying differential tax rates to particular sectors is a form of industrial policy. Direct taxes, especially corporate and personal incomes taxes, can be tailored for income distribution purposes, and can also act as built-in stabilizers, as they rise in good times and fall in recessions. In developed countries, income tax is still the predominant source of revenue, followed by social contributions (chart 7.2).

Developing countries tend to rely more on revenues raised from indirect taxes on consumption and trade. In 2012, VAT alone accounted for 22 per cent of total revenues in Africa, 26 per cent in Latin America and 29 per cent in East, South and South-East Asia. Only in West Asia was its contribution rather modest (12 per cent), since most of the revenues there originated from the extractive industries. In addition, since the early 1990s, the share of VAT in GDP rose in every region of the world. Even developed countries are increasingly applying consumption taxes, which have become the second highest source of their tax revenues after income taxes.

This trend has a negative distributional impact, as VAT and other indirect taxes are regressive compared with income taxes. Some countries have tried to reduce their regressive nature through exemptions and differential treatment. In Latin America, some products are zero-rated and exemptions are offered in certain industrial sectors or to particular categories of consumers (ECLAC, 2014a).[2] Other countries use differential VAT rates to promote environmental priorities, for example, by setting higher rates on purchases of plastics, fuels and motor vehicles. Also in Latin America, several countries recently adopted dual tax systems similar to those applied in the Scandinavian countries, with standard tax rates for capital income, higher rates for corporate taxes and progressive rates on labour income. In other countries of that region, fiscal instruments have been used to boost formal employment, helping to shift the tax burden from companies in sectors that employ more formal workers towards those, such as extractive industry TNCs that are more capital-intensive (ECLAC, 2014a).

Compared to such compensatory efforts, other policies have tended towards fiscal regressivity. Ortiz and Cummins (2013) found that some 94 governments in 63 developing and 31 high-income countries considered options to boost revenue by increasing VAT or sales tax rates or removing exemptions as one of the most common post-crisis adjustment measures.

In addition, a major trend in all regions is the steady decline in the rates of corporate income taxes, as governments compete to attract or retain mobile investors (*TDR 2012*, chap. V). Average corporate tax rates in many OECD countries fell from over 45 per cent in the early 1980s to below 25 per cent by 2012. Corporate tax rates in developing countries also fell significantly, on average from 38 per cent in the early 1990s to 32 per cent by the early 2000s (Keen and Simone, 2004), and again to around 27 per cent in 2012.[3] These cuts in corporate tax rates did not necessarily lead to proportional reductions in corresponding tax revenues. In some cases they were compensated by a broadening of the tax base, while in others they were amplified by measures such as tax holidays, reduced statutory rates for particular sectors or regions, and direct tax breaks for exporters and free-trade zones.

Reducing corporate tax rates in developing countries seems to go against the usual advice to broaden their tax revenues: if those countries have huge public revenue requirements to finance

investment and limited capacity to raise revenues by other means, why would they reduce tax rates for the economic agents most easily taxable (at least technically)? One possible reason is that "perhaps their political and institutional structures are more vulnerable to the exercise of influence by interest groups, including foreign multinationals" (Keen and Simone, 2004: 1321). Such a tendency may also be a response to greater competition to attract global investors, although tax differentials do not seem to be the most important determinant of FDI. This is evidenced in developed economies, where tax incentives to corporations have not led to rising productive investment. Despite the steady fall in the rate of statutory corporate income taxes since the early 1980s, and other tax incentives designed to encourage investors, gross fixed capital formation declined in a large number of developed countries, even before the global crisis (*TDR 2012*, chap. V, section C).

The composition of taxes matters because of its distributive implications and its role in generating incentives for particular elements of demand and supply.

In 2011−2012, the share of government revenues from corporate taxes in GDP increased, despite the continued downward trend of corporate tax rates, mainly because the share of profits in GDP increased in most countries. Public revenues from corporate taxes rose significantly in most regions of the developing world, as company profits benefited from economic growth and the rise in international trade. However, the extent to which corporate taxes contributed to total revenues has varied, and in general it has not kept pace with the increase in profits during these years (UN-DESA, 2013).

Another major change in fiscal composition that reflects global influences concerns border and trade taxes. Revenues from import tariffs typically accounted for a large proportion of public revenues in developing countries, and especially in LDCs. This was mainly because they are fairly easy to implement, requiring only a relatively simple institution such as a customs authority at the border, compared with other taxes, such as VAT or income and corporate taxes. However, trade liberalization agreements and progressive tariff reductions have had a major impact on what was once one of the most important sources of revenue for many developing-country governments.[4] By 2012, almost 40 per cent of international trade was duty-free under MFN terms, and an additional 35 per cent was duty-free under bilateral or regional preferential terms. In addition, given the many ongoing negotiations for bilateral and plurilateral economic partnership agreements, the contribution of import duties to public revenues will likely continue to erode in the years to come.

Such a trend would have significant adverse effects on fiscal revenues in a number of low-income countries. In Africa, border taxes accounted for 15 per cent of government revenues in 2011−2012. Those revenues remain particularly significant for LDCs; indeed, they have become even more important in recent years, partly owing to these countries' increasing participation in international trade (both in imports and exports), and partly because their tariff rates remain higher than those of other countries (UNCTAD, 2014). The total imports of sub-Saharan African countries, for instance, increased by over 70 per cent between 2006 and 2011. Import tariff revenues accounted for 5 per cent of GDP on average in LDCs, compared with just 0.5 per cent in developed countries (chart 7.2).

Export taxes can also be applied, and are imposed most frequently on exports of metals, including waste and scrap, minerals and agricultural commodities. Those tax rates can be relatively high, at around 20 per cent on unprocessed commodities and 13−17 per cent on semi-processed or finished goods (UNCTAD, 2014). Apart from augmenting revenues, export taxes are imposed by governments for a number of other reasons as well, including for conserving natural resources, protecting health and the environment, encouraging domestic value-added activities in processing primary commodities, and also for "sterilizing" windfall profits from price increases. However, many of the ongoing trade negotiations at multilateral and bilateral levels include reducing or eliminating these taxes, which means their use may diminish in the future. Given the multiple purposes served by export taxes, such restrictions may have negative impacts, and not only on fiscal revenues.

Many governments have turned their attention to new sources of tax revenue relating to the financial

sector and financial transactions, including proposing levies on trading in stocks, bonds and derivatives (in the EU), or taxes on the repatriation of overseas earnings (in the United States). If these were to materialize, they could create a significant change in tax structures. The proposed financial transactions tax (FTT) could be considered a globalized version of stamp duty, which is one of the oldest taxes in existence. The latter was introduced in the United Kingdom more than 300 years ago, and has long been applied to purchases of shares, as well as property, in many other countries as well. Like many fiscal charges, they are promoted for multiple purposes. The FTT is proposed not only for its capacity to earn substantial revenues, but also as an instrument to influence the behaviour of economic agents. It may dampen speculative activities that can be damaging for the rest of the economy, and ensure a more equitable treatment of the financial sector vis-à-vis other sectors.

It seems, therefore, that different forces are influencing the composition and level of fiscal revenues, sometimes in opposite directions. These are not purely technical matters, since the enlargement or retrenchment of fiscal space is key to the implementation of different development strategies. Furthermore, they involve a distribution of the tax burden, which has distributional and economic impacts, benefiting (or affecting) some agents more than others.

In this context, it is worth mentioning the de facto pervasive influence of sophisticated lobbyists and interest groups on national and international policymaking, which is often insufficiently recognized. While lobbying has been a long-standing and accepted feature in the United States, it is gaining in importance in other developed and developing countries as well. Lobbyists can benefit society as a whole by conveying complex information from experts to legislators and bureaucrats, but they can also lead to the generation and private appropriation of rents that are detrimental to society. Lobbying is costly, and collective action problems mean that households, consumers and industry groups with many small actors and disparate interests are unlikely to be adequately represented. The financial sector, for example, is well organized and has a high level of "firepower" aimed at fiscal policymaking far beyond the scope of the households who use or are affected by financial services.[5] Its influence on fiscal space can be direct; for example, more than 900 of the 1,700 amendments that were tabled by EU parliamentarians to legislate on the activities of hedge funds and private equity firms had been authored by financial industry lobby groups, and there was evidence of large-scale "copy and paste" of texts given by the lobbyists (Corporate Europe Observatory et al., 2014). Similarly, in the United States it has been found that firms that increased their lobbying expenditures by 1 per cent in one year reduced their effective tax rates in the range of 0.5 to 1.6 percentage points the following year (Richter et al., 2009). The suggestion that strategic lobbying yields quantifiable benefits for particular groups is supported by the scale of recent efforts on the part of corporations to promote a package of tax breaks estimated to cost $46 billion in 2014 and about $700 billion over 10 years, according to data from the Congressional Budget Office reported in a recent survey.[6] Particularly when combined with the "revolving door" that often allows lawmakers, bureaucrats and lobbyists to change places, these practices directly and indirectly affect fiscal policies. The recent proliferation of such practices in several developing countries is another factor affecting fiscal space.

C. Tax leakage and international governance of taxation

Until the twentieth century, tax collection and enforcement were primarily a domestic concern, with little spillover to tax systems in other countries. Today, although tax collection remains mostly a national concern, with the process of globalization tax systems in some countries can affect public revenue collection in other countries. This has had the negative effect of creating new channels through which some taxpayers – particularly high-net-worth individuals (HNWIs) and TNCs – can reduce or even avoid paying taxes. HNWIs avoid paying wealth and inheritance taxes, as well as taxes on income from these assets, mainly by placing their financial assets in tax havens. In addition, part of their income is sometimes routed through these jurisdictions to hide it from the tax authorities. As for TNCs, tax avoidance mainly takes the form of "creative accounting" practices, although they may also hold financial assets or register non-financial assets in tax havens.

Three points are important when looking at the international dimension of tax leakages. First, such practices result in massive losses of public revenues. Second, a large proportion of the financial flows resulting from such creative accounting goes through offshore financial centres (OFCs) based in tax havens, or more precisely, in secrecy jurisdictions. Third, many flaws remain in the international taxation architecture, which has failed to properly adapt to the current reality.

1. Key concepts

(a) Tax havens, secrecy jurisdictions and offshore financial centres

Tax havens, secrecy jurisdictions and OFCs are often considered synonymous. However, the three terms refer to distinct aspects of the same problem. Tax havens are political jurisdictions – not all of them identical to sovereign States – which have sufficient autonomy to write their own tax, finance, and other laws and regulations in order to create a legislative framework designed to assist non-resident persons or corporations in avoiding regulatory obligations imposed on them in the places where they undertake the substance of their economic transactions (Palan et al., 2010). They provide a place to record, for accounting and tax purposes, transactions that have impacts elsewhere (Tax Justice Network, 2012). Such places offer an escape not just from taxes, but also from many other rules and regulations, because the structures created under their local laws can be used either completely anonymously, or largely so (Shaxson, 2011). In addition, prosecution of economic and financial crimes and judicial cooperation with other countries are often extremely limited. For these reasons, these places are also widely referred to as "secrecy jurisdictions" because they provide secrecy to OFC commercial operators and their clients, thereby facilitating various kinds of illicit financial flows (IFFs).

In many respects OFCs are fictional spaces. The term refers more to a set of activities than to a geographical setting.[7] The term offshore derives from the fact that the transactions recorded in the secrecy jurisdictions actually take place in other locations. A subtle distinction is sometimes made between tax havens and secrecy jurisdictions, on the one hand, and OFCs on the other. The latter comprise accountants, lawyers and bankers, plus their associated trust companies and financial intermediaries, who sell services to the residents of other territories or jurisdictions wishing to exploit the mechanisms created by legislation in the tax havens or secrecy jurisdictions. In practice, these operators can easily move their operations to wherever they want at any time; indeed, they have sometimes used this power to threaten to leave a jurisdiction that does not secure the legislation they desire (Murphy, 2008).

The OECD has taken the lead at the international level to address the problem of tax havens, using several criteria on the size and transparency of fiscal rules to identify such locations (OECD, 1998).[8] Based on these criteria, the OECD identified 35 jurisdictions as tax havens in 2000, but this list was criticized by a number of researchers because it omitted many jurisdictions that displayed the characteristics of tax havens.[9] Between 2000 and April 2002, the majority of these listed tax havens made formal commitments to implement the OECD's standards of transparency and exchange of information and were subsequently taken off this list; only seven jurisdictions that did not make commitments to the OECD's standards were identified as "unco-operative tax havens", but subsequently, following various commitments by them, they were removed from the list between 2003 and 2009. As a result, no jurisdiction remains currently listed as an "unco-operative tax haven" by the OECD, though new lists have recently appeared under the umbrella of the Global Forum (see below subsection 4 (a)).

The 2013 Financial Secrecy Index (FSI) developed by the Tax Justice Network (TJN) offers an alternative to the OECD approach (TJN, 2013). It establishes a ranking of 82 jurisdictions that provide financial secrecy according to both their degree of secrecy and their relative importance in global finance. The focus shifts, therefore, from governance issues within countries to the jurisdictions' responsibility for offering financial secrecy at the global level. Instead of relying on a binary indicator, which is often prone to political negotiations, the FSI is based on a secrecy score constructed from 15 indicators, which ranges from zero (total financial transparency) to 100 (total financial secrecy).[10] None of the analysed jurisdictions has scored less than 30, suggesting that there is no clear dividing line between "secrecy jurisdictions" (or tax havens) and others, and that there is a wide spectrum of secrecy.

From this perspective, some of the world's leading providers of financial secrecy are among the world's largest and wealthiest countries. This contrasts with the widespread perception that tax havens are small (often tropical) islands or micro-States.[11] Indeed, tax havens are not working on the margins of the world economy, but rather as an integral part of modern business practices. According to one estimate, two million international business companies and thousands (if not millions) of trusts, mutual funds, hedge funds and captive insurance companies are located in the 56 countries that could be considered tax havens in 2009. About 50 per cent of all international bank lending is routed through these jurisdictions and 30–40 per cent of the world's stock of FDI is accounted as assets of firms registered there (Palan et al., 2010).

> Tax havens are not working on the margins of the world economy, but rather as an integral part of modern business practices.

It has been pointed out that a number of developed countries, and even locations within these countries,[12] have some key features in common with more traditional tax havens. *The Economist* has recently shared this view by noting that "some of the biggest tax havens are in fact OECD economies". Moreover, it draws attention to the fact that "[these economies] provide something the offshore islands cannot: a destination for money rather than a mere conduit".[13] They also benefit from the perception that, overall, they are politically stable and that there are strong lobbies that support their tax haven status. Thus, OFCs, and the secrecy jurisdictions that host them, are not part of a parallel economic system; they are fully integrated into the global financial system and exist not necessarily in opposition to the State, but often with its accord. Moreover, as further discussed in subsection 2, many well-established taxpayers, both individuals and corporations, turn to them with a certain degree of impunity and (at least alleged) innocence. In the view of TJN,[14] the implications for global power politics are significant, and could help explain why international efforts to crack down on tax havens, OFCs and financial secrecy have so far been rather ineffective, despite recurrent announcements by the G20 and OECD countries for the need to address these issues. Indeed, some of the economically powerful residents of these economies are the primary beneficiaries of the so-called "illicit financial flows" and are able to influence the rules of the game (Rodrik, 2014).

(b) Illicit financial flows

One of the major roles of secret jurisdictions is the facilitation of illicit financial flows. There are two definitions of IFFs. In a narrow sense, they refer to

all unrecorded private financial outflows involving capital that is illegally earned, transferred, or utilized. In this regard, they are generally used by residents to accumulate foreign assets in contravention of applicable domestic regulatory frameworks. Thus, even if the funds originate from legitimate business activities, their transfer abroad in violation of local law, such as exchange control regulations or tax regulations, would render the capital illicit. In a broader sense, IFFs also encompass all kinds of artificial arrangements that have been put in place for the essential purpose of circumventing the law or its spirit. Thus, illicit might not necessarily mean contravening the letter of the law but going against its spirit. In this case, illicit can be understood as something hidden or disguised.

It is generally accepted that the narrow definition is inadequate for describing tax-motivated IFFs. It fails to take into account several practices designed to reduce tax liability which go against the interests of society and ultimately harm the majority of the citizens, even if they cannot be proved to be illegal. In this *Report*, the key criterion used is whether such tax-motivated IFFs are justified from an economic point of view. If a given international financial flow is part of a "tax-optimization" scheme without any concrete related economic activity, it could be considered "illicit". To take a concrete example, several TNCs have taken advantage of a contentious loophole in Irish corporate law[15] known as the "double Irish". This allows them to be registered in Ireland without being considered a tax resident, because, as far as the Irish authorities are concerned, the company is a tax resident in Bermuda, which has a zero rate of corporate tax. Yet in practice, most of the real economic activities are not undertaken in Ireland or in Bermuda. Such aggressive tax planning arrangements also need to be considered when analysing the factors that may reduce fiscal space.

Empirical estimates show that tax-motivated IFFs account for the bulk of all the IFFs.

Empirical estimates show that tax-motivated IFFs account for the bulk of all the IFFs.[16] Among the three broad types of motivations – crime, corruption and tax abuse – that drive people and entities to turn to IFFs and tax havens, only about a third of total IFFs represent criminal money, linked primarily to drugs, racketeering and terrorism. It is noteworthy that money from corruption is estimated to amount to just 3 per cent. The third component, which accounts for the remaining two thirds of the total, refers to cross-border tax-related transactions, about half of which consists of transfer pricing through corporations (Baker, 2005).

2. Cross-border tax dodging mechanisms

International tax dodging takes many forms, all of which aim at reducing tax liabilities. Such practices are arrayed along a spectrum of varying degrees of legality (Herson, 2014). One such practice is illegal *tax evasion*, which refers to a taxpayer's attempts to escape a tax liability under a country's law. It typically involves concealing from the fiscal authorities the income and assets which are liable for taxes or, in the case of fraud, falsifying paperwork. This implies a criminal activity or at least a failure to make a required disclosure.[17] Many tax evasion practices may occur only at the national level, but as the aim of this chapter is to analyse what structures in the global economy can favour such behaviours, purely national practices are not addressed here.

Another form of tax dodging is referred to as *tax avoidance*, including aggressive tax planning, whereby individuals or companies exploit loopholes in legislation to pay lower taxes. These practices may be within the law, but they can be perceived as crossing ethical boundaries. Tax avoidance is often understood as referring to practices designed to gain a tax advantage by contravening the intention, but not the letter, of the legislation (Herson, 2014). In practice, the difference between tax avoidance and tax evasion is frequently blurred. For instance, tax payments can be avoided by using mispricing techniques in intra-firm transactions or recording artificially high payments for intra-firm debt. The legality of these manoeuvres is open to question. Much of it depends on how domestic laws are drafted to avoid the existence of loopholes. Moreover, some strategies that have been argued as constituting "avoidance" have been judged as "evasion" when challenged and scrutinized in courts. This is even more relevant when tax schemes involve

several jurisdictions. Since international taxation is extremely complex, tax payers embarking on such tax optimization strategies often are not sure whether these strategies are fully legal (Palan et al., 2010). It is for this reason that this *Report* refers to tax-motivated IFFs whenever the international structuring of transactions or asset portfolios has little or no economic substance, and their express purpose is to reduce tax liabilities.

For the purpose of tax avoidance, firms usually create one or more subsidiaries, affiliates or shell companies in one or several tax havens. This allows their real economic beneficiaries to relocate, at least on paper, a certain proportion of their activities to low-tax and/or secrecy jurisdictions to minimize their tax liabilities. Such relocation techniques often offer secrecy of ownership, no filing requirements, protection from creditors, low incorporation costs, and other subterfuges that facilitate sham operations.[18]

Many tax avoidance schemes exist worldwide. Evidence suggests that in developing countries trade and transfer mispricing is the main vehicle for tax avoidance, evasion and tax-related capital flight through tax havens (Palan et al., 2010).[19] Transfer pricing refers to the mechanism by which cross-border, intra-firm transactions are priced. It is often used in the global transactions of TNCs in the form of transfer of property or services among affiliates of the same TNC. The OECD has estimated that about one third of world trade takes place between such "related parties" (Lanz and Miroudot, 2011).[20] However, if the intra-company price does not reflect the true value, profits might effectively be shifted to low-tax or no-tax jurisdictions, while losses and deductions are shifted to high-tax jurisdictions. These practices clearly result in an overall erosion of the tax base and, *ceteris paribus*, in lower revenues.

It is generally accepted that pricing reflects the true value of transactions, including under Article 9 of the United Nations Model Double Taxation Convention between Developed and Developing Countries, when it occurs "at arm's length" (UN-DESA, 2011). This principle implies that the transfer price corresponds to the price that would be paid in a market where each participant is acting independently in its own interest. In practice, however, it is often difficult to assess whether the reported price corresponds to an arm's length valuation. Many intra-firm transactions relate to specialized goods not traded in any market, or to fees for the use of intangibles whose value is inherently difficult to establish (e.g. royalties for brands). This makes such pricing susceptible to tax abuses. The practice of shifting profits for the minimization of customs duties or taxes through the manipulation of transfer prices is called transfer mispricing.

One purpose of transfer pricing regulations is to clearly determine how a firm's profits are distributed between two jurisdictions in order to avoid double taxation (i.e. when the cross-border activities of a company operating in several countries could be taxed by more than one tax authority). However, because of the separate entity principle in tax treaties, which restricts adoption of a unitary approach to corporate groups and requires the application of the so-called arm's length principle, international tax rules have provided a perverse incentive to tax "planning" or avoidance by using intermediary entities in secrecy jurisdictions. Hence, in practice the proliferation of bilateral tax treaties has often resulted in a double non-taxation.

International cooperation across countries on tax matters remains limited.

Transfer mispricing and other practices aimed at tax avoidance can be challenged by tax authorities. Yet the process can be difficult, as those actions result from increased globalization in production processes, international competition amongst countries to attract capital and the aggressive exploitation of grey areas in tax laws. The latter is particularly common among TNCs that operate across several jurisdictions and hire specialized professionals and consultants specifically to handle tax planning. Moreover since international cooperation across countries on tax matters remains limited, for example in the area of transparency and exchange of information, it is difficult for an individual tax administration to control transfer mispricing and other tax avoidance practices. This is particularly true in low-income countries whose governments have fewer resources to fight tax-related capital flight and tax base erosion than corporations that plan their tax matters aggressively. In addition, the administrations in tax havens do not have a strong interest in cooperating with their counterparts in countries that

may have legitimate claims, since they obtain some benefits from the situation.

Current international rules provide considerable scope for "base erosion and profit shifting" (BEPS). This refers to tax planning strategies, which enable companies to exploit gaps and mismatches in tax rules to make profits "disappear" for tax purposes. They do this by shifting their profits away from jurisdictions where the activities are taking place to jurisdictions where taxes are low, so that they pay little or no overall corporate tax (OECD, 2013a and b).

There is wide agreement that the public revenue losses due to tax abuses are huge.

The overall effect of BEPS is a tendency to associate more profits with legal constructs and intangible rights and obligations, and to legally shift intra-group risk, which reduces the share of profits associated with substantive operations (OECD, 2013c). These tendencies become more pronounced over time as economic activities are increasingly based on information technology and intangibles. The overall effect of these corporate tax planning strategies is to erode the corporate tax base of many countries in a manner that is not intended by domestic policy. This reflects the fact that BEPS takes advantage of a combination of features of tax systems which have been put in place by home and host countries (OECD, 2013c). It implies that while international or bilateral cooperation to effectively combat BEPS behaviours is preferable, countries can also act individually to fight some of these practices.

3. *Magnitude and impact of international tax abuses on mobilization of public revenue*

The scale of IFFs, the amount of assets that foreigners hold in tax havens and the magnitude of the related public revenue losses are difficult to estimate. By their very nature, these activities are characterized by a lack of transparency, and estimates of the amount of such assets do not always consider exactly the same items or use the same methodologies and/or assumptions. Nevertheless, some recent and well-documented studies offer a hint of the magnitudes involved.

Regarding global offshore financial wealth, it has been estimated that it amounted to $5.9 trillion in 2008, suggesting that approximately 8 per cent of the global net financial wealth of households (bank deposits, equities, bonds and insurance contracts, net of debts) was held in tax havens, three quarters of which went unrecorded. Developing-country residents hold around 30 per cent of all offshore wealth, of which one third is owned by residents of oil-exporting countries (Zucman, 2013). These are probably underestimations; other estimates suggest a range of $21−$32 trillion in 2010, with roughly one third (between $7.3 and $9.3 trillion) originating in developing countries (Henry, 2012).[21] However, none of these studies takes into account non-financial wealth (such as real estate, yachts, racehorses and goldbricks) that can also be "owned" by offshore shell structures. This roughly corresponds to 10−15 per cent of all the estimated global financial and non-financial wealth.[22]

The loss of public revenue resulting from asset holdings in tax havens motivated by tax evasion is enormous. Henry (2012) estimates that if the unreported $21−$32 trillion had earned a modest rate of return of just 3 per cent, and if the income from the returns had been taxed at 30 per cent, this would have generated income tax revenues of $189−$288 billion per year. For developing countries, a similar calculation yields a tax gap of $66−$84 billion per year, which is about two thirds of total official development assistance (ODA). These are, by construction, conservative estimates, especially because they do not take into account the loss of tax revenue on the income generated by this capital before it was transferred to tax havens. Moreover, this figure would be considerably higher if additional taxes on this capital, such as taxes on inheritance, capital gains and wealth, were to be included.

With respect to the magnitude of IFFs, estimates are also very large. Nominal commercial illicit outflows from developing countries amounted to $946.7 billion in 2011, up 13.7 per cent from 2010. And they are estimated to have amounted to about 4 per cent of GDP over the past decade (Kar and

LeBlanc, 2013). In Africa, for instance, conservatively estimated cumulative illicit financial outflows totalled $437 billion over the period 2000−2008 (Kar and Cartwright-Smith, 2010). Similarly, Boyce and Ndikumana (2012) have estimated that illicit financial outflows from a group of 33 sub-Saharan African countries amounted to $814 billion (in constant 2010 dollars) from 1970 to 2010.

Estimating the revenue losses associated with IFFs, Christian Aid (2008) suggests that developing countries lose an annual $160 billion in revenues from corporation taxes due to transfer mispricing and falsified invoicing in international trade. Even though these practices represent only a subset of illegal activities resulting in public revenue losses, they amounted to more than one-and-a-half times the combined aid budgets of the entire developed world in 2007. FitzGerald (2012) looks at the gap between the tax revenue that could be legally collected and the actual revenue that results from tax misconduct associated with undeclared expatriated profits and overseas assets; estimates of public revenue loss for developing countries were $200−$250 billion annually in the mid-2000s. This figure is likely to have increased in subsequent years because of growth in the world economy and further financial integration. An earlier estimate by Cobham (2005) puts the revenue loss in developing countries at $385 billion annually. This includes tax losses due to domestic "shadow economic activity", together with the non-payment of taxes on income from assets held in OFCs and from profits earned by the corporate sector that were shifted to lower tax jurisdictions. TJN (2011) uses estimates from Schneider et al. (2010) on the size of the shadow economy (including, but not limited to, OFCs). It finds that tax evasion costs countries around the world more than $3.1 trillion annually. Of this total, Africa accounts for about $79 billion, Asia for $666 billion, Europe for $1.5 trillion, North America for $453 billion, Oceania for $46 billion and South America for $376 billion.

Some of these estimates are criticized on methodological grounds.[23] However, mostly, their magnitude is in line with that of national tax authorities or other official sources.[24] Notwithstanding the inherent limitations of such assessments, there is wide agreement that the public revenue losses due to tax abuses are huge. This calls for improving tax scrutiny, but also for preventing tax-related capital flight or complex tax schemes through tax havens and shell companies whose sole function is to reduce tax liabilities without creating any economic value.

4. Recent attempts to tackle international tax leakages

The fallout from the global financial crisis of 2008-2009 crisis prompted intensified efforts, at both national and international levels, to target tax abuse and the secrecy jurisdictions that facilitate these practices. Tax leakages have always been a serious issue for developing countries, but in a context of fiscal austerity and spending cuts in developed economies, this has also become increasingly recognized by their governments and public opinion as an issue that needs to be tackled. Some of the main recent developments with cross-border effects are outlined below.

(a) Global Forum on Transparency and Exchange of Information for Tax Purposes

The Global Forum has been the main multilateral framework within which work on transparency and exchange of information for tax purposes and other related domains has been carried out since 2000.[25] The OECD, which initiated this process, later opened this platform to non-OECD countries. In September 2009, it was restructured in response to a call by the G20 to strengthen exchange of information so as to protect the tax bases of governments from non-compliance with their tax laws.[26] The work of the Forum involves three main initiatives as described below.

(i) Country classification and peer review process

The Global Forum has started to report on individual countries, based on internationally agreed tax standards. According to its classification, countries are divided into three groups: jurisdictions that have substantially implemented the internationally agreed tax standard (also referred as the "white list"); jurisdictions that have committed to the internationally agreed tax standard, but have not yet substantially implemented it ("grey list"); and jurisdictions that have not committed to the internationally agreed

tax standard ("black list"). In April 2009, the third category was nothing but an empty shell, and since then most of the jurisdictions have moved from the second to the first category. This was not difficult: in order to be removed from the black list, it was sufficient to provide the OECD with the solemn assurance that it intended to abide by international agreements in the future. Acceptance into the white list requires a jurisdiction to have signed only 12 or more agreements that meet the standard. Thus, several grey list jurisdictions signed bilateral tax agreements among themselves to reach this threshold. Thus, the apparent disappearance of tax havens (according to this new OECD standard) was, above all, the result of skilful diplomacy. According to some critics "even the most notorious offshore financial centres have managed to quickly purge themselves of all suspicions of aiding and abetting tax evaders."[27] Johannesen and Zucman (2014) show that these new treaties have affected only a small proportion of offshore deposits, mainly through their relocation between tax havens, but have not resulted in significant repatriations of funds. The least compliant havens appear to have attracted deposits while the most compliant have lost some, leaving roughly unchanged the total amount of offshore-managed wealth. Meanwhile, the Global Forum's peer review process started in 2010, and in November 2013 it adopted ratings on the level of compliance with the internationally agreed standard for exchange of information. However, it has been criticized for its bias towards standards that align with the interests of OECD member States and for giving notorious tax havens a full seat at the table from the very beginning, which may explain why the agreed standards are weak (Meinzer, 2012).

(ii) Declaration on Automatic Exchange of Information in Tax Matters

At their meeting in the Russian Federation in September 2013, the G20 leaders issued the Declaration on Automatic Exchange of Information in Tax Matters (AEoI). This was endorsed in May 2014 by all 34 OECD member countries, as well as by Argentina, Brazil, China, Colombia, Costa Rica, India, Indonesia, Latvia, Lithuania, Malaysia, Saudi Arabia, Singapore and South Africa. Through this Declaration, these countries have thus committed to implementing a new single global standard on AEoI.[28] The standard mostly incorporates elements of both EU initiatives and the United States Foreign Account Tax Compliance Act (FATCA). These served to catalyse moves towards the automatic exchange of information in a multilateral context.

However, the lack of inclusion of developing countries in the design phase of the new system and the premature inclusion of countries known to be tax havens risk weakening the new system.[29] The poorer countries that are not yet in a position to provide reciprocal information will gain little from it, while some developed countries have suggested that developing countries be excluded because they cannot be trusted to keep information on their own taxpayers confidential.[30] One solution could be to establish a fixed transition period of some years during which developing and transition economies could receive data without reciprocity. This would allow them to ascertain the value of the data, adapt their own systems to make good use of it, and invest in the capacity to reciprocate (Cobham, 2014).

(iii) Initiatives on base erosion and profit shifting

In July 2013, at the request of G20 Finance Ministers, the OECD launched an Action Plan on Base Erosion and Profit Shifting (BEPS) to draw up new global tax rules to counter BEPS. This contains 15 actions to address a range of issues relating to tax transparency, accountability, information exchange and other potential changes to international taxation. The action plan also insists on the need for international agreement and cooperation so that countries will not have to act unilaterally. There are six key areas where there is urgent need for action (OECD, 2013c):

- International mismatches in entity and instrument characterization, which includes hybrid mismatch arrangements and arbitrage;
- Application of treaty concepts to profits derived from the delivery of digital goods and services;
- Tax treatment of related party debt-financing, captive insurance and other inter-group financial transactions;
- Transfer pricing, in particular in relation to the shifting of risks and intangibles, the artificial splitting of ownership of assets between legal entities within a group, and transactions between such entities that would rarely take place between independents;

- The effectiveness of anti-avoidance measures, in particular the general anti-abuse rule, controlled foreign company regimes, thin capitalization rules and rules to prevent abuse of tax treaties; and
- The existence of harmful preferential regimes.

Another topic that appears throughout the action plan concerns tax-related disclosures by companies to the tax authorities on a country-by-country basis. Using a common template, TNCs will be required to provide all relevant authorities with necessary information on their global allocation of income, economic activity and taxes paid. Although a majority of business leaders now support country-by-country reporting (CbCR), the publication of this data is being fiercely opposed by some business representatives and some national governments.[31]

(b) Other G20 and related initiatives

In addition to the initiatives discussed above in the context of the Global Forum, in November 2008 G20 leaders declared their intention to promote information sharing with respect to all kinds of abuses and fraudulent activities (G20, 2008). At their London Summit, in April 2009, they announced that the era of bank secrecy was over. They called on all jurisdictions "to adhere to the international standards in the prudential, tax, and AML/CFT [anti-money laundering/combating the financing of terrorism] areas", with the aim of protecting their public finances and curbing tax abuses. Since then, several initiatives that could help tackle tax abuses have been launched by different actors, over and above those of the OECD. In particular, the Financial Stability Board has worked on the establishment of a global legal entity identifier system that will attribute a reference code in order to uniquely identify a legally distinct entity that engages in a financial transaction. This would help track financial flows, even in secrecy jurisdictions.

(c) United Nations Committee of Experts on International Cooperation in Tax Matters

The work of the United Nations Committee of Experts on International Cooperation in Tax Matters (a subsidiary body of the Economic and Social Council) offers a useful framework for addressing international tax challenges. In particular, it aims at enhancing technical capacity in developing countries to handle complex matters in taxation. The Committee has recently provided two main contributions to influence international tax practices. One is the 2011 revision of the *United Nations Model Double Taxation Convention between Developed and Developing Countries* (UN-DESA, 2011). This addresses possible abuses with respect to capital gains, the importance of exchange of information and assistance in the collection of taxes. The other is the *United Nations Practical Manual on Transfer Pricing for Developing Countries* (United Nations, 2013a). This offers practical guidance to policymakers and administrators on the application of the arm's length standard among both developing and developed countries. Regarding the OECD and G20 BEPS project, in October 2013 the Committee established a specific subcommittee for monitoring developments on BEPS-related issues and communicating with officials in developing countries.

(d) Other regional, bilateral and national initiatives with spillover effects

Regional cooperation between tax authorities via regional platforms, such as the Inter-American Centre of Tax Administrations and the African Tax Administration Forum (ATAF), has helped strengthen mutual assistance and capacity-building. In particular, the recently created ATAF has worked towards increasing the level of voluntary tax compliance whilst combating tax evasion and avoidance. Compared with these regional initiatives, regional cooperation among Asia-Pacific tax authorities in establishing frameworks and practices has been modest, so far (Araki, 2014).

In parallel to the progress made in the Global Forum on AEoI, numerous bilateral tax treaties (BTTs) and tax information exchange agreements (TIEAs) have been signed recently. However, many developing countries do not benefit from them. Indeed, only 8 per cent of BTTs, and 5 per cent of TIEAs,[32] have been signed with LDCs since 2008. Furthermore, some OECD tax havens have used the negotiations with developing countries for inclusion of information exchange clauses as a leverage to push for significant concessions from the partners to the agreements.[33]

In the *United States*, in the context of the post-crisis scandals related to foreign banks aiding tax evasion, FATCA has sought to recoup federal tax revenues by making it more difficult for taxpayers to conceal assets held in offshore accounts and shell corporations. In particular, FATCA requires all United States nationals, including those living abroad, to report their financial accounts held outside the country. It also requires foreign financial institutions to report on their United States clients to the Internal Revenue Service. However, this measure will only affect interest on directly held, non-business bank deposits of individuals. Wealthy individuals who use corporations and limited liability companies (LLCs) registered in Delaware, for instance, would not be affected.[34]

In December 2012, the European Commission presented an action plan for more effectively dealing with tax evasion and avoidance in the *EU*. The action plan specifies a comprehensive set of measures, to help member States protect their tax bases and recapture billions of euros legitimately due to them. The plan highlights the need to promote automatic information exchange as an international standard, and to end “double non-taxation” by companies and individuals. This includes, for instance, the Revised Savings Taxation Directive adopted in March 2014. EU governments are expected to implement the amended rules and adopt an EU-wide anti-abuse law − a safeguard against abusive tax practices − by the end of 2014.

In the *United Kingdom* in November 2012, the House of Commons Public Accounts Committee held hearings on the behaviour of three top United States TNCs that have used cross-border royalty payments, transfer pricing and siting of regional headquarters to lower their corporation tax payments. Members of parliament accused these TNCs of manipulating their accounts to minimize the corporate tax they paid in the United Kingdom, despite their significant commercial presence in that country. The consequent public outcry led one of the companies to announce voluntary payments of £20 million to HM Revenue and Customs within two years. This was after it emerged that the company had paid just £8.6 million in corporation taxes in 14 years of trading in the United Kingdom and none between 2009 and 2011.[35]

As a unilateral attempt to fight trade mispricing in commodities, *Brazil* introduced a simplified comparable uncontrolled price method in 2012 (Ernst & Young, 2013; Pereira Valadão, 2013). This aims to provide a reference price for commodities that Brazilian exporters and importers should use to avoid trade mispricing in their valuation of international trade. In particular, the Law (no. 12715/2012) authorizes the Brazilian tax authorities to determine what should be considered as commodities, and which commodity exchange should be recognized for applying the newly introduced methods. The law allows for price adjustments such as market premium and transportations costs, and, where there are no internationally recognized spot or futures quotations, the price of imported and exported goods could be compared with the prices obtained from independent data sources provided by internationally recognized research institutions.

D. Improving public revenue mobilization from the extractive industries

1. *Fiscal regimes and tax incentives in the extractive industries*

(a) *Tax incentives: Risk of a race to the bottom*

The generation of public revenues from the extractive industries and their use for financing development are central to the strategies of many developing countries. In resource-rich countries, these industries have been the main source of foreign currency and fiscal revenues. With the rise of commodity prices over the past decade, the magnitude of natural-resource rents and, consequently, their potential for supporting investment and growth have increased significantly. This has led to renewed interest in the issue of distribution of those rents among the owners of the resources and the companies that are assigned exploitation rights.[36]

As extractive industries are typically large scale and highly capital intensive, firms that invest in this sector tend to be very large. They normally possess the necessary financial resources and exploitation technology that most governments in developing countries lack. They are generally private TNCs, mostly based in developed countries, though an increasing number of State-owned enterprises, including from developing countries, are also operating in this sector. Investors have to negotiate the terms of their investment and subsequent operations with the governments of the countries owning the natural resources, which have sovereignty over these resources.[37]

Extractive industries present some special features that influence each party's position in such negotiations. Since the natural resources exploited by these industries are non-renewable, as a source of revenue they will be exhausted sooner or later. Hence, from the point of view of producing countries, capturing a significant proportion of the rents generated from their exploitation is crucial for financing diversification of the domestic economy to enable it to generate new sources of income, foreign exchange earnings and public revenues. In this context, the "fiscal linkage" is of particular importance since other linkages of the extractive industries with the domestic economy (e.g. employment and demand for domestically produced inputs) tend to be weak, except during the initial period when the production facilities and associated infrastructure are being built. Moreover, since most of the firms in the sector are TNCs, a large share of their revenues is likely to be repatriated rather than reinvested in the country where the natural resources are being exploited.

From the point of view of the TNCs, activities in this capital-intensive sector typically involve high sunk costs, investments have a long gestation period, and the prices for their products are volatile. Thus the profitability of their investment is extremely uncertain. Moreover, once an investment has taken place, it cannot be moved to another location. This is why they try to obtain special fiscal treatment and favour a stable tax regime.

Therefore, governments need to establish a fiscal framework for the extractive industries that responds to two major – and potentially conflicting – objectives: first, the fiscal conditions should be appropriate to attract investment; and second, they should ensure that the State receives an appropriate share of the rents for financing its development goals. Reconciliation of these two objectives results essentially from the respective bargaining power of governments and TNCs. Such bargaining power has changed significantly – in different directions – in

the past few decades, based on developments in commodity markets.

With the commodity price hikes of the 1970s and the perceived risk of supply shortages, the bargaining power shifted in favour of the producing countries which owned the scarce resources. This led to a wave of nationalizations of the oil and mining sectors in many developing countries. However, following the debt crisis of the 1980s, and with commodity prices declining in the 1990s, the balance of power changed again in favour of TNCs. These firms owned the technologies and the financial resources that many developing producing countries lacked for profitably exploiting their resources at a time of low prices. Under these circumstances, governments in many developing countries sought to attract FDI to the extractive industries either by privatization of their State-owned enterprises, especially those on the mining sector, or by opening the sector to foreign companies while maintaining some State participation. In both cases, they used a variety of tax incentives for TNCs, many of which are still applied today.

These incentives can take the form of reduced tax rates (royalties or corporate tax rates) or tax holidays, accelerated depreciation periods, or capital cost allowances that allow them to recover capital costs during the first years of production or carry forward losses. Similarly, firms may have the possibility to consolidate revenues and losses of different investment projects if the government does not impose a ring-fencing regulation. Other incentives include lower corporate taxes for reinvested earnings, tax-free remittance of profits to home countries and exemptions on fuel and import duties. In addition, TNCs may be exempted from capital gains taxes. This particular tax incentive is set to become increasingly relevant in an evolving environment where small and high-risk-taking junior companies engaged in exploration activities tend to sell their rights to larger companies that extract the resources. There can also be stabilization clauses that fix fiscal conditions for long periods of time, or even for the entire life of an extractive industry project.

It is important to recognize that the granting of tax privileges in one country tends to have an impact on other countries. Foreign companies take their investment decisions in an international context, comparing the profitability of similar investments in different locations. Thus, a neighbouring country or a country in another region that is endowed with the same or similar natural resources may feel the pressure to offer similar or even better incentives to compete as a destination for FDI. This not only undermines the effectiveness of fiscal incentives, but also runs the risk of leading to a race to the bottom, where all countries reduce their taxes to harmfully low levels, with no winners but the foreign private firms, most notably the TNCs.

The "fiscal linkage" is of particular importance since other linkages of the extractive industries with the domestic economy tend to be weak.

Privatization and liberalization of fiscal regimes in the extractive industries took place in many countries under the auspices of the Bretton Woods institutions in the context of structural adjustment programmes. In its Strategy for African Mining in 1992, the World Bank presented its private-FDI-led approach to the mining sector in African countries.[38] Similarly, in 1996 the World Bank formulated a mining strategy for Latin America and the Caribbean, although the principles underlying this strategy had been applied long before. The idea was that, thanks to increasing FDI, government revenues would automatically accrue from the rising production.

By the turn of the century, the mining sector in developing countries was largely dominated by TNCs, mostly from developed countries, that engaged in large-scale production.[39] By contrast, in the oil and gas sector, State-owned enterprises have continued to play a prominent role. This is probably because they managed to remain profitable even when oil and gas prices were low, and because the technology requirements for exploiting existing fields were lower than those in the mining sector.

Tax incentives have been widely questioned on the grounds that their costs in terms of foregone public revenues may often outweigh the benefits for the domestic economy. In particular, following the recovery of commodity prices since 2003, it is increasingly recognized that the public revenue gains often have not been commensurate with the increasing profitability of activities in this sector.[40] Civil society organizations have been playing a prominent role

in raising awareness about what is seen by many as unfair fiscal regimes in many developing countries.[41] The World Bank (2010: 9) has also acknowledged that “Mining fiscal regimes developed in the past (often under Bank guidance) were not adequate to capture much of the large increase in rents generated by these price increases”. For example, a study of four countries in East Africa (Kenya, Rwanda, Uganda and the United Republic of Tanzania) by Tax Justice Network-Africa and ActionAid International (2012) shows that tax incentives are resulting in large losses of government revenue of up to $2.8 billion annually, depriving those countries of critical resources for development and poverty reduction. The IMF has also emphasized the need for developing countries that are becoming new producers of natural resources to pay greater attention to the design of their fiscal regime in order to tap into this potential source of revenue (IMF, 2012).

Several international institutions and civil society organizations have warned about the lack of economic effectiveness of tax incentives to attract FDI (IMF et al., 2011; Tax Justice Network-Africa and ActionAid International, 2012). Similarly, the United Nations (2010: 2) concludes that “investment incentives are generally unnecessary for the mining sector because mining activities are location based and governments should collect the rents from such resources”. This is equally applicable to oil and gas extraction.

Tax incentives have been widely questioned on the grounds that their costs in terms of foregone public revenues may often outweigh the benefits for the domestic economy.

Indeed, there are indications that, in many cases, tax privileges for foreign companies in the extractive industries have far exceeded reasonable limits, and that such privileges may often be unnecessary. For instance, the African Development Bank (AfDB) et al. (2010: 109) recognize that “most natural resources can be taxed, within the bounds of reason, without scaring away investors”. Moreover, various surveys among investors have confirmed that tax motivations rank low among the factors influencing a decision on where to invest; in other words, in many cases investment would most likely take place anyway, even with lower or no special tax incentives (Keen and Mansour, 2009; Vale Columbia Center on Sustainable Investment, 2013).

Since the early 2000s investment in natural resource exploitation, particularly FDI, has surged (UNCTAD, 2007),[42] particularly in Africa, Latin America, West Asia and the transition economies. However, there is no clear evidence that this was due to tax incentives (World Bank, 2012a: 132). Rather, it is more likely to have been motivated by the expectation of new profit opportunities resulting from increasing demand from emerging market economies, particularly China, and the commodity price boom since 2003. But there have been growing concerns that neither the higher commodity prices nor the increase in FDI have significantly improved development prospects in many producing countries.

TNCs in the extractive industries saw their profits soar during the price boom: between 2002 and 2012 revenues of the world’s largest mining companies increased fivefold and net profits more than tenfold (Stevens et al., 2013). Meanwhile, government revenues from natural resources lagged far behind. Many commodity-dependent countries failed to achieve marked improvements in terms of income distribution, poverty reduction or human development.[43] By the second half of the 2000s, it had become evident that the incentives to attract FDI had been overly generous, especially in the context of the changed commodity markets environment. Therefore, it was considered necessary to revise taxation policies related to the extractive industries in order to protect the interests of the host countries. As in the 1970s, strong demand and higher prices again increased the bargaining power of producing countries, which provided additional political impetus for such revisions.

Host governments have also seen their bargaining position strengthened by the emergence of new major players in the extractive industries. While TNCs from developed countries continue to dominate the scene in commodity-producing developing countries, FDI from emerging countries is growing very rapidly. This gives producing countries a greater choice of investors. Therefore, contracts with these traditional TNCs may be negotiated more favourably for the host country.

(b) *Forms of State participation in the extractive industries*

There are different ways for the State to capture a share of the rents of the extractive industries. These range from royalties and various forms of taxation, to contractual arrangements such as production-sharing and services contracts, as well as full participation in production, either through public ownership or through joint ventures between State-owned enterprises and private firms. Methods of raising public revenue can be based on production or on profits. Production-based methods, in the form of per unit or "ad valorem" royalties, are more advantageous for the government as it receives them from the moment the project begins operation, even if the companies do not register profits in their accounts. For this reason, governments tend to prefer them. They are also relatively easy to administer, an advantage which is of particular importance in developing countries where tax administrations often find it difficult to correctly assess taxable revenues. Private companies, on the other hand, prefer taxation based on profits, mainly through corporate income taxes, as they start paying taxes only when they record profits. Special taxation in the extractive industries based on profits may also include resource rent taxes and taxes on windfall profits, although these are less common. Another advantage of profit-based taxes for TNCs, but a major disadvantage for producing countries, is that profits are more difficult to monitor which makes it easier for companies to adopt tax evasion and avoidance techniques (see section C).

> Producing countries should not only be able to negotiate a taxation system that effectively expands their fiscal space…

Governments can also impose export taxes on the extractive industries, as another form of production-based taxation. They may offer the advantage of being easier to collect, while also helping to control the volumes, prices and qualities of the commodity exported at the customs point. For instance, a company may try to avoid taxation by underestimating the grade of the mineral ores or of possible by-products contained in the exported concentrate, and this could be controlled by the customs authorities in producing countries.[44] Such taxes could also be used as an instrument of industrial policy if the tax rate is lower for processed products than for the raw materials. Another way to increase public revenues in producing countries is by taxing capital gains in the extractive industries, which are increasing in importance, as mentioned above. Additionally, environmental taxes can be applied to internalize the external costs of extractive activity.

> … they must also be able to enforce it, avoiding massive losses due to aggressive tax planning and accounting practices of TNCs.

Overall, there is no universal recipe for an optimal taxation regime for this sector. In practice, governments tend to use a combination of instruments. The final outcome depends largely on the specific geological, economic, institutional and political circumstances of each country. As a result, there is no absolute benchmark or reference point based on which particular fiscal regime for the extractive industries could be judged as "fair" or "unfair". In practice, a wide range of taxation levels are applied in different countries.[45]

Producing countries should not only be able to negotiate a taxation system that effectively expands their fiscal space; they must also be able to enforce it, avoiding massive losses due to aggressive tax planning and accounting practices of TNCs, such as transfer mispricing and thin capitalization. This is particularly important, since the natural resources sector is usually the main source of illicit financial flows in resource-rich countries (AfDB and GFI, 2013).

Transfer mispricing practices appear to be quite common in the extractive industries. TNCs can manipulate profit reporting by inflating costs and undervaluing prices in their intra-firm operations. In this way they can shift profits from the tax jurisdiction of the natural-resource-producing country to a lower tax jurisdiction.[46] Tax losses from these kinds of practices may be huge. The United Nations Economic Commission for Africa (UNECA, 2013) has found that illicit financial flows from Africa in the form of trade mispricing are highly concentrated in a few sectors, notably in the extractive industries.

During the period 2000–2009, more than half (56 per cent) of those flows from Africa were from oil, precious metals and minerals, ores, iron and steel, and copper. And a report of the Africa Progress Panel (APP) titled “Equity in Extractives” prepared under the leadership of former Secretary-General of the United Nations, Kofi Annan, emphasized that Africa loses $38 billion annually due to trade mispricing (APP, 2013).

The abuse of transfer pricing is facilitated by the way in which TNCs design their corporate structures. In an attempt to unravel the labyrinthine corporate structures created by the biggest companies in this sector, PWYP (2011) found that the 10 most powerful corporations in the extractive industries owned 6,038 separate companies. Similarly, an investigation into extractive industries projects financed by the World Bank’s International Financial Corporation (IFC) found that 57 per cent of the companies analysed channel their investments in developing countries through intermediate holding companies located in tax havens (Dan Watch, 2011). It may be difficult to explain why TNCs in the extractive industries have their headquarters or subsidiaries in low-tax jurisdictions if not to avoid paying taxes in the producing countries.[47]

Another damaging practice for producing countries, similar to transfer pricing, is that of thin capitalization. According to the United Nations (2013a) *Practical Manual on Transfer Pricing*, a company is said to be “thinly capitalized” when it has a high proportion of debt in relation to its equity capital. Excessive debt funding of a subsidiary company in a producing country is a disguised way of transferring profits to headquarters. This can lead to an unacceptable erosion of the revenue base of the producing country, such as when the interests paid are inflated so as to show higher costs, and consequently, lower profits.[48]

In addition to ensuring appropriate fiscal regimes and negotiation of contracts as well as adequate collection of taxes in the extractive industries, a final important aspect in the taxation chain is that of jurisdiction for the settlement of disputes between foreign investors and the government. In principle, according to the voluntary *OECD Guidelines for Multinational Enterprises*, foreign investors should abide by national laws. However, under bilateral investment agreements, investors can submit tax disputes to international arbitration.[49] TNCs can also file cases at international arbitration centres when governments review their tax regimes or renegotiate contracts on the ground of breaches of stability clauses (on this issue, see also chapter VI).

2. *Distribution of rents in the extractive industries*

An empirical assessment of the size of a State’s participation in the rents from its natural resources remains a difficult task. Natural resource rents are defined as the difference between the sales value and the cost of production of the commodity concerned. Costs of production normally refer not only to operating costs but also to amortization and depreciation, as well as other costs such as interests from loans; and in the most comprehensive definition, normal profits are also considered a component of production costs. Calculation of the value of production is straightforward, because data on production by country and on international commodity prices are readily available. However, there is very little information on the cost of production. An additional complication is the availability of specific data on government revenues from natural resources, since few countries report them as a separate item.[50]

With these considerations, this subsection updates previous UNCTAD work in this area (*TDR 2005,* chap. III, section F and annex; and *TDR 2010,* chap. V, section D.5) in order to throw more light on the recent evolution of the share of government revenues in the rents of the extractive industries.[51] The results, by product and country, are shown in table 7.1. It was possible to perform calculations mainly for countries where a particular mineral or oil accounts for a major proportion of their natural resources production. For example, in the case of gold, the cost of production in African countries could be calculated by referring to the average production costs reported by major TNCs that provided these data in their annual reports. As governments do not report their natural resource revenues disaggregated by product, the data on revenues cover those from gold and other metals. Gold revenues account for most of government revenues from the extractive industries in these countries, and even though they lead to an overestimation of government’s share in

Table 7.1

SHARE OF GOVERNMENT REVENUES IN RENTS FROM THE EXTRACTIVE INDUSTRIES, SELECTED COMMODITIES AND COUNTRIES, 2004–2012

(Per cent)

	2004	*2005*	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*Cumulative share*
Oil										
Angola	63.2	56.8	75.9	81.4	79.6	81.4	88.1	91.9	95.1	83.3
Colombia	32.7	28.7	34.1	44.3	39.0	52.4	34.0	37.0	55.1	41.1
Ecuador	71.8	67.4	69.5	68.8	65.8	66.6	72.9	93.1	93.5	76.3
Venezuela (Bolivarian Republic of)	58.4	54.9	70.1	72.1	52.0	56.4	63.5	70.3	70.9	64.1
Copper										
Chile	50.9	53.5	51.0	54.0	60.1	44.7	51.3	50.1	55.5	51.9
10 major private firms	*20.7*	*27.7*	*28.8*	*35.7*	*36.8*	*24.0*	*29.8*	*38.3*	*40.4*	*32.0*
CODELCO	*99.7*	*84.3*	*88.9*	*90.7*	*101.1*	*79.3*	*91.3*	*66.3*	*89.5*	*86.9*
Peru	23.5	37.5	30.9	24.5	31.0	34.0	32.2	33.7	47.0	32.7
Zambia	0.8	2.0	3.4	8.9	21.6	167.4	19.2	30.5	..	17.5
Gold										
Ghana	20.1	61.9	27.6	29.8	23.9	18.6	21.0	31.1	32.8	27.7
Mali	21.4	18.0	29.6	43.3	38.5	39.6	35.8	28.3	..	33.6
Peru	23.7	24.6	26.4	25.7	28.1	28.3	29.2	28.1	29.9	27.7
United Republic of Tanzania	17.3	37.5	12.8	12.6	17.4	13.2	12.2	13.9	28.5	17.9

Source: UNCTAD secretariat calculations, based on annual reports of producing companies; *UNCTADstat*; IMF, *Country Reports*, various issues; IMF, *International Financial Statistics* database; World Bureau of Metal Statistics, *World Metal Statistics Yearbook 2014*; BP, *Statistical Review of World Energy 2014*; *EITI Country Reports*, various issues; and national sources.

the rents, the data are considered to be valid as an approximation for this exercise.[52]

These estimations show that there is wide variation in the size of governments' shares of the rents, as expected. The main reason for the differences is the degree of ownership of the natural resource by the State. In those countries where the State participates in production through State-owned companies, such as Sonangol in Angola, PDVSA in the Bolivarian Republic of Venezuela, Petroecuador in Ecuador for oil, and CODELCO in Chile for copper, the governments' shares of the rents are relatively high.[53]

By contrast, in those countries and activities where private companies are the only or dominant actors, the share of government revenues in the rents is much lower. This is mainly the case for countries producing minerals, such as Zambia, where the State captured an extremely low share of the rents from copper up to the end of the last decade. This could be attributed largely to the generous terms of the agreements that were reached between the Government and TNCs. For example, even though the royalty rate was 3 per cent in the general mining regime, in reality TNCs paid only 0.6 per cent as a result of specific development agreements. In the case of Ghana, where the range for royalties had been generally established at between 3 and 6 per cent, most companies paid at the lower level of the band. The share of the State in rents from gold production in the United Republic of Tanzania has also been very low. Similarly, the share of the State in the rents from mining production in Peru, which is controlled by the private sector, is relatively low.

In Latin America, the comparison of the distribution of copper rents in Chile and Peru provides interesting insights. In both these countries, when only private firms are taken into consideration, the government appropriates about one third of the rents. When considering the State-owned enterprise,

CODELCO, in Chile the public share is over 50 per cent. While CODELCO accounted for about 36 per cent of total copper production in the last decade, it contributed as much as 60 per cent of total government revenues from this activity. This difference is due to the fact that CODELCO transferred to the government more than 85 per cent of the rents generated.

In general, up to the turn of the decade, the amount of government revenues from mining was quite low, except in the case of Chile when CODELCO is included. While the share of the government in the rent has fluctuated over the period considered, particularly in African countries,[54] the cumulated flows show that the government captures between 17 per cent and 33 per cent of the rents. According to Daniel et al. (2013: 22) "Fiscal regimes around the world offer governments, on average, about half of the rents generated by mining, and two-thirds or more from petroleum—perhaps because petroleum usually generates more rent. Actual collections may be lower if there are loopholes or inefficiencies in collection. Fiscal policies that raise less than these benchmark averages may be cause for concern".

The increases in the share of the government in the rents that have occurred in the past few years may be partly related to recent changes in regulatory regimes for the mining sector, which aimed at raising the State's share (see below). It may also be due to the fact that companies that had benefited from accelerated depreciation and loss-carry-forward incentives had to start paying corporate income taxes when the period for these incentives expired.

Until recently, royalties were the main component of government revenues in the extractive industries. However, it appears that the trend is changing, probably due to the increasing importance of corporate taxes that TNCs are now being obliged to pay. In Latin America, the principal source of government revenues from mining is a tax on profits reported by the mining companies, while royalties account for only a small share (ECLAC, 2014b). This may not be the case yet for many African countries, where royalties still account for the major share of government revenues from the mining sector (Gajigo et al., 2012b). One reason for this difference may be that production in African countries started later, and therefore most TNCs operating there are still enjoying the benefits of accelerated depreciation. It may also be that the capacities of African countries to control and prevent harmful tax management practices are more limited than those of Latin American countries.

3. *Recent initiatives related to taxation in the extractive industries*

(a) *Changes in the regulatory environment for the extractive industries*

With rapidly rising commodity prices, the perception grew that the distribution of rents between the State and foreign private corporations tended to be skewed in favour of the latter, thus depriving host-country governments of an appropriate share in the rising value of their natural resources. This has led, since the mid-2000s, to an increasing trend towards reviewing the fiscal conditions under which the extractive industries operate. In many natural-resource producing countries, governments have taken different measures to correct the situation. As illustrated with the selected examples presented in table 7.2, these may take various forms, including revision of contracts that may lead to their renegotiation or cancellation, increases in tax or royalty rates or the introduction of new taxes, and changes in State ownership of the extractive projects.

Although the main objective of these changes was generally to improve the distribution of the rent, on some occasions revisions in the regulatory environment may also aim at expanding the production or the local transformation of primary commodities. The government may apply the principle of "use it or lose it" if there is insufficient investment in, or development of, a particular concession or project. For example, in April 2012 the Government of Argentina assumed majority ownership of Repsol YPF, the largest oil-producing company in the country, by taking over the Spanish TNC, Repsol's 51 per cent stake in that company. The Government claimed that insufficient investment by the latter had led to a steep decline in oil and gas production and had turned Argentina into a net importer of hydrocarbons, from having been a net exporter. In less than two years, the State-controlled company reversed the decline in investment and production.[55] Taxes may also be introduced or raised for industrial policy purposes. For instance, in January 2014 Indonesia imposed an export tax, along with a ban on mineral ore exports,

in order to induce mining companies to process the raw materials domestically.

In a number of countries, governments' attempts to introduce changes to their fiscal regimes for extractive industries have been foiled by various pressures. In Zambia, for instance, a 25 per cent windfall tax was introduced in 2008, but it was repealed in 2009 following a fall in copper prices after the global financial crisis. TNCs' warnings about the possibility of investment reductions and mine closures, and their threats to take legal action also played a role. Likewise, the Government of Ghana's plan to introduce a 10 per cent tax on windfall revenues in its 2012 budget was dropped following threats by mining companies to lay off workers.[56] However, in general, TNCs do not follow through on their threats to leave a country after it introduces regulatory changes. For instance, in Ecuador in 2010 most companies accepted the Government's request to renegotiate their contracts with the Government. Similarly, after the changes in public ownership in the natural gas sector in Bolivia in 2005-2006, TNCs stayed on in the country under the new conditions; and foreign TNCs are continuing to sign contracts with Argentina's YPF for exploration and exploitation of large shale oil and shale gas reserves in the country.

It is not only developing countries that have introduced, or attempted to introduce, changes to their fiscal regimes relating to the extractive industries; a number of governments in developed countries have also been reviewing their shares in the distribution of the rents from these industries. As shown in table 7.2, in the United Kingdom, the supplementary tax on oil production was increased in 2011, and in Australia, against heavy opposition from the booming mining sector and after a long (and ongoing) debate, the Government introduced a mineral resource rent tax in 2012 of 22.5 per cent". [57]

Revisions of the regulatory environment for the extractive industries are ongoing processes throughout the world. In a number of countries, discussions among different stakeholders continue to take place with a view to reforming tax and ownership regimes. These include Brazil, the Democratic Republic of the Congo, India, Mali, Mozambique, the Philippines and South Africa but also the United States.[58] In South Africa, there has been extensive debate on the issue of nationalization of the mining sector. This resulted in a report on State intervention in the mineral sector in 2012 (known as the SIMS report),[59] which ruled out nationalization, but considered ways for a fairer redistribution of mining profits, including through a resource rent tax of 50 per cent and the creation of a State mineral company to develop strategic minerals.

(b) Transparency-related initiatives

Increased transparency about the activities of both governments and TNCs is a key component for ensuring appropriate public revenue collection from the extractive industries. The main initiative concerning transparency in this context is the Extractive Industries Transparency Initiative (EITI) launched in 2003.[60] A multi-stakeholder initiative, EITI involves governments, companies, investors, civil society organizations and other partner organizations, who work together to improve openness and accountable management of revenues from natural resources. Countries implementing the EITI Standard are expected to ensure full disclosure of taxes and other payments made by oil, gas and mining companies to governments. These payments are disclosed in annual EITI Reports. By July 2014, there were 29 EITI-compliant countries (i.e. countries that were meeting all the requirements of the EITI Standard), all of which were developing and transition economies, except Norway, and 16 candidate countries (i.e. countries which were implementing EITI but not yet meeting all the requirements). In addition, 35 countries had produced EITI reports.[61]

> Increased transparency about the activities of both governments and TNCs is a key component for ensuring appropriate public revenue collection from the extractive industries.

The EITI marks significant progress towards increasing transparency in the extractive industries. Nevertheless, it has some major weaknesses. First, it is voluntary, and is therefore non-binding on both governments and private corporations. As a result, it has limited effect, since a considerable proportion of global production by the extractive industries remains outside its standards. Second, the EITI reconciliation exercise is unidirectional in that it only allows checking whether the revenues reported by

Table 7.2

EXAMPLES OF REVISIONS IN THE REGULATORY AND FISCAL REGIMES FOR THE EXTRACTIVE INDUSTRIES

Measure	*Country*	*Details of change*	*Year*
Contracts/ licences revisions or renegotiations	Democratic Republic of the Congo	An expert committee reviewing 61 mining deals concluded that they were all bad deals, and recommended cancellation of 22 and renegotiation of 39.	2009
	Dominican Republic	Renegotiation of contract with Barrick Gold Pueblo Viejo Mine.	2013
	Ecuador	Law compelling private oil companies to renegotiate their service contracts in order to replace the taxation arrangement in production-sharing agreements with a flat rate per barrel of oil.	2010
	Guinea	Review of validity of existing contracts.	Ongoing
	Liberia	Review of concession agreements signed between 2003 and 2006 (36 out of a total of 105 contracts were recommended for outright cancellation and 14 for renegotiation).	2006
	United Republic of Tanzania	Review of mining development agreements and the fiscal regime for the mineral sector, leading to renegotiations on a case-by-case basis.	2006
	Zambia	Ending of tax stability clauses in development agreements.	2008
Changes in royalty rates	Chile	Increase from 5 to 9 per cent.	2010
	Ghana	Increase from a range of 3−6 per cent (which in practice was normally 3 per cent) to 5 per cent.	2010
	Peru	Companies that do not have stabilization clauses or agreements with the Government must pay royalties of 1−12 per cent on operating profits (before the new law, rates ranged from 1 to 3 per cent on net sales), as well as a special tax ranging from 2 to 8.4 per cent of operating profits. Companies that have stabilization clauses must pay a special mining lien of between 4 and 13.12 per cent of operating profits.	2011
	United Republic of Tanzania	Royalty rate for copper, gold, silver and platinum group minerals increased from 3 per cent to 4 per cent, while that for other minerals, including gemstones and diamonds, remained at 5 per cent.	2010
	Zambia	Increase from 0.6 to 3 per cent.	2008
	Zambia	Increase from 3 to 6 per cent.	2012
Changes in corporate tax rates	Ghana	Increase from 25 to 35 per cent.	2012
	United Kingdom	Increase in supplementary tax rate from 20 to 32 per cent in the hydrocarbons sector.	2011
	Zambia	Increase in company income tax from 25 to 30 per cent.	2008
Introduction of new taxes	Australia	Resource super profits tax (RSPT) with a headline tax rate of 40 per cent, applicable to all mining projects (but replaced soon after approval).	2010
	Australia	Mineral resource rent tax, replacing RSPT, with a reduced headline tax rate of 30 per cent (effectively 22.5 per cent), applicable to coal and iron ore.	2010

Table 7.2 (concluded)

EXAMPLES OF REVISIONS IN THE REGULATORY AND FISCAL REGIMES FOR THE EXTRACTIVE INDUSTRIES

Measure	*Country*	*Details of change*	*Year*
	Chile	Mining royalty of 5 per cent.	2006
	Mongolia	Windfall tax of 68 per cent on profits from copper and gold.	2006
	South Africa	Royalty rate that varies with mine profitability.	2008
	Zambia	Windfall tax of 25 per cent.	2008 (but revoked in 2009)
	Zambia	Variable income tax rate, in addition to fixed rate of 30 per cent; it applies when assessable income is higher than 8 per cent of gross sales, with a maximum rate of 15 per cent.	2009
Increasing the State's equity participation	Algeria	Participation rate of national oil company Sonatrach is fixed at a minimum of 51 per cent.	2006
	Argentina	State takes a 51 per cent majority stake in hydrocarbons company YPF.	2012
	Bolivia (Plurinational State of)	Increased participation of the State in the hydrocarbons sector from 18 to 82 per cent of production value.	2005/2006
	Bolivia (Plurinational State of)	Law of mining rights increases State´s expropriation powers targeting mines deemed unproductive, inactive or idle.	2013
	Guinea	Expropriation of half of Simandou iron ore deposit from Rio Tinto, claiming slow development of the deposit by the company.	2008
	Guinea	Mining code that grants the State a 15 per cent stake in all projects, as well as an option to buy up to 35 per cent equity.	2011
	Kazakhstan	Kazmunaigas (KMG), a State energy company, doubled its share in the Kashagan consortium to 16.6 per cent.	2008
	Namibia	State mining company, Epangelo, is established.	2008
	Papua New Guinea	Government takes full ownership of the Ok Tedi copper and gold mine.	2013
	United Republic of Tanzania	Increased government participation but percentage not stated in mining act.	2010
Other	Ghana	Tax depreciation reduced, introduction of ring-fencing.	2012
	United Republic of Tanzania	Income tax ring-fencing by mine licence area.	2010
	Zambia	Capital depreciation allowance reduced to 25 per cent.	2008 (but back in 2009)
	Zambia	Ring-fencing of non-contiguous mines.	2009

Source: UNCTAD secretariat compilation, based on Kingsley, 2014; Stevens et al., 2013; Medina Herasme, 2014; UNCTAD, 2012; Eigen, 2013; Sachs et al., 2012; Tarimo, 2013; Ralbovsky and Caywood, 2013; Muganyizi, 2012; ZIPAR, 2013; USGS, 2006; National Treasury of South Africa, 2008; Park and Benayad, 2013; EY Resource Nationalism Updates (various); Gray Molina, 2013; Hawala, 2013; and RioTinto Mongolia, available at: http://www.riotintomongolia.com/ENG/oyutolgoi/881.asp.

governments correspond to the payments reported by the companies, but there is no judgement about the appropriateness of TNCs' tax burden. Thus, the EITI focus is limited to preventing corruption in producing countries. Third, there is room for improvement in simplifying the presentation of the reports, which may be difficult for many stakeholders to understand. The quality, timeliness and consistency of the data could also be improved. Finally, there is no clear course of action when mismatches are found in data disclosure.

Since the global financial crisis, there has been growing interest in improving transparency in the extractive industries. In the context of reforms of the financial system, G8 and G20 countries have been supportive of country-by-country reporting on those industries. This trend has led to various developed countries passing new regulations concerning public disclosure of financial payments by private corporations. The United States took the lead, stimulating a wave of changes in other developed countries. New regulations for increased transparency in the extractive industries emerged from Section 1504 of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (known for short as the Dodd-Frank Act). On 22 August 2012, the Securities and Exchange Commission (SEC) adopted rules mandated by the Act requiring companies in the extractive industries to disclose certain payments made to the Government of the United States or to foreign governments. The activities covered by commercial development of oil, natural gas and minerals include exploration, extraction, processing and export, or the acquisition of a licence for such activities; trading is not included.[62] The disclosure provision applies to any company listed on a stock exchange in the United States. This includes 90 per cent of all major internationally operating oil and gas companies, and 8 of the 10 major mining companies globally. Payments by subsidiaries are also included (RWI, 2011). However, following a lawsuit filed by the American Petroleum Institute against this SEC rule, a United States Court ruled in favour of the Institute. As a result, the SEC has to reissue another rule before Section 1504 of Dodd-Frank Act can be implemented, which it has publicly pledged to do by March 2015. A large number of investors, government officials and civil society organizations have called on the SEC to reissue strong disclosure rules, by country and by project (PWYP, 2014). Similarly, on 26 June 2013, the European Parliament and the EU Council passed new laws requiring oil, gas, mining and logging companies to disclose payments made to governments annually on a country-by-country and project-by-project basis. The new disclosure rules are included in the EU Accounting Directive and the revised EU Transparency Directive. They apply to all companies, parent and subsidiaries, that are active in the extractive industry or in the logging of primary forests, and that are either listed on an EU-regulated stock market or are large extractive and forestry companies.[63] Activities include exploration, prospection, discovery, development and extraction. Once again, trading activities are excluded from these regulations.[64]

In addition, a number of developing countries have decided to publish all their contracts with companies in the extractive industries. These include Azerbaijan, the Plurinational State of Bolivia, Ecuador, Guinea, Liberia, Niger, Peru and Timor-Leste (Berne Declaration, 2012). Furthermore, the Vale Columbia Center on Sustainable Investment, the World Bank Institute and Revenue Watch Institute, in collaboration with a wide array of partners from civil society organizations, have developed a searchable database of publicly available oil, gas and mining contracts all over the world.[65]

(c) *Other relevant initiatives in the extractive industries*

Probably the most remarkable initiative that has been recently adopted at the regional level is the African Mining Vision (AMV), approved by the African Union Summit of Heads of State and Government in February 2009.[66] Its main goal is to create "a transparent, equitable and optimal exploitation of mineral resources to underpin broad-based sustainable growth and socio-economic development". According to the African Union (2009: 14), "African states with weak governance generally fail to impose resources tax regimes that ensure an equitable share of the rents, particularly windfall rents, due either to a lack of state capacity or the subversion of that capacity to produce overly investor friendly outcomes". The Vision underlines that revenues from the exploitation of minerals and responsible taxation that allows host countries to better capture windfall gains are central to the process of structural transformation. It recommends self-adjusting resource tax regimes that can respond to changing economic circumstances.

Focusing on the importance of the developmental state, the AMV calls for enhancing the capacity of governments to negotiate contracts with a view to securing better deals, and for improving their ability to audit, review and renegotiate existing mining agreements. It warns against stabilization clauses, as well as bilateral and international investment agreements that may have negative impacts on policy space. Enhancing tax administration capacities to prevent damaging illicit financial flows, including transfer mispricing, is also part of the strategy advocated by the AMV. Further, it favours a collaborative approach among different stakeholders in the sector, with a focus on regional cooperation and a pooling of resources for capacity development and the financing of such reforms. The Vision is translated into an Action Plan which is implemented through the African Minerals Development Centre created in December 2013. The main value of the Vision as an element of a development strategy is its cooperative ownership by African countries, which can help to improve policy space for development at the national and regional levels.

The main value of the African Mining Vision as an element of a development strategy is its cooperative ownership by African countries.

Another relevant initiative at the regional level in Africa is the African Legal Support Facility created by the AfDB. It aims to assist African countries in the negotiation of contracts and complex transactions related to the extractive industries (Ngalani, 2013). There have also been attempts at the subregional level to harmonize mineral policies and regulatory regimes in the mining sector. One of the objectives of such initiatives is to prevent competition among countries in offering tax incentives that could lead to a race to the bottom. The Southern African Development Community (SADC) started the harmonization process in 2004, and appears to have made progress towards harmonization in a number of areas, including discouraging competitive behaviour among the member countries (Mtegha and Oshokoya, 2011). Similarly, the Economic Commission of West African States (ECOWAS) issued a Directive on the Harmonization of Guiding Principles and Policies in the Mining Sector in 2009. This included the implementation of a common mining code.

In other developing regions, there have been fewer efforts with regard to regional cooperation and harmonization of tax issues in the extractive industries. Nevertheless, in 2013 the Union of South American Nations (UNASUR) promoted a common strategy for the profitable use of natural resources, which could lead to increased cooperation in these matters. Also, in the Declaration of the First Ministerial Conference of Latin American States affected by Transnational Interests that took place in Ecuador in April 2013, it was agreed to establish a regional framework for coordinating actions to tackle the growing number of international dispute cases being filed against governments by TNCs, including those in the extractive industries. This included the creation of a regional arbitration centre (Khor, 2013).

In a context of high commodity prices, industrialized countries have directed their attention to strategies to secure access to these commodities. One example in this regard is the 2008 European Union Raw Materials Initiative (EU RMI),[67] which aims to promote undistorted access to raw materials on world markets. With an emphasis on trade and investment conditions, the resource diplomacy envisaged in the EU RMI would lead to pressure on developing countries to liberalize their raw materials markets, including their tax regulations. This has raised concerns about its effects on development policies as it may affect policy space in developing countries (Curtis, 2010; Fair Politics, 2011; Küblböck, 2013). In the spirit of a global partnership for development, it is of the utmost importance that the EU RMI does not undermine recent strong attempts by many developing countries to ensure that income generated in their mining and oil sectors effectively contributes to sustainable and inclusive growth and development.

E. Summary and conclusions

Fiscal space is consubstantial with policy space. Even if governments have the possibility to conduct their development policies within the multilateral, regional or bilateral frameworks, they will still need to finance the investment and other spending required by those policies. Therefore, strengthening government revenues is essential. Fiscal space has a quantitative dimension, roughly approximated by the share of government revenues in GDP and its capacity to expand public spending according to various macroeconomic goals and constraints. It also has a qualitative dimension, related to the desired structure of government revenues and spending, and the ability to reorient them as needed. Both dimensions are dynamic in nature, as they must adapt to the development process. Historical experience and the comparison between high- and low-income countries show a positive relationship between the share of governments' revenues and spending in GDP, on the one hand, and the level of development on the other. This relationship is neither linear nor mechanical, as different countries (or the same country at different times) make diverse choices with respect to the role of government in delivering social services and in assuming the tasks of a developmental State. Such choices frequently lead to larger or smaller levels of government revenues and expenditures in countries with similar levels of per capita GDP.

Fiscal space is both a cause and an effect of economic growth and structural change. Higher average income and the expansion of the modern sectors of the economy vis-à-vis the informal ones broaden the tax base and strengthen revenue collection capacity. This, in turn, allows for higher growth-enhancing public spending, both on the supply side (e.g. investment in infrastructure, research and education) and the demand side (e.g. social transfers). Reciprocally, the lack of fiscal space and the constraints on expanding it in many low-income countries are among the most serious obstacles to escaping the underdevelopment trap.

This general need for maintaining or expanding fiscal space faces particular challenges in the increasingly globalized economy. On the one hand, there is the possibility to increase fiscal space, at least temporarily, through foreign financing. In this context, ODA may be of vital importance for LDCs, and foreign credit may enlarge fiscal space if it is used for expanding production capacities, which in turn would generate more fiscal revenues. However, excessive reliance on foreign sources has in many cases led to overindebtedness and chronic deficits in the fiscal and external balances, limiting fiscal space in the long run. In addition, those deficits create the need for more foreign financing, which is subject to conditions that may significantly hamper overall policy space. Therefore, fiscal space should rely basically on domestic revenue mobilization if it is to sustain a national development strategy.

Globalization has affected the ability of countries to generate domestic government revenues and to choose their taxation structure.

On the other hand, globalization has affected the ability of countries to generate domestic government revenues and to choose their taxation structure. Lowering trade tariffs has significantly reduced revenues from border taxes, while the increased mobility of capital and its intensive use of fiscal havens have greatly altered the conditions for taxing income and wealth. The globalized economy has favoured tax competition among countries, pushing them into a

"race to the bottom" in offering incentives to foreign investors in the form of lower taxes. Corporate tax rates have declined in developed and developing countries alike, and many of them have also offered subsidies or tax exemptions to attract or retain foreign investment. In addition, finance-led globalization has led to a proliferation of offshore financial centres, tax havens and secrecy locations that provide potential taxpayers, including internationalized firms and wealthy individuals, with various means for tax avoidance or evasion. This not only means a very significant loss of public resources, it also tends to make taxation systems more regressive if countries increase VAT and other indirect taxes in an attempt to offset declining revenues from direct taxes.

The main vehicle for corporate tax avoidance or evasion and capital flight from developing countries is the misuse of transfer pricing (i.e. the valuation of intrafirm cross-border transactions by international company groups). If the intracompany or intragroup price does not reflect the price that would be paid in a market where each participant acts independently in its own interest, profits within a company group can be effectively shifted to low-tax or no-tax jurisdictions, while losses and deductions are shifted to high-tax jurisdictions. Such operations explain the large number of companies registered in tax havens and offshore centres, and the significant proportion of financial and trade transactions that nominally transit through them.

The negative consequences of secrecy jurisdictions, transfer pricing, profit shifting and all the other practices leading to an erosion of the tax base go well beyond their impact in terms of public revenue losses; they also affect the fairness of the tax system, undermine taxpayers' confidence in its integrity and distort trade and investment patterns as well as human and physical capital allocations.

The international tax architecture has failed so far to properly adapt to this reality. The opacity surrounding tax havens may partly explain the difficulties faced by policymakers in curbing tax evasion practices, but there are also significant political and economic obstacles. Offshore financial centres and the secrecy jurisdictions that host them are fully integrated into the global financial system, and large shares of trade and capital movements (including FDI) are channelled through them. Moreover, the most important providers of financial secrecy are some of the world's biggest and wealthiest countries, or specific areas within those countries. Thus, changing this system requires not only knowledge of the technicalities involved, but also strong political will and determination.

Recently, there have been a number of developments aimed at improving transparency and exchange of information on tax issues: in particular, since 2009 the OECD has hosted a restructured Global Forum on these specific issues, and has launched an Action Plan on Base Erosion and Profit Shifting; the G20 leaders declared their intention to promote information sharing with respect to all kinds of abuses and fraudulent activities; several national tax authorities or parliaments have also increased the monitoring of tax abuses by rich individuals and TNCs; and numerous bilateral tax treaties and tax information exchange agreements have been signed.

There are risks that the debate on international taxation issues will not fully take into account the needs and views of most developing and transition economies.

Although these initiatives are all steps in the right direction, their implementation has sometimes been slow, as has enforcement of the agreements reached. This is especially the case for transfer pricing abuses, which are particularly harmful for developing countries, as they result in the loss of not only public revenues, but also foreign exchange. Because these initiatives are mostly led by the developed economies – some of which themselves harbour secrecy jurisdictions and powerful TNCs – there are risks that the debate will not fully take into account the needs and views of most developing and transition economies. It will therefore be important to give a more prominent role to institutions like the United Nations Committee of Experts on International Cooperation in Tax Matters, and consider the adoption of an international convention against tax avoidance and evasion. A multilateral approach is essential because, if only some jurisdictions agree to prevent illicit flows and tax leakages, those practices will simply shift to other, non-cooperative locations.

A multilateral framework would also facilitate the adoption of measures for radically addressing tax

avoidance by TNCs, such as rules of unitary taxation of such corporations, making the firms pay taxes in the countries where they actually conduct their activities and generate their profits (United Nations, 2014). This would require the implementation of country-by-country reporting employing an international standard supported by the International Accounting Standards Board or a similar body,[68] and ensuring that these data are placed in the public domain for all stakeholders to access. In addition, even without the establishment of a fully unitary taxation system, much could be improved by replacing the separate entity concept with a unitary approach (Picciotto, 2013).

Although the very nature of the problem calls for a multilateral approach, governments can also apply measures at the national level, such as including a general anti-avoidance rule in legislation to increase the probability that "aggressive" tax schemes end up being declared illegal once challenged in courts (European Commission, 2012). Governments can also more effectively address transfer mispricing in their international trade by using reference prices for a number of traded goods. This would be of particular relevance for commodity exports, which are relatively homogeneous goods, and usually account for a large share of the exports of commodity-producing countries.

In many developing countries, increasing the generation of public revenues from natural resources – especially the extractive industries – is essential for the financing of development. Indeed, government revenues are often the main contribution of these activities to development, as they otherwise tend to generate enclave economies. Capturing a fair share of resource rents from a country's natural resources and deciding how they will be used for development is its government's responsibility, which cannot be transferred to the private companies exploiting the resources. Corporate social responsibility has a role to play here, but it should not be considered a primary means for TNCs in the extractive industries to contribute to the societies or communities in which they operate. The task of providing social services and infrastructure should be the government's responsibility. The principal contribution of TNCs to the producing country should be through taxation. Yet, while the rise of commodity prices in the last decade led to a tenfold increase in the profits of the world's largest mining companies, the gains for public revenues more often than not lagged well behind the growth of natural resource rents. This was mainly because taxation regimes in developing countries, which had been established at a time of low prices, and often on the recommendation of the Bretton Woods institutions, placed too much emphasis on attracting FDI through tax incentives.

Against this background, many governments – both from developed and developing countries – have begun to revise their policies with regard to the extractive industries. This has included renegotiation or cancellation of existing contracts, increases in tax or royalty rates, introduction of new taxes and changes in the degree of State ownership of extractive projects. Successful renegotiations have been facilitated by the stronger bargaining power of host governments resulting from the appearance of new major players in the extractive industry, such as companies from emerging economies.

Fiscal space and governance issues should be a prominent part of the post-2015 development agenda.

A comprehensive policy aimed at improving revenues from natural resources needs to incorporate several elements. First, governments should retain sovereign capacity to review the tax regimes and ownership structures whenever deemed necessary for the economic and development interests of the country. A minimum level of taxation could also be negotiated at the regional or international levels to avoid a race to the bottom on this matter. Second, they should have the means to enforce the rules and obtain the due revenues by controlling transfer pricing manoeuvres and underreporting of export volumes. Third, they should be allowed to do so without the threat of legal retribution through the existing investment dispute mechanisms, for the reasons noted in chapter VI.

Most of the needed measures can be taken at the national level, but multilateral cooperation is still of the utmost importance. Transparency initiatives such as the Extractive Industries Transparency Initiative (EITI) should be made mandatory and extended: they should not focus only on governments, but also on producing firms and commodity trading

companies. There is also a need to increase the focus on monitoring, auditing and accountability, as well as strengthen enforcement of the fiscal conditions and regulations under which extractive industries operate; for instance, frequently, the volume produced and exported is reported by the operating TNC with little or no effective control by host States. Institutional development and capacity-building are crucial, in particular to improve the capacity to monitor production costs, import and export prices, volumes, qualities and time of delivery of the natural resources extracted as well as to help in data collection and processing. Given its expertise in the area of commodities, transport, customs and trade, UNCTAD could provide support in this domain.

Regional cooperation initiatives for capacity-building can be very useful. The international donor community has an important role to play in supporting such initiatives. ODA and other international support could be significantly expanded in the area of improving developing countries' tax systems and contract negotiating capacities, as well as curtailing tax-motivated IFFs.

Much can be done also to curtail transfer mispricing. At present, recommended protocols for controlling this practice suggest comparing the prices fixed by TNCs with those of a similar operation made by non-related agents (a "compared uncontrolled price"), which would indicate the fair market (arm's length) price. In practice, finding such a "free market" comparable transaction may be complex (or virtually impossible), and requires strong administrative capabilities and costly procedures (United Nations, 2013a). A more workable alternative, already used by some developing countries, is to generate a clear benchmark of publicly quoted commodity prices which would be of mandatory use in commodity transactions, in particular those that take place between related parties (OECD, 2014). Extensive data processing will be necessary, not only to identify the right international prices, but also to adapt them to the specific conditions of the transactions. Such initiative could be facilitated by the creation of a public international database of reliable comparable prices, which would enable tax authorities in developing countries with limited resources to be better equipped to deal with potential abuses in this area.

Given their relevance for many developing countries and transition economies, fiscal space and governance issues should be a prominent part of the post-2015 development agenda. International cooperation in tax matters should be enhanced in a coherent manner in order to support national development objectives. Avoiding the resource drain caused by illicit financial flows would help provide the necessary resources to finance the attainment of development goals. ■

Notes

1 In chart 7.2, East, South and South-East Asia includes: Afghanistan, China, Hong Kong (China), Taiwan Province of China, India, Indonesia, the Islamic Republic of Iran, the Republic of Korea, Lao People's Democratic Republic, Malaysia, Nepal, Pakistan, the Philippines, Singapore, Sri Lanka, Thailand and Viet Nam; Latin America includes: Argentina, the Plurinational State of Bolivia, Brazil, Chile, Colombia, Costa Rica, Cuba, the Dominican Republic, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and the Bolivarian Republic of Venezuela; Africa does not include: Botswana, Burkina Faso, Equatorial Guinea, Lesotho, Liberia, Madagascar, Mauritania, Mayotte, Saint Helena, Seychelles, Somalia, Western Sahara and Zimbabwe; West Asia does not include the Occupied Palestinian territory; Croatia is included in the transition economies; and developed economies includes: Australia, Canada, EU member countries (excl. Croatia), Iceland, Israel, Japan, New Zealand and the United States.

2 For example, Uruguay initiated a system where low-income households making purchases with credit cards could be paid a VAT refund through the electronic banking system.

3 Sources include KPMG International, *Corporate and Indirect Tax Survey 2012 and 2014*; http://www.kpmg.com/GLOBAL/EN/SERVICES/TAX/TAX-TOOLS-AND-RESOURCES/Pages/corporate-tax-rates-table.aspx and OECD tax database; available at: http://www.oecd.org/tax/tax-policy/tax-database.htm#C_CorporateCaptial.

4 Between 2002 and 2012, the average applied tariff imposed by developing countries in East Asia fell from around 8 per cent to 4 per cent, and in Latin America from 6 per cent to 4 per cent. In regions with a large number of LDCs (e.g. sub-Saharan Africa), the average applied tariff fell by a lesser extent, from 8 per cent to 7 per cent (UNCTAD, 2014).

5 Financial sector legislation has been one of the key priorities of the EU, and Europe's financial sector spends more than 120 million euros annually and employs over 1,700 lobbyists devoted to influencing EU institutions, according to new research by the Corporate Europe Observatory and the Austrian Federal Chamber of Labour and Trade Union Federation (Corporate Europe Observatory et al., 2014). This amounts to more than two financial industry lobbyists for every European Parliament member and 60-plus lobbyists for each Minister of the Council of the EU, in addition to the lobbyists from other sectors of the economy. By comparison, there were only 150 civil society organizations reported to be lobbying legislators covering all issues, not just finance. The financial sector outspends its civil society counterparts by a ratio of at least 30 to 1.

6 Americans for Tax Fairness and Public Campaign (2014) reports that 1,359 lobbyists supporting the package made more than 12,378 visits or contacts to members of Congress and their staff between January 2011 and September 2013. This represents a minimum of 93 contacts per week, on a single issue alone. There are more than 2.5 lobbyists for every member of Congress, and more than 21 for every member of the two tax-writing committees in Congress: the House Ways and Means Committee and the Senate Finance Committee.

7 See *The Economist*, "Onshore financial centres – Not a palm tree in sight", 16 February 2013.

8 These criteria are: (i) No or only nominal taxes are imposed on the relevant income; (ii) A "ring-fencing" regime effectively protects the sponsoring country from the harmful effects of its own regime on its domestic economy; (iii) Lack of transparency in the operation of tax laws makes it harder for the home country to take defensive measures; and (iv) Lack of effective exchange of tax information relating to taxpayers benefiting from the operation with foreign tax authorities.

9 See *BBC News*, "Sanctions threat to 'tax havens'", 26 June 2000; available at: http://news.bbc.co.uk/2/hi/business/806236.stm.

10 Full details of the FSI methodology are available at: http://www.financialsecrecyindex.com.

11 For further discussions on the myths linked to tax havens and other related issues, see, for example, Palan et al., 2010; and Shaxson, 2011.

12 For countries that are identified as tax havens by at least two different studies, see Palan et al., 2010, table 1.4.

13 *The Economist*, "Onshore financial centres – Not a palm tree in sight", 16 February 2013.

14 For more details, see: http://www.financialsecrecyindex.com/.

15 For further details about the Irish inversion, see *Financial Times*, "Tax avoidance: The Irish inversion", 29 April 2014.

16 Not all the IFFs are tax-motivated in a narrow sense. For instance, the main motivation for IFFs may be for evading exchange controls or for money laundering. Yet, even if they are not specifically tax-motivated, they do have fiscal consequences, and thus reduce fiscal space.

17 Herson (2014) notes that if the taxpayer falsifies paperwork, for example by knowingly making false statements in a tax return or engaging in false invoicing, this constitutes tax fraud. Tax evasion usually involves a wider range of practices, such as forgetting to declare some elements that must be taken into account in a taxpayer's tax returns. The distinction is important, because tax evasion, unlike tax fraud, is not (or has not been) treated as a criminal offence in every country. For this reason, some countries where this is, or has been, the case have systematically refused to provide judicial and administrative assistance to foreign countries in relation to tax offences that are not liable to prosecution in their country. A notable example is Switzerland, which, until recently, did not provide any administrative assistance in cases of tax evasion, except to a few countries with a double taxation agreement that conforms to the OECD standard.

18 The creation of trusts, foundations and Liechtenstein Anstalts (an anonymous company with a single secret shareholder) in secrecy jurisdictions provides the same kind of facilities to individuals (for further details, see, for example, Palan et al., 2010).

19 When such practices take place between unrelated, or apparently unrelated, parties they are referred to as "re-invoicing". When they take the form of cross-border intra-group transactions, they are referred to as "transfer mispricing".

20 Other studies suggest this figure is a rather conservative estimate. For instance, an article in the *OECD*

Observer noted that "more than 60 per cent of world trade takes place within multinational enterprises" (See: http://www.oecdobserver.org/news/archivestory.php/aid/670/Transfer_pricing:_Keeping_it_at_arms_length.html%22%20/l%20%22sthash.RvTzq9X0.dpuf.

21 Other estimates of global offshore financial wealth suggest $6.7 trillion in 2008 (Boston Consulting Group, 2009), $8.5 trillion in 2002 (Merrill Lynch and Cap Gemini Ernst & Young, 2002), $11.5 trillion in 2005 (TJN, 2005) and $12 trillion in 2007 (Frank, 2007).

22 Credit Suisse (2011) estimated total global wealth at $231 trillion in mid-2011, including financial assets and non-financial assets at market value.

23 For details, see, for instance, Fuest and Riedel, 2009; GIZ, 2010; and Henry, 2012.

24 Most of the official estimates were for developed economies. In the United Kingdom, for instance, total tax evasion and avoidance cost the Exchequer about £9 billion in both 2010/11 and 2011/12 (HM Revenue & Customs, 2012 and 2013). In the United States, the total "net tax gap", which refers to the amount of tax liability that will never be paid to the United States Internal Revenue Service (IRS), amounted to $290 billion in 2001 and $385 billion in 2006 (IRS, 2012). Finally, according to a report of the European Parliament (2013), an estimated one trillion euros of potential tax revenue for the EU is lost annually from tax fraud, tax evasion, tax avoidance and aggressive tax planning.

25 The Global Forum's main achievements have been the development of standards of transparency and exchange of information through the 2002 Model Agreement on Exchange of Information on Tax Matters, and the issuance of a paper setting out the standards for the maintenance of accounting records, titled, Enabling Effective Exchange of Information: Availability and Reliability Standard developed by the Joint Ad Hoc Group on Accounts in 2005. For a critical assessment of the Global Forum's work, see Meinzer, 2012.

26 More information of The Global Forum on Transparency and Exchange of Information for Tax Purposes is available at: http://www.oecd.org/tax/transparency/global_forum_background%20brief.pdf and http://www.oecd.org/tax/transparency/Frequently%20asked%20questions.pdf.

27 See Spiegel International Online, "The world's shortest blacklist: Why the fight against tax havens is a sham", 11 April 2009; available at: http://www.spiegel.de/international/world/the-world-s-shortest-blacklist-why-the-fight-against-tax-havens-is-a-sham-a-618780.html.

28 For more information, see: http://www.oecd.org/tax/transparency/automaticexchangeofinformation.htm.

29 See Thomson Reuters Foundation, "Developing countries not ready to join tax evasion crackdown – OECD", 26 May 2014.

30 See *Financial Times,* "Poorest nations will gain nothing from tax pledge", 9 May 2014.

31 *Reuters*, "CEOs back country-by-country tax reporting – survey", 23 April 2014.

32 UNCTAD secretariat calculations following the methodology of Misereor (2010) and based on the Tax Research Platform of the International Bureau of Fiscal Documentation (http://www.ibfd.org) and the OECD database on TIEAs, available at: http://www.oecd.org/ctp/exchange-of-tax-information/taxinformationexchangeagreementstieas.htm.

33 In the case of Switzerland, for instance, the developing countries concerned must, among other things, declare their readiness to lower withholding taxes on the earnings of Swiss companies abroad (Alliance Sud, 2014).

34 See, for instance, Sheppard, 2013.

35 *BBC News Business*, "Starbucks, Google and Amazon grilled over tax avoidance", 12 November 2012, and "Starbucks agrees to pay more corporation tax", 6 December 2012.

36 Rent is defined in this *Report* as the difference between the value of production (at international prices) and its cost, including normal profits.

37 The United Nations General Assembly Resolution 1803 (XVII) of 14 December 1962 established: "The right of peoples and nations to permanent sovereignty over their natural wealth and resources must be exercised in the interest of their national development and of the well-being of the people of the State concerned… The exploration, development and disposition of such resources, as well as the import of the foreign capital required for these purposes, should be in conformity with the rules and conditions which the peoples and nations freely consider to be necessary or desirable with regard to the authorization, restriction or prohibition of such activities… The profits derived must be shared in the proportions freely agreed upon, in each case, between the investors and the recipient State, due care being taken to ensure that there is no impairment, for any reason, of that State's sovereignty over its natural wealth and resources."

38 For a recent in-depth discussion on the role of the World Bank in mining reforms in Africa, see Jacobs, 2013; and Besada and Martin, 2013. See also UNCTAD, 2005.

39 One notable exception is Chile, where the public company, CODELCO, has continued to play an important role in copper production, although private firms now produce about two thirds of Chilean copper.

40 Increasing interest in the issue of taxation in the extractive industries is evidenced by the enormous

number of seminars and discussions on this issue that have been taking place at national, regional and international levels in recent years. Similarly, there has been a substantial increase in the body of research on this topic since the second half of the 2000s. In the United Nations, apart from the analyses on the distribution of rents from the extractive industries in *TDR*s *2005* and *2010,* UNCTAD (2005 and 2007) have looked at issues relating to FDI in the extractive industries. At the regional level, the Economic Commission for Latin America and the Caribbean (ECLAC), for instance, has produced several studies on this issue. In addition, the United Nations Committee of Experts on International Cooperation on Tax Matters convened an Expert Group Meeting on Extractive Industries Taxation in May 2013 (see United Nations, 2013b and c). At the operational level, it is mainly the United Nations Development Programme (UNDP) that provides advice relating to this subject, mostly on a country-by-country case basis (see for instance, UNDP-Cambodia, 2008). The international financial institutions have also published relevant studies, including the IMF (2012) Daniel et al. (2010) for the IMF, Otto el al. (2006) for the World Bank, and the World Bank (2012a). Some examples of research on this topic by academia, civil society organizations and the private sector include PWYP (2013), the University of Calgary (2012), the German Development Institute (DIE, 2011), the Raw Materials Group (2013a) and the International Council on Mining and Metals (ICMM, 2009).

41 Indeed, much of the most useful research and case study analyses on issues related to fiscal regimes for the extractive industries and their consequences for developing countries during the first decade of this century have been produced by civil society organizations.

42 The analyses of UNCTAD's *World Investment Report* of subsequent years continued to confirm the importance of natural resources for FDI in Africa and Latin America.

43 For example, the World Bank (2012b) has shown that in Africa the decline in poverty rates in resource-rich countries has generally lagged behind that of counties that are not rich in natural resources.

44 This is also an advantage in the case of exports of more refined products, as it may be easier to check them for quality than it is to check ores.

45 For comparisons of taxation in the extractive industries in different countries, see, for example, Raw Materials Group, 2013b; Gajigo et al., 2012a; Conrad, 2012; and IHS-CERA, 2011. Global consulting companies, such as Deloitte, Ernst and Young, KPMG and PricewaterhouseCoopers (PWC) also produce regular reports providing information on taxation in the extractive industries around the world. Although this information is very illustrative, it is likely intended as advice to corporations on how to optimize their tax payments.

46 Price manipulation can also occur in operations of commodity trading companies located in international trading hubs. A recent study has found that the average prices for commodity exports from developing countries to Switzerland, where several of these companies are located, are lower than those to other jurisdictions, while (re-)export prices for those commodities from Switzerland are higher than those from other countries, which may be due to a tax rate differential (Cobham et al., 2014).

47 An example of transfer mispricing in the extractive industries is the case of Mopani Copper Mines (MPM) in Zambia. MPM was the subsidiary company of Glencore International AG and First Quantum Mineral. In 2010 two auditing companies hired by the Zambian Government, found that MPM-Glencore had succeeded in substantially reducing accounting profits and therefore its tax payments over the period 2003–2008. The anomalies found included an unexplained increase in operating costs in 2007 of over $380 million, a declaration of very low cobalt production volumes compared with other companies of similar size in the region, and the manipulation of copper sale prices in favour of Glencore. In April 2011, five NGOs filed a complaint with the OECD against these corporations based on the findings of the audit report (Sherpa et al., 2011). However Glencore contested the allegations, questioning the information and methodology used in the report. Other examples of trade mispricing in Africa can be found in countries like Ghana, Malawi and the United Republic of Tanzania. In Australia, by July 2013 the tax Office was running 26 investigations into suspected profit shifting, 15 of which were in the energy and resources sector (see PWP, Out of Africa, tax tricks emerge, 6 July 2013 at: http://www.publishwhatyoupay.org/resources/out-africa-tax-tricks-emerge). In South Africa, Bracking and Sharife (2014) found discrepancies indicative of possible transfer pricing manipulation of rough diamond values.

48 For example, in Chile, as noted by Riesco (2005: 15), "Compañía Minera Disputada de Las Condes, a mine owned by Exxon, ostensibly operated at a loss for 23 years. Therefore, it did not pay any taxes at all and, on the contrary, accumulated $575 million in tax credits. Nevertheless, in 2002 Exxon (by then Exxon Mobil) sold this "money-losing" operation for $1.3 billion ... Exxon exported the mining operation's substantial profits, mostly disguised as interest payments to Exxon Financials, a subsidiary in Bermuda."

49 This is what happened recently in Mali, when the Government claimed a due payment of taxes from the gold producing company, Randgold Resources

(see EIU, 2013; and Randgold Resources's *Annual Report 2012)*.

50 The IMF is currently attempting to improve this situation. It has developed a draft standard template for countries to use for the collection of data on government revenues from natural resources, which is available at its website: http://www.imf.org/external/np/sec/pr/2014/pr1454.htm .

51 The World Bank, in its *World Development Indicators* database, has provided estimations of the rents from natural resources for a wide range of countries, covering a long period of time. They are available at the Changing Wealth of Nations Dataset, at: http://data.worldbank.org/data-catalog/wealth-of-nations. These data are being increasingly used worldwide in analyses on this subject. However, the methodology of calculation remains unclear, and a comparison with previous UNCTAD estimates shows significant differences. Therefore, as UNCTAD remains cautious about World Bank data on the natural resource rents, it was decided to continue to use its own estimations.

52 The contribution of the extractive industries to government revenues is often measured in terms of the effective tax rate, or what is called government take. By whatever measure, it is important to clarify if the contribution is assessed against sales revenues or against the rents from the natural resources, as is the case here.

53 In the case of Colombia, although there is also a State-controlled enterprise (Ecopetrol) which produces about two thirds of total oil, the share of the rent captured by the government is comparatively low. This is due to the high proportion of profits retained by the company.

54 Table 7.1 shows remarkably high levels of the share of the governments in the rents for 2005 in Ghana and the United Republic of Tanzania and for 2009 in Zambia. This has not resulted, however, from significant changes in public revenues, but rather from temporary reductions in the magnitude of the rents. In the cases of Ghana and the United Republic of Tanzania, gold production costs increased much more than prices. In Zambia, the reason for the decline in the rent was the collapse in copper prices that followed the global financial crisis.

55 See, for instance *El País*, “La petrolera argentina YPF aumenta la producción y las reservas en 2013” (Oil company YPF increases production and reserves in 2013), 9 March 2014.

56 See *Reuters*, “Ghana puts plans for mining windfall tax on hold”, 24 January 2014.

57 The Henry Tax Review (after Ken Henry, who was then the Secretary of the Treasury of Australia) recommended a uniform resource rent tax of 40 per cent to guarantee an appropriate return on non-renewable resources. The Government then proposed a resource super profits tax (RSPT) of 40 per cent for any profit above a given threshold, which would be applied to all minerals. There was strong opposition to this decision from the sector. The RSPT was later replaced by a mineral resource rent tax (MRRT) which took effect in July 2012 at a reduced effective rate of 22.5 per cent, and only for iron and coal projects. However, the controversy continued, and on 24 October 2013 the Government announced that it would seek to repeal the MRRT law with effect from 1 July 2014. Legislation to repeal the mining tax was rejected by the Australian Senate in March 2014. The Henry Tax Review can be accessed at: http://taxreview.treasury.gov.au/Content/Content.aspx?doc=html/home.htm.

58 See, for instance, GMP (2013) and recent EY Resouce Nationalism updates.

59 The SIMS report was commissioned by the African National Congress to inform the debate. Another relevant contribution in this context was the study of the Southern African Institute of Mining and Metallurgy on the rise of resource nationalism (see SAIMM, 2012).

60 The creation of the EITI had been announced earlier, in September 2002, by the Prime Minister of the United Kingdom at the World Summit on Sustainable Development in Johannesburg.

61 Source: EITI website at: http://eiti.org/countries (accessed 16 July 2014).

62 For more information, see SEC Adopts Rules Requiring Payment Disclosures by Resource Extraction Issuers; available at: http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171484028.

63 According to PWYP Australia (2013), regulations of the United States and the EU together will cover about 65 per cent of the value of the global extractives market, and over 3,000 companies, including most of the major international mining and oil and gas companies, as well as Chinese, Russian, Brazilian and other State-owned enterprises.

64 For detailed information, see PWYP Fact Sheet – EU rules for disclosure of payments to governments by oil, gas and mining (extractive industry) and logging companies, July 2013; available at: http://www.pwyp.ca/images/documents/Working_Group/EU_Fact_Sheet.pdf.

65 The database is available at www.resourcecontracts.org.

66 The AMV process was initiated through a Task Force involving different organizations at the multilateral and regional levels, including UNCTAD. For more information on the Vision, see: http://africaminingvision.org/.

67 The EU RMI is included in the Communication presented in November 2008 by the European Commission to the European Parliament and the Council under the heading, *The Raw Materials Initiative – Meeting Our Critical Needs for Growth*

and Jobs in Europe. It was further developed in 2011 in the European Commission Communication titled, "Tackling the Challenges in Commodity Markets and on Raw Materials".

68 In its present form, the International Accounting Standards Board (IASB) may not be the suitable body for this task, as it is not a public international body accountable to national or multilateral bodies. The IASB is in fact a private organization financed by the Big Four accountancy firms, major banks and global multinationals. It is headquartered in the City of London and registered in Delaware (See IFRS, *Annual Report 2013*; available at: http://www.ifrs.org/The-organisation/Governance-and-accountability/Annual-reports/Documents/IFRS-Foundation-Annual-Report-2013.pdf).

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