

INTERNATIONAL TAX COOPERATION AND DEVELOPMENT BEYOND MONTERREY

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Introduction: What Happened, and Didn't Happen, in Monterrey on Taxation

The International Conference on Financing for Development, held in Monterrey, Mexico this past March, attempted to look comprehensively at major issues affecting, impeding, or promoting development in poor countries. Taxation was among the subjects addressed, and rightly so: For the developing countries of the world, taxation policy and the development agenda are inseparable. However, the approach to taxation in Monterrey was impoverished. At best, the Monterrey conclusions on taxation constitute a superficial statement of the obvious; at worst, the taxation references are a mere cover for the summit's failure to address more fundamental ways in which international tax policy and development financing are linked. The purpose of this brief paper is to highlight the shortcomings of the Monterrey Consensus² as it relates to taxation, and to identify the more fundamental tax policy issues that are being overlooked, perhaps with intention.

The Monterrey Consensus addresses taxation from two perspectives. First, attention is given to the domestic tax administration of developing countries. Domestic budgets depend on effective taxation systems. Also, coherency, transparency and fairness in taxation systems are needed to facilitate business and investment. And so, the Monterrey Consensus briefly addresses domestic tax administration, recognizing the "need to secure...equitable and efficient tax systems and administration".³ The Monterrey Consensus also mentions the importance of avoiding double taxation in order to facilitate business and to attract foreign investment.⁴

The second perspective on taxation from Monterrey has to do with international tax co-operation. The final document provides:

"To strengthen the effectiveness of the global economic system's support for development, we encourage the following actions: [...]"

- *Strengthen international tax cooperation, through enhanced dialogue among national*

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²The Monterrey Consensus document is the final outcome of the International Conference on Financing for Development. The document, reference A/AC.257/L.13, is available at www.un.org/ffd.

³Monterrey Consensus, paragraph 15.

⁴Monterrey Consensus, paragraph 21.

tax authorities and greater coordination of the work of the concerned multilateral bodies and relevant regional organizations, giving special attention to the needs of developing countries and countries with economies in transition.”⁵

Based on the preparatory documents for the Monterrey summit, the tax cooperation envisioned seems to be a vehicle for bringing developing countries into the tax agenda of the developed world. As part of the preparatory work, the U.N. Secretary General commissioned a high-level panel, headed by former Mexican president Ernesto Zedillo, to advise on steps that international actors could take to advance the development agenda under each of the FfD’s six thematic areas. The Zedillo panel issued its report on June 25, 2001⁶ (the “Zedillo Report”), and following the Secretary General’s lead, included international tax co-operation as a significant element of its recommendations. The Zedillo panel specifically endorsed the creation of an International Tax Organization, with a proposed main agenda that, with one exception, would look remarkably like the agenda of the tax directorate of the Organization for Economic Cooperation and Development (OECD), the ad hoc grouping of highly industrialized countries. The main agenda points would be⁷:

- To compile statistics, identify trends and problems, present reports, offer technical assistance, and provide a forum for the exchange of ideas and the development of norms for tax policy and tax administration;
- To engage in surveillance of tax developments in the same way that the IMF maintains surveillance of macroeconomic policies;
- To engage in negotiations with tax havens to persuade them to desist from harmful tax competition and take a lead role in restraining tax competition designed to attract multinationals;
- To develop procedures for arbitration when frictions develop between countries on tax questions;
- To sponsor a mechanism for multilateral sharing of tax information in order to curb tax evasion;
- In due course, to seek to develop and secure international agreement on a global formula to apportion profits of multinational enterprises.

The only item on the above list that is not already being carried out by OECD is the last point, to develop proposals for global apportionment of profits. That idea was firmly rejected by OECD when it published its Transfer Pricing Guidelines in 1995.⁸

If the interests of developing countries were intended to be central in the limited Monterrey

⁵Monterrey Consensus, paragraph 64.

⁶ www.un.org/esa/ffd/PRZedillo1200.htm.

⁷ Zedillo Report page 15.

⁸ Transfer Pricing Guidelines for Multinational Enterprises (OECD 1995) (“OECD Transfer Pricing Guidelines”), Chapter I.

deliberations in taxation matters, it is hard to glean this intent from the Zedillo Report or other preparatory documents. Although tax competition was listed as a potential topic, there is no discussion to suggest that the concerns of developing countries were a priority. The other agenda items would seem to add little to what developing countries already receive from OECD, which compiles tax statistics even outside its own interest group, gives significant technical assistance to developing countries, has a draft arbitration convention, and would welcome new adherents to its exchange of information mechanisms. The only basis for proposing a new organization to do these same tasks would be to provide what the OECD lacks: real representation and influence for developing countries. The Report fails to give attention to this essential element. Notably, while the Monterrey Consensus identifies as a “first priority” the enhancement of effective participation of developing countries in international dialogues and decision-making processes, the subsequent reference to international tax cooperation stops short of that goal. It mentions special attention for the “needs” of developing countries, without mentioning special attention to the voice of those countries.

While developing countries are interested in diminishing tax competition, the type of tax competition that the OECD is examining is not necessarily the type that most concerns developing countries. OECD’s work in this area addresses only geographically mobile financial and service income.⁹ Developing countries are more concerned with competition for real investment, an issue that OECD hesitates to touch. In fact, recent developments in the OECD project suggest that the developed world, or at least the United States, is losing its taste for any restrictions on the ability of countries to use tax incentives to compete for investment, even of the mobile variety, provided there is adequate exchange of information.¹⁰ Perhaps more importantly, a developing country’s share of the tax base is strongly affected by other fundamental taxation principles that were not examined in the preparations or outcome of Monterrey. Policy issues of greatest concern to developing countries should be the hallmark of the agenda on development and taxation, not the exception. A deep reflection is needed on developing country participation in agenda setting and decision-making in international bodies that deal with tax matters.

It’s not that the Monterrey Consensus statements on international taxation are problematic of themselves. Certainly, domestic tax administration must function well in order for a country’s tax system to produce sufficient revenues. Likewise, greater coherence and co-operation to eliminate tax evasion is a worthwhile goal. But each of these two items has an embedded presumption that the Monterrey Consensus failed to test. As regards domestic tax administration, equitable and effective tax systems for developing countries presuppose equitable international tax policy, since presumably most developing countries will need to raise revenues not just from their own citizens but from foreign enterprises doing business in their jurisdictions. Thus, the domestic tax reflection from Monterrey really can work only if the international tax policy governing the allocation of income for cross-border business allows the developing country to collect a fair share of tax. The Financing for Development Conference failed to assess

⁹ See Tax Competition: An Emerging Global Issue (OECD 1998), paragraph 12.

¹⁰ See US Treasury Secretary O’Neill’s Statement at Senate Government Affairs Panel Hearing on Offshore Tax Havens (July 18, 2001), 2001 WTD 139-20.

this assumption.

Monterrey's international tax co-operation advice has a similar Achilles heel. It assumes that developing countries and the developed world have a unity of interest as regards coherence, exchange of information, and the end of tax evasion. It also assumes that the existing "rules of the game" are the standard to which tax coherence can and must aspire. The assumption is so ingrained in the developed world that it seems no one took notice of these assumptions or thought to question them. This is not very surprising. For finance ministers in the rich world, to question the status quo of international tax policy is like questioning the need for the sun to rise in the morning. The status quo has taken on the patina of theology.

Some Fundamental Tax Principles for Discussion

To engage a truly meaningful dialogue on taxation as it relates to development in poor countries almost would mean revisiting – or at least entering into dialogue -- on some fundamental tax principles. The existing rules, at least as applied to direct income taxation, have been designed to benefit the rich countries, those "first to the table" in international commerce. The "last to the table" developing countries face a system decidedly tilted against their interests, with the most fundamental and important questions of tax policy routinely "off the table", i.e. not open to discussion. Some of the fundamental issues at stake include:

- When does a country have jurisdiction to tax (i.e. the right to collect tax on a transaction, under commonly agreed principles)?
- What means should be used to prevent double taxation when two countries have the right to tax under the commonly agreed principles (this issue is usually addressed by adopting tax treaties indicating how double taxation is to be avoided)?
- What tax principles should be adopted for taxation of electronic commerce transactions?
- What principles govern the allocation of profit from a cross-border transaction between two related members of the same corporate group (the "transfer pricing" issue, because the profit is determined by the price charged between the two affiliates)?
- What principles should govern the taxation of financial service income and derivatives?
- What types of new or special taxes should be considered (e.g. currency transaction tax, environment tax, etc.)?

The manner in which these issues have been settled among the developed countries has significant impact on the role that taxation can play in financing development for poor countries. Accordingly, it is essential that these matters be discussed in an appropriate international forum where developing countries have a strong voice. Some examples of how the existing consensus on international tax policy can affect developing countries are given below.

The Residence Principle. The "last to the table" phenomenon is best highlighted by reflecting on the fundamental principle that presently guides the coordination of international taxation of

business income among the OECD countries: the “residence” principle. Under this principle, the country of residence of a taxpayer has primary taxing jurisdiction, meaning that this country can impose its taxes on business income of a resident regardless of the source of the income. The “residence” principle tends to favor the countries “first to the table”, which are the locations from which most transnational businesses operate.

Under the residence principle, the country that is the source of income on a transaction is not permitted to tax business income unless it is derived from a “permanent establishment” within the country – meaning a business enterprise that has a level of presence in the country sufficient to justify taxation. Thus, a company in an OECD country that sells its product into the market of a developing country would not pay direct tax on the sales income to the developing country, unless the company had established a base of operations there.

Tax on un-remitted profits. The above discussion focuses on limitations on a “source” country’s right to tax. However, current international tax principles also can effectively take away a “source” country’s right not to tax, i.e. its ability to attract investment through tax breaks. This result applies to income from types of activity that are considered mobile and/or passive, such as certain types of financial services, other services and sales activities. So, for example, if a company in the United States sets up a subsidiary in a developing country to serve as a regional sales center, some of the profit that the subsidiary derives from products manufactured and sold outside the subsidiary’s country could be taxed in the United States even before the profits are remitted to the U.S. parent. This means that any tax incentive the subsidiary’s country may provide as an incentive to have operations located there is effectively “soaked up” by the United States. While there are many cases where this pre-remittance tax is needed to prevent tax abuse, other cases are less clear. The application of such a tax to the business profits derived from internet services, for example, could effectively prevent many developing countries from attracting this types of business through tax incentives.

The denial of a right not to tax was one of the key complaints of tax havens that were examined by the OECD in its project on tax competition. The OECD countries have not asked tax havens to impose taxes, but they have asked them to design their laws in such a way as not to facilitate tax cheating by residents in the OECD countries. While this approach may seem reasonable at first blush, in fact in some ways it evidences a double standard. Most OECD countries would preach the sovereign right to apply a “worldwide” system of taxation, meaning that they are able to tax income of their residents (under the “residence principle”) from whatever source derived. Under this approach, the claim of sovereign rights is seen as trumping any concern about application of the residence principle in some way harming the development agenda of less developed countries. But OECD countries are less willing to recognize the sovereign right of tax havens to design their tax laws in a way that helps their development agendas, if exercise of those rights impedes the ability of OECD countries to enforce their domestic laws. OECD countries might claim the moral high-ground, especially given the premium placed on transparency in the post-September 11 world. But, from the perspective of a small island state, an OECD country over-reaching in terms of tax collections would almost surely not be credited with moral supremacy over an island state that allows the victims of over-reaching to benefit from fiscal non-transparency. In fact, as discussed below, the United States itself has some

limits on disclosure that effectively allow non-U.S. residents to hide investments of portfolio interest from their domestic tax authorities.

Income Allocation Rules. Even where a company in an OECD country decides to establish a base of operations, e.g., for sales, in a developing country, OECD rules for allocating income (the “transfer pricing” rules) usually would limit the profit booked in the developing country to a routine profit from sales (or manufacturing, in the case of a plant). Any profit attributed to intangibles used in the manufacture or sale of the profit would be attributed to the deemed “residence” of the intangibles – the place where the risk was borne to develop the intangibles. The profit from intangibles therefore is often attributed to the country of residence of the corporate parent, although many companies today engage in tax planning to position this risk (and associated profit) elsewhere, e.g. in a tax haven. The OECD has definitively rejected an approach to income allocation that would divide the total profit based on a formula that would include sales, with the possibility of giving more profit to the “source” country whose market is responsible for those sales. Thus, under the status quo, the “source” country that provides the market for sales of a product usually obtains only a limited allocation of profit (if any).

Direct v. consumption taxes. There are also issues about the proper composition of tax revenue – i.e. what types of taxes should be adopted. Most developing countries obtain a high percentage of tax revenues from the value-added tax, which taxes consumption and so gives a country a share of tax base according to its market. While all OECD countries (except the United States) have types of value-added taxes, OECD countries continue to derive significant revenue from direct income taxes. There seems to be a view that developing countries need to adopt such direct tax systems, particularly for individuals, as a crucial step along the way to economic growth. However, it appears that some developing countries would rather avoid the complexities of a direct tax system and continue with a consumption-based system only. Thus, the composition of tax revenue is another area where developing countries might want debate in an international context.

Taxation of portfolio (interest) income. Some developing countries complain that they are prevented from taxing bank interest of their residents by the tax policy in the United States of not taxing bank interest paid to non-U.S. persons. A developing country would be concerned that a tax on bank interest imposed in its own country would only drive investments to the United States. While the bank interest might remain taxable in the developing country even when derived from U.S. investments, many developing country tax administrations would have difficulty auditing these investments, particularly because the United States does not automatically provide information on such investments to foreign tax authorities. The Clinton administration proposed some last minute regulations that would require automatic exchange of this information, but the regulations were pulled for reconsideration by President Bush.

Conclusion

The above illustrations are not intended to suggest that the existing international tax principles are necessarily wrong as a matter of policy. The illustrations do, however, highlight areas in

taxation where developing countries may have different views on principles than those held by the developed world. It would seem that a true reflection on the role of taxation in financing for development would necessarily entertain an appropriate exchange of views on these basic issues. There is no excuse for the failure of OECD countries to engage a reflection on whether the current international principles are globally correct or just correct for themselves.

Developing countries should be empowered to pursue the possibility of obtaining a larger share of inter-company profit as part of a fair allocation of the tax base. Much attention is given in the Monterrey Consensus to official development assistance granted by rich countries to less developed countries, but should decision makers not also ask whether part of these funds should have been in the hands of the developing countries in the first place? One approach, as mentioned, would be a serious analysis of allocating taxes based on a global formula, with particular attention to the likely impact on developing countries. Even if this task is not undertaken, it would not be inappropriate to have a policy reflection on whether source countries are obtaining their fair share of the tax base. An example that illustrates the need for this reflection is the application of existing rules to the allocation of profits from internet transactions. With the rise in e-commerce, some countries may be less able to claim a fair share of tax base under the residence principle, because the new technologies decrease the need of companies to have substantial presence in developing countries.

At the present time, international tax policy has been formulated without considering its impact on development policy. It might have been hoped that the Monterrey summit, with its special focus on financing for development, would have changed this reality. It is essential that, in the future, development issues are taken into account when international tax policy is formulated. The examples above show that the tax policies of developed countries may in some cases impede the efforts of developing countries to attract business. A number of purposes might be served by considering the development impact of international tax policies. In some cases, developed countries might try to formulate domestic tax positions so as to be more supportive of development efforts, for instance by limiting the circumstances in which a “residence-based” tax is imposed on profits prior to remittance (i.e. CFC rules). In other cases, a reflection on development issues could lead to profit allocation rules that tilt in favor of developing countries or to the adoption of international taxes (such as CTT) intended to redistribute income for development assistance purposes. If developing countries are truly to have the main role in their own economic growth, as the Monterrey Consensus asks, then let international taxation policies support their efforts.