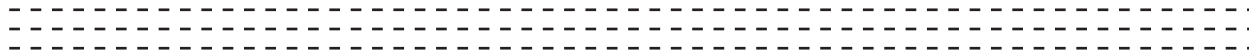


Driving the Getaway Car?

Ireland, Tax and Development

Dr. Sheila Killian

University of Limerick, Ireland, March 2011



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A note on language

Throughout the document the terms 'North/South', or 'global North /global South' are used, rather than 'First World/Third World, or 'Developed/Developing' countries. When we write about countries of the 'North' we are broadly describing countries in the continents of Europe, North America and Australia and when we write about countries of the 'South' we are broadly referring to countries in the continents of Africa, Asia and Latin America. None of these terms fully describe the diversity within our global society (for example, the terms North and South minimise inequalities within Northern and Southern societies). We use them as a short hand in a way that seeks not to imply superiority or inferiority between people.

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Executive Summary

Taxation is about far more than revenue-raising: it concerns power and impacts taxpayer behaviour. It is pivotal in enhancing accountability and participation in young states through the bargaining process between a government and its citizens. Very significantly, it often has unexpected consequences, and the tax system of one country can easily have an impact on economic or social behaviour in another. Since business is now international, it is important that taxes are designed not only with a domestic agenda in mind, but with a view to their consequences internationally, particularly for vulnerable economies in the global South.

The ability to collect tax is particularly important for Southern countries, for which it represents a far more sustainable solution to poverty than international aid. But Southern countries face particular challenges in this area. On a domestic level, there is the problem of how to tax a vast informal economy with little financial infrastructure. Southern taxing authorities struggle to collect revenue in the face of post-colonial attitudes resulting in poor tax compliance, relative tax complexity and poor taxpayer education, major gaps in their capacity, shifting tax structures often driven by IMF or World Bank lending, trade liberalisation, corruption and a deficient rule of law.

On an international level, tax challenges for Southern countries include capital flight, a lack of relative power in negotiations around foreign direct investment (FDI), tax competition, transfer pricing abuse by multinational firms, secrecy in some tax haven jurisdictions, and isolation through a thin network of tax treaties.

Mozambique was chosen for particular examination in Section 5 of this report because it is an Irish Aid priority country. The country has been through IMF-led tax reform, and illustrates many of the classic problems encountered by the taxing authorities of Southern countries. Suggested solutions to some of Mozambique's difficulties may be taken from the experience of other African countries.

Ireland may pose an inadvertent threat to the tax capacity of Southern countries if its tax system is used by multinational firms as part of capital flight, or international tax evasion schemes. Ireland has attracted considerable foreign direct investment (FDI) through tax competition using a low rate of corporation tax, a wide network of double tax treaties and incentives for intellectual property to encourage multinational firms to locate in the country. Although Ireland has recently introduced new rules to counter transfer pricing abuse, these have significant weaknesses. There is a clear risk that without closing these gaps, our tax system can become a vehicle for complex tax avoidance schemes used by multinational firms to reduce their global tax liability. This is neither in the interests of countries which lose revenue to these firms, or in the interest of Ireland as a legitimate destination for FDI.

A relatively small player, Ireland has disproportionate influence internationally through its participation in international tax initiatives at OECD and EU level, the cooperation between the Irish Revenue Commissioners and the Rwanda Revenue Authority, Irish Aid's participation in the African Tax Administration Forum and increased moves towards the exchange of information with other tax authorities. Nevertheless, Ireland's tax system can be abused by

multinational firms to reduce their worldwide tax, and in the process to impoverish the revenue authorities of Southern countries, as Section 4 of this report demonstrates. This also has the potential to damage Ireland's international reputation, and impair its ability to attract foreign direct investment.

Ireland made a commitment to policy coherence in the 2006 White Paper on Irish Aid. This extends to all government policies, and aims to ensure that as far as possible, all government interactions are harnessed to contribute to global development and the aims and objectives of Irish Aid. With this in mind, this report has the following recommendations to make, none of which would incur any significant cost to implement, some of which would produce immediate revenue for the Irish exchequer, and most of which would secure our long-term viability as a destination for FDI.

Recommendations – On a national level

1. Adjust the transfer pricing regime to grant powers to the Revenue Commissioners to adjust transactions which boost Irish profits as well as those which deplete them.
2. Maintain vigilance on companies operating in Ireland without a large economic presence, particularly those with large intra-group transfers.
3. Continue to provide a steady and predictable stream of aid to Southern countries, targeted at measures which improve the state capacity to collect revenue.
4. Continue to set an international example of the links between tax and accountability and governance by working towards a situation in which all Irish workers in Southern countries pay tax locally.
5. Abolish the tax exemption on patent royalty income, as recommended by the 2009 Commission on Taxation report.

Recommendations - On an international level

6. Continue to work with the taxing authorities of Southern countries to expand their capacity following the model established with Rwanda.
7. Negotiate Tax Treaties with Southern countries on a multi-lateral basis using the UN model as the template.
8. Use Ireland's influence within OECD, EU, World Bank and IMF to support Southern countries in designing and strengthening their own tax systems and in continuing to impose trade tariffs and customs duties where necessary.
9. Enhance the level of information exchange between the Irish Revenue and other taxing authorities.
10. Proactively advocate for the introduction of country by country financial reporting for multi-national corporations by the International Accounting Standards Board (IASB).
11. Strengthen Ireland's position on international tax evasion through enhanced tax transparency and improved measures to combat capital flight.

International tax evasion and capital flight are seriously depleting the tax revenues of the global South, and Ireland's tax system can be used by multinational firms as a vehicle to facilitate this. Even if Ireland does not actively participate in capital flight whether legal or illicit, the Irish government has a moral responsibility to ensure that its tax rules are not supporting a practice that impoverishes hundreds of millions of the world's poorest citizens, in direct contravention of its own stated values as a people. To use a very basic metaphor, Southern countries are clearly being robbed. Ireland needs to make sure that its tax system does not become the getaway car.

1.

Introduction

Whose tax is it, anyway?

Popular media has never been more preoccupied with tax than over the last few years, with a wide range of attitudes to taxation on display in popular discourse in different countries. In the US, Sarah Palin has made taxation a major plank of her political platform with her tea-party followers believing that all tax is effectively theft, an unjust imposition by a government intent on stealing money from hardworking citizens to use for its own questionable purposes. By contrast, we see Canadians who are proud to pay their taxes, and link it to the high quality healthcare and education systems which they enjoy. In Finland, taxpayers can opt to tick a box on their annual return declaring their membership of the Evangelical Lutheran Church of Finland. Most Finns do not attend weekly church services, and ticking this box on their annual tax return makes them liable to an extra 1% tax, paid directly to the church. Despite this, at the end of 2009 almost 80% of the population self-declared as membersⁱ, and voluntarily paid the tax, as it is seen as a social good to support the church.

In Ireland, the attitude falls somewhere in between. Taxpayers demand services from the government, and expect support for state education and health care, but those who do not like to pay are often given a grudging admiration as rogues, rather than being seen as thieves who are impoverishing the exchequer at a time when hospitals are closing, and vital state services are being cut back. In many ways, this is a post-colonial attitude, linked to the tea-party arguments of Sarah Palin's supporters. For a colonial power, Bush and Maltby (2004) outline how the imposition of taxes is linked to control of the occupied population. It follows that the patriotic and nationalist response among taxpayers is to avoid and evade their taxes. In Ireland, creative means of avoiding payment to the British occupying forces were celebrated in folklore. To cheat on taxes was as acceptable then as stealing Trevelyan's corn.ⁱⁱ Post-independence, there is no Trevelyan. Those who evade tax are stealing from all of us.

While the problem of underpayment or avoidance of tax is serious in Northern countries, it is even more so in the global South. There, internally-generated income in the form of tax is a far more sustainable solution to poverty than international aid, and in the long-term, good aid practices seek to support internal tax collection.

Tax and governance

Taxes are a central part of the development of a young nation in a post-colonial situation. They are about far more than raising revenue; they are also central in developing good governance. A key idea discussed in Bräutigam et al (2008) is "*that authority, effectiveness, accountability and responsiveness is closely related to the ways in which government is financed. It matters that governments tax their citizens ... and it matters how they tax them.*" They argue that taxes are a vital part of state-building, since they increase the capacity of governments to interact with their societies in a useful way, and to pursue public goals. This is echoed by Prichard (2010) who sees taxation as a sort of catalyst for the development of government that is responsive and accountable to its population.

The central idea is that taxes are effectively a sort of bargain between the government and the citizens. In the negotiation of terms, not only does the government get the resources it needs to govern, but the population reclaims some power from government. When governments need acceptance from the population as a whole for taxes they

want to impose, this makes them more accountable to that population. It also gives the population more of a stake in government, and more moral power in how the revenue is spent.

Perhaps the most interesting specific evidence on this accountability comes from a wide-ranging study by Timmons (2005). Using data from ninety countries, he examined the policies implemented by governments which drew their tax revenue mainly from one sector of the population. The study finds if most revenue came from those on higher incomes, the policies on property rights etc tended to favour that group. Governments which drew most of their tax from the poor had more pro-poor policies. He concluded that the tax itself made the governments more accountable to the taxpayers.

The OECD (2008) supports the idea that this relationship between tax and governance is heightened when the revenues of the state are largely drawn from taxes on the general population. This idea is commonly supportedⁱⁱⁱ by citing the so-called "resource curse" the phenomenon whereby governments who are mainly dependent on mining royalties rather than mainstream taxation for their revenue feel themselves accountable only to the large mining corporations rather than to the people. A similar although smaller effect can sometimes arise from undue dependence on foreign aid. For example, Moss et al (2006) in a widespread review of the literature focussing on sub-Saharan Africa conclude that those countries which raise most of their revenue from overseas aid become, over time, "*less accountable to their citizens and under less pressure to maintain popular legitimacy.*" They argue that long-term dependency on aid will therefore erode the development of democratic institutions in emerging nations.

This problem of lack of accountability is sometimes presented as a variation of the Irish saying "*The person who pays the piper is entitled to call the tune.*" This is a dangerous attitude with two troubling corollaries. The first is that it suggests that the burden of taxation in Southern countries should be borne by the people rather than corporations which operate there, which ignores the fact that the corporations also consume the services provided by the state from the tax revenue raised, and that they are in a better position to bear the burden. The second is that in some sense the payment of taxation is a way of "buying" what should be basic rights conferred on all regardless of ability to pay. Clearly, people who cannot pay tax for any reason have the same citizenship entitlements as those who can. Both of these are effectively distortions of the basic link between accountability and tax, and of the general idea that the burden of providing public goods and benefits should be borne by as wide a selection as possible of the consumers of those goods and services, both personal and corporate.

Tax and behaviour

Taxes impact the world in ways that are not always visible. Taxes incentivise certain behaviours, as when tax breaks are given for investment in nursing homes, for instance, or in the film industry. They penalise activities considered undesirable, such as the burning of high-carbon fuels, or the use of plastic shopping bags. So it stands to reason that governments can and should use taxes carefully and strategically, because they are a powerful influence on human behaviour. One difficulty with any tax is the difficulty in predicting its impact on behaviour. Taxes often have unexpected consequences. For example, tax breaks given in Ireland throughout the 1990s for holiday homes and hotel developments have been taken up to a level that could not have been anticipated, arguably resulting in inappropriate infrastructure around the coasts. Similarly, while some urban renewal schemes have worked very well, other rural renewal schemes have resulted in the much-publicised ghost estates that blight Ireland's midland towns.

Taxes without borders

This kind of collateral effect can occur not only in the country in which the original tax measures are enacted, but also beyond its borders. As more and more industrialised nations are tailoring their tax systems to the needs of large multinational corporations, taxes are increasingly international in their effect, and such overseas spillovers will increase. The global South, already struggling with systemic issues of poverty, conflict and infrastructural disadvantage including in health and education, is particularly vulnerable to this phenomenon. This places a moral imperative on industrialised

nations such as Ireland to take these concerns into account in drawing up its own tax policy, and in influencing tax developments within the EU. This is given added impetus by the recently published Yaounde Declaration on Taxation and Development^{iv}, in which civil society groups from eight African countries came together to set out a framework for taxes as the solution to the shocking levels of poverty in the region. The first point highlighted was the struggle against tax laws that permitted fraud, evasion and capital flight in the South.

It is high time that tax received this sort of attention. It has long been seen as a primarily technical discipline, and in many ways, this gave rise to a lack of scrutiny that did not serve the cause of social justice. Boden et al (2010) argue that the lack of attention to tax in mainstream discourse "*may in part be a consequence of the extent to which tax in its practical application is controlled by professional bodies, be they accounting or law. It may suit the professions to keep tax safely within its technical box; a convenient lie to keep prying eyes from closely examining the hidden power plays at work.*" (Boden et al, 2010:541)

Whether or not there is a concerted effort to keep discussions on tax within a small circle of technically-educated professionals, it is vital that the conversation moves outside of those closed rooms, and into the public domain. The consequences of not doing so, particularly for the global South, are critical.

Structure of this report

Section 2

This report begins by reviewing the tax-related problems faced by Southern countries with a focus first on Southern domestic tax systems including corruption, lack of tax capacity, and the informal economy. It goes on to outline how international issues impact on Southern countries, covering capital flight, tax competition, tax treaties, and transfer pricing.

Section 3

Section 3 discusses the role played by Ireland in international development, including participation in international bodies, capacity building in the global South and Ireland's response to the major international challenges facing Southern countries. Some of the adverse impacts of Ireland's tax system are highlighted here.

Section 4

Section 4 uses pro-forma calculations to illustrate how transfer pricing can be used to shift taxable income globally, and the impact this can have on Southern countries. In particular, it highlights how Ireland's tax system could be used by unscrupulous multinational firms to reduce their global tax bill, meaning that they pay less to the low-cost Southern countries which host their production facilities.

Section 5

Next, Mozambique is taken as a case study to highlight both the internal issues it faces, and the way in which its tax system interacts with that of Ireland. Mozambique is chosen because it is a striking example of many of the challenges faced by sub-Saharan countries in particular, and because it is a major recipient of Irish Aid funding.

Section 6

Finally, the report set outs clear recommendations, with a specific focus on what Ireland can do to work for greater tax justice for Southern countries.

2.

Tax challenges facing Southern countries

The ability to raise tax domestically is important for Southern countries where it is needed not only to provide basic goods and services, but also to build up infrastructure or service crippling international debt. The ability to raise domestic revenue remains a far more sustainable stream of revenue than international aid, though for most countries in the global South it is unlikely to replace it in the short term. As noted by the European Commission 2010 staff working document on tax and development, the tax-to-GDP ratio of most Southern countries is roughly half that of developed countries. This leaves a significant gap which is currently often met by international aid.

While this paints a bleak picture, it does clearly indicate that there is scope by improving the tax capacity of Southern countries to increase this level, if the local and international barriers to higher tax revenue can be overcome. This would result in a more sustainable source of revenue for the countries concerned, and real hope that the population of these countries could escape the spiral of poverty.

Broadly speaking, the challenges faced by Southern countries in establishing a fair and sustainable tax system may be grouped between domestically centred problems and those caused or exacerbated by the architecture of the international tax system. These factors obviously overlap a great deal – for instance the post-colonial attitude to taxation is connected to the informal economy, which is itself tied in to a deficient rule of law, corruption etc. However, for clarity in presenting the issues, they are considered separately below.

2.1: Domestically-centred problems

A review of the literature^v identifies five main domestically-centred challenges for revenue collection in Southern countries. It's important to note that these are not discrete factors, but rather are inter-related, and influence each other. Broadly speaking, the five are as the informal economy, tax attitudes, complexity and gaps in the capacity of the taxing authorities, trade tariffs/liberalisation and corruption together with the deficient rule of law. They are each dealt with below.

The informal economy

This refers to a situation where a significant proportion of an active economy lies outside of the tax net, and is perhaps the biggest single challenge faced by Southern countries. The reason for the informal economy is often inaccurately portrayed as simply a culture of tax evasion. In fact the cause is more closely linked to poverty, education, and a lack of financial infrastructure. In many countries, a vast swathe of the population is 'unbanked', meaning they have no account with a bank or financial institution, and no financial records of trading transactions. Trade is often carried out at a subsistence level, where there is low financial literacy and people may not have access to any secure means of savings or borrowing. This poses a clear challenge to taxing authorities, and to the citizens themselves who are trapped at a low level of income generation, with very limited opportunities to expand.

It is not surprising then that personal income taxes in Southern countries account for a very low proportion of overall tax revenue, in comparison with more industrialised countries, and have been found not to contribute greatly to income redistribution (Fakile 2010 and Bird and Zolt 2008). This is caused by the difficulty in taxing people in the informal sector, and may be due to low rates of collection rather than low rates of tax. This low rate of tax payment from large sections of Southern populations becomes a problem not only of revenue generation, but also of participative democracy, as tax payment is linked to an entitlement to accountability from government (as discussed in section 1). It also contributes to a spiral of evasion; it is difficult to establish a culture of tax payment as long as the bulk of the population remains outside of the tax net. It is almost impossible to accurately estimate the size of the informal economy, because of the nature of the problem. Nonetheless, estimates vary from 26.4% in Ghana (Prichard 2009) to over 40% in Brazil (Russel 2010). Probably more important than an absolute estimate is to observe changes in the scale of unregistered transactions and to monitor closely the sectors most affected.

Attitudes resulting in low compliance.

As outlined in section 1 low tax compliance – meaning tax evasion or avoidance by individuals and companies – in part, stems from colonial times. When a country is colonised, any tax paid simply funds the occupying power, and so the patriotic thing to do may be to avoid or evade taxes. After independence, the revenue is used to fund the fledgling state, and so overnight, the patriotic thing to do becomes to pay one's fair share. However, attitudes may not keep pace with such rapid political changes.

Kenya: Political resistance: tax and accountability

In 1995, citizens in the wealthy suburbs of Nairobi, Kenya brought a law suit against Nairobi City Council. The issue was that the Council had failed to supply their district association with budgetary records detailing how the US\$ 13.3 million in annual service charges to Nairobi City Council was being spent. The campaign was in response to the failure of the Council to collect rubbish and maintain roads, sewage and water systems. The claim focused on Part XVII of the Local Government Act requiring local authorities to keep proper accounts. The High Court forced Nairobi City Council to establish a joint fund with the suburbs in question to manage their rate payments. However, such a quick fix may not treat the underlying problem. Civil society network Tax Justice Network Africa (TJN-A) highlights the long term nature of seeking government accountability on tax expenditure, not least in relation to specific 'ring fenced' funds such as that won by the Nairobi residents (Tax Justice Africa, 2009). TJN-A highlights the 'partial' nature of the campaign victory, even for this more powerful segment of Kenyan society - '*because the city council decided it was easier simply not to use the funds rather than engage with the residents and their demands*'.

Low tax compliance is also attributable to a perception that taxes fall disproportionately on those with low income. If the elites do not pay tax, the poor will feel justified in evading tax. A further factor is that tax evasion within the informal sector is relatively easy. If the initial tax barrier for new entrants into the formal system is too high, this will be a disincentive to full economic participation. The European Commission also link this to the poor provision of public services, which reduces the legitimacy of tax collection, and a general deficiency of law enforcement and capacity which introduces effective impunity for tax evaders (EC 2010).

The attitudes may be exacerbated by the unwillingness of foreign workers in the global South, often including aid workers, in Southern countries to pay tax locally. Irish Minister for Overseas Development Peter Power indicates that the issue of taxing aid goods and services, including NGOs, has been given new impetus by the Africa Tax Administration Forum recently (Power 2010). OECD (2010) also reports that at the African Economic Outlook experts meeting in Paris in December 2009, "*Removing tax exemptions on [overseas aid]-funded goods and services, as well as matching*

donor contributions and collected taxes were mentioned as ways of promoting greater coherence between tax policy and aid for development purposes.” Clearly, in the context of Ireland’s commitment to policy coherence this will be a growing point of concern.

Russell (2010) has a number of suggestions for countries with large informal economies, and makes addressing attitudes to tax central to the solution. He suggests a mixture of the carrot and the stick: on the one hand, widespread campaigns aimed at raising awareness on the role of taxes in nation-building in order to promote a voluntary compliance culture, and at the same time education on the efficiency of the tax collecting authority and the dangers of dealing with unregistered traders. A good example of this in practice is the Rwanda Revenue Authority, whose motto is “*Taxes for growth and development*”. It is of course open to question whether the wider population in Rwanda accept this at face value.

Links: Resistance of dispossessed communities and tax accountability

The Tax Justice Network Africa points to the possibilities of linking tax accountability to economic justice campaigns led by the dispossessed communities in Kenya. Unfortunately these communities often depend on external financial donor support for their implementation rather than on domestic revenue. For example, the Nairobi Campaign in Korogocho slum in Nairobi, launched in 2004, aims to stop the mass evictions and demolition of the slums in Nairobi, and demands the rehabilitation of the slums and land redistribution. The campaign sought funding from the Italian government for the rehabilitation element of the campaign on condition of strict financial management and monitoring mechanisms to be put in place by the Kenyan government. The Tax Justice Network Africa notes that the political demands of such important campaigns could become more powerful. For example the Korogocho residents could demand accountability from the Kenyan government on how their taxes are spent, and how their landlords are taxed.

As well as more ideological and attitudinal reasons for low compliance, there is the very simple and obvious fact that tax can be very technical, and is not widely understood. It is not always easy, even for willing citizens, to comply with tax rules that can be complex, non-transparent, and couched in very technical terms. This means that there is a need for simplification, of course, but there is also a pressing need in many countries for more widespread taxpayer education. Russell (2010) emphasises that as well as education, investment must be made in good quality interfaces between the taxing authority and the taxpayers, including phone centres, online information and self-assessment tools. These need to be accessible and useful to a population with widespread illiteracy and multiple languages.

There is also a role for civil society in addressing tax attitudes. An excellent example of good practice in this area is the Tax Justice Network – Africa, a pan-African network of different civil society organisations across the continent, launched at the World Social Forum in 2007 and based in Nairobi. This network facilitates research and campaigning on issues of tax, development and fairness, cooperation on research and mainstreaming of tax in the discourse of the communities.

Complexity / Gaps in capacity

Very often the tax system presents unduly onerous challenges to the tax payers. It can be a complex task to comply fully with the demands of the tax system, particularly for a population which has educational disadvantage or literacy problems, or in a country with many languages. This is linked to the lack of financial infrastructure and to education – when people are unbanked with no secure access to savings and borrowings, taxation is a very complex matter to navigate. Perversely, Russell (2010) demonstrates that the business of complying with tax is actually more complicated in the countries where education is a bigger issue: for example tax compliance around a business start up takes on average 13 days across the OECD, but more than 45 days in sub-Saharan Africa (Russell 2010:3).

This relative complexity also poses challenges for a resource-strapped taxing authority which may have serious gaps in its capacity to collect taxes. There are many reasons for this, including low wages, better opportunities overseas for suitably qualified officials, inadequate levels of education and training, poorly resourced taxing authorities and weak internal systems based on relatively simple colonial models that are unable to address either the informal economy or the increasing internationalisation of business.

Tax administration in Ghana: declining scale?

The Tax Justice Network Africa (TJN-A) and Ghanaian justice organisation ISODEC highlight some of the challenges facing Southern tax administrations by outlining the management of the originally promising tax administration system in Ghana in the 1980s only to see it decline in the face of significant gaps in institutional capacity and political failures. Prichard (2009) describes how in the 1980s Ghana's 3 tax agencies (Internal Revenue Service; Value Added Tax Service; and the Customs, Excise and Preventative Service) were coordinated under the umbrella of the National Revenue Secretariat (NRS) and granted a degree of political and financial autonomy. For example, for a brief time a separate cabinet level post was created for overseeing revenue collection, and three per cent of total revenue was ring-fenced to meet the agencies' resource needs. However, political infighting resulted in the abolition of the NRS and the tax agencies were brought under closer control of the Department of Finance. Efforts to more closely integrate the different tax services failed, apparently due to territorialism among the agencies, bureaucratic inertia, and constitutional barriers to changing the tax institutions in place.

TJN-A and ISODEC highlight two important reforms that have recently led to a more coherent tax administration, namely the establishment of a board to support information sharing between the tax agencies, and the establishment of an independent Large Taxpayers Unit with significantly better data management capacity than the other tax agencies.

However, they also highlight two practical barriers to a future effective tax administration system in Ghana namely the lack of:

1. The capacity of Ghanaian tax agencies to cross reference tax filings amongst each other and with government departments, which would close huge loopholes, particularly regarding income tax collection levels. TJN-A and ISODEC argue that the failure to address this is due to bureaucratic infighting and an overall lack of political will to hold high net worth individuals to account;
2. An effective information technology (IT) system within the Internal Revenue Service which still remains an almost entirely manual system. While a relatively successful automation pilot project has been run and funded by the German government, TJN-A and ISODEC fear that the lessons from this pilot have not been applied at a national level as the government may be awaiting the implementation of the major World Bank funded 'E-Ghana' project to automate government operations overall.

Both of these factors seem to be the kind of problem that can be addressed through targeted aid and mentoring from taxing authorities in countries which have successfully addressed the problems.

The loss of internally trained tax officials to better-paid positions in the private sector is a serious concern in some countries, as it results in a serious loss of skills and experience from the tax-collecting authority. However, in a country with very little financial infrastructure, such as Rwanda, such a migration may actually help the overall tax take, as it provides a cadre of well-trained tax professionals who can help businesses with compliance issues. Nevertheless, in the short term, it leaves the taxing authority short of skilled people to collect the taxes they need. Without the capacity to collect, it is difficult to engender a compliance culture in the population.

Trade tariffs and trade liberalisation

As noted by the European Commission low income countries initially designing their tax system generally choose to raise most of their revenue through trade tariffs or taxes and import and export duties because these taxes are collected at border crossing points, and so they only require a limited number of potential tax collection points to be supervised (EC 2010). The reduced capacity discussed above leads many Southern countries to prioritise tax collection where it is easiest. Rather than addressing the population as a whole, with all the problems of education, infrastructure and evasion within the informal economy, it is easier to focus on a few set points and impose taxes at the border crossings of their countries.

A major challenge to this practice comes from trade liberalisation - when countries are forced by international influences to reduce their tariff levels. For example, the current negotiation of a major set of new trade agreements called the Economic Partnership Agreements (EPAs) between the EU and African, Caribbean and Pacific (ACP) countries pushes those regions to eliminate duties on up to 80% of imports from the EU. Oxfam (2008) estimates that even the first stage of liberalisation may result in African countries losing \$359m per year, and, in the case of Cote d'Ivoire, an estimated \$83m by 2012. This is equivalent to its current health spending for half a million people. Many ACP countries have raised concerns about the impact of these deals on their ability to raise revenue and develop their economy and industry, and have resisted signing EPAs, in spite of significant pressure from the European Commission. At the time of publishing this report only 10 African countries had signed up to an EPA, with negotiations progressing slowly. The European Commission also asks ACP countries to agree not to use export taxes in the EPA negotiations. As noted above, export taxes are a relatively easy way for Southern countries to raise revenue, since collection is concentrated at a limited number of border points. They are also used to promote local industry, by encouraging value addition over the export of raw materials. See Curtis (2010) for an up-to-date discussion on the issue.

The European Commission (2010) also note that there is an increasing tendency for Southern countries to raise revenue through forms of consumption or sales tax, such as VAT. Often this comes as a response to the enforced phasing out of tariffs as a condition of funding from the IMF or World Bank^{vi}, or it is seen as the next easiest option to collecting at border crossings as some of the burden of collection is pushed onto compliant traders.

Ghana and the politics of VAT

In Ghana, VAT at a rate of 17.5% was introduced in 1995 under pressure from the IMF in a crisis situation. There was almost no taxpayer education, and the tax was vehemently opposed by political parties who were at the time boycotting parliament due to claims of election fraud. Prichard (2009) describes how these circumstances led to widespread violent opposition to the tax, including riots in which several people died. The tax was withdrawn by government, and not reintroduced until 1998, when it was set at the lower rate of 10%.

Consumption and Value Added Taxes have a tendency to be regressive, meaning that the tax can fall disproportionately on the poorest in society. People on very low incomes spend almost all of their money,

because they cannot afford to save. This means that a broad-based tax on spending will take up a higher proportion of their incomes than of those who can afford to save or invest. A VAT charge on a newspaper, for instance, is paid by students, pensioners, the homeless, etc as well as by those on higher incomes.

Drivers of low tax policies

The IMF, the World Bank, the World Trade Organisation and other institutions can be broadly categorised as drivers of low tax policies in the countries in which they have influence. In a paper for Christian Aid, Marshall (2009) finds that the conditions attached to IMF lending systematically promote an almost uniform set of tax policies. These are applied to Southern countries regardless of their individual characteristics, and focus on reducing income taxes on both corporations and individuals in favour of broad-based consumption taxes such as VAT "*often in spite of evidence that the implied policies are failing to meet their objectives*". The study, spanning 18 countries in sub-Saharan Africa concludes that these policies inhibit the ability of many countries to realise the benefits of an optimal tax system. The imposition of policies from a template not designed for the local conditions also seriously inhibits the nation-building qualities of taxation discussed above.

Another review of IMF country reports (Damme et al, 2008) from 2005 – 2008 of 10 low-income and 10 middle income countries finds that the IMF places particularly high emphasis on value added tax (VAT), pushing countries to have few rates and few exemptions. The study found that in most countries surveyed, the IMF recommended or endorsed VAT with a decrease in tax exemptions. However, the impact on the poor of abolishing these exemptions was only addressed in a minority of the countries. The authors highlight serious concerns about the lack of regard for the complexity of implementing changes in VAT policy in poor countries.

The World Bank has also promoted this tax consensus, described by Bird (2010) in a recent World Bank paper as the "*broad-based, low-rate (BBLR) approach*". For example, its influential 'Doing Business Report 2010'^{vii} ranks the 'best' countries as those with lowest corporate tax rates, implying an endorsement of low corporation taxes as the 'right' way to achieve equitable economic growth, despite the damage this can do to Southern economies. Singapore ranks at the top of the 'Doing Business' index for the fourth year in a row, although its low tax policies have clearly not addressed the needs of the population. For instance Asher and Nandy (2009) find that Singapore's "*high and increasing income inequalities are an outcome of the particular set of policies adopted by Singapore, and not due to the general effect of globalization alone.*"

The World Bank is not unaware of the failure of its policies. Bird (2010) admits that "*There is no magic blueprint—no tax system, structure, or particular policy that makes sense for all countries at all times.*"

The World Trade Organisation (WTO) consistently promotes tax policies, particularly in the area of trade tariffs and export taxes. Murphy (2010) raises concerns about state-owned development finance institutions using tax havens as intermediary holding company locations when investing for development in Southern countries. This is seen as particularly problematic by the tax justice movement as it implies an endorsement of damaging tax havens by the very bodies that seek to promote development in the global South.

The regressive nature of VAT can be mitigated somewhat if the base on which the tax is levied is carefully chosen to exclude basic essentials. Even when this is well-executed, however, consumption taxes are problematic for Southern countries. For example, in the context of a very large informal sector, a consumption tax widens the gap between registered and unregistered traders. This is because a registered trader is generally obliged to pass on the tax to customers, pushing up the cost of his or her services. This creates a motivation to remain unregistered, and so exacerbates the problem of avoidance.

Corruption and deficient rule of law

The European Commission identifies deficiencies in the rule of law as a particular risk to the tax capacity of Southern countries (EC 2010). If the taxing authority – perhaps because it is under-resourced – is unable to enforce penalties for late payment or for evasion, it loses credibility with the population and will be unable to collect even that basic revenue which is legally due. Stijns (2010) observes that the low revenue levels of many African states “*is to a large extent the result of resistance from the ruling elites.*” This view is echoed by Michael Gaffey, Deputy Director General of Irish Aid who observed at the May 2010 Joint Oireachtas Committee^{viii} on Foreign Affairs (JCFA, 2010) meeting that “*Elites are ... very hard to tax, as they avoid, evade or take advantage of weak tax enforcement*”. This is a combination of the deficient rule of law and the related issue of corruption.

Corruption in practice

The U4 Anti-Corruption Resource Centre operated by the Chr. Michelsen Institute (CMI), a Norwegian social science research foundation, provides detailed descriptions of how this issue can arise in both the public and private sectors. When a tax system is not very carefully designed for a population facing poverty, there is a risk that tax officials will be tempted to engage in corrupt practices in order to boost their income, and that taxpayers will prefer to pay a bribe than to pay tax. Childs (2008) in a study for the U4 Centre cites the following common examples of tax corruption, when a tax official can accept a bribe:

- to speed up tax services, particularly at border points
- to overcome complex compliance;
- to assist taxpayers in overstating or understating values;
- to sell sensitive information about competitors;
- to impede the free movement of competitors' goods;
- to “lose” files or information about the taxpayer;
- to charge for services that should be free;
- to turn a blind eye to informal activities;
- to facilitate or organise smuggling.

Corruption at all levels is a problem for tax collection in most Southern countries. At a petty level, where officials are underpaid and systems of oversight are poor, there is moral hazard, i.e., the risk that the temptation to act in a corrupt manner may be overwhelming. For instance, an underpaid official whose work is not overseen may be tempted to solicit a small bribe from a taxpayer. In turn, the taxpayer may prefer to pay this small bribe than face a large tax bill. At a more systemic level, in some countries corruption also extends to the negotiation of secret terms around the tax treatment of specific companies or industries.

Childs (2008) highlights possible solutions to the problem, focussing on perceived fairness within the system, good recruitment, codes of conduct, promotion prospects for tax officials, improved salaries and staff welfare and management systems which provide cross-checks around the handling of payments.

2.2: The global tax environment

Taxation has traditionally been a matter closely related to national sovereignty, targeting domestic economic activity to fund the expenses of the state. For example, writing in 1821, George Warde-Norman saw no need to look at international business, and kept his review of potential utopian taxes at a purely domestic level (Warde-Norman 2009). In the early 21st century, however, tax is no longer an exclusively national issue, and many of the problems faced by Southern countries may be roughly classified as international in origin. Again, these factors overlap significantly, and need to be read together rather than in isolation.

Capital flight

This usually refers to the deliberate stripping away of the resources of the country and their expropriation overseas, and is a massive problem for the global South. At both the Monterrey and Doha Financing for Development Conferences (in 2002 and 2008 respectively) capital flight was singled out as a significant barrier to be overcome by Southern countries seeking to raise more revenue domestically “*Capital flight, where it occurs, is a major hindrance to the mobilization of domestic resources for development. It is vital to address the problem of illicit financial flows*” (Doha 2008). Illicit capital flight is a subset of this, generally defined as including all illegal, unregistered financial flows that leak from Southern countries to tax havens including those located within the EU. The role of secrecy in banking and tax havens has often been highlighted as a facilitator of illicit capital flight, particularly where the emphasis is on illegal flows of capital. Studies such as Kar and Cartwright-Smith (2009) estimate the scale of illicit capital flows from Southern countries to be in the region of \$858.6 billion – \$1.06 trillion per year from 2002 to 2006, at least seven times the total value of inward development assistance. Christian Aid (2008) note that if even US\$ 160 billion of this – representing transfer pricing abuse and false invoicing - were spent on healthcare, at current costs the lives of 350,000 children in Southern countries would be saved every year. While this figure is shocking, it does not include the impact of routine mis-pricing of traded goods. In this latter respect, the casual, unintentional impact of competitive tax systems in Northern countries may be a possible contributory factor in enabling tax avoidance as we shall see in section 4 below.

Power

Multinational firms have far more power than many of the countries in which they operate, and far more of a global influence. **Appendix One** to this report compares the GDP of the largest countries in the world with sales income of some of the world’s largest firms. The table represents 50 of the largest economies in the world in 2009. The data shows that a third of this top fifty were companies, rather than countries, and that over 40% of these were oil and gas exploration firms. The table illustrates the relative economic power of multinational firms and the countries which seek to tax them. The most impoverished countries in the world fall far below the level for inclusion in the top 50 list, highlighting their very weak economic bargaining position with multi-national corporations. In practice, this power imbalance has resulted in real losses for Southern countries in tax negotiations

Power: Sierra Leone, and London Mining Company

The London Mining Company is a UK-incorporated company which in August 2009 was granted a 25-year licence by the government of Sierra Leone for the operation of the Marampa hematite iron ore mine, of which the company owns 100%. There is a clear power imbalance between the company and the country with which it was negotiating.

Sierra Leone is one of the poorest countries in the world, with a life expectancy at birth of just 48 years for men and a literacy rate of only 40%. The country had most of its external debt cancelled in 2006 following the introduction of World Bank approved tax policies, but in 2008 it had external debt of over \$388 million^{ix}. London Mining Company, by contrast, had net assets of US\$307 million in that year, with no long-term debt at all. The London Mining Company's chief executive was paid just over US\$9 million in 2008^x, with gains on his share options of over US\$15 million. The 2008 salary of the president of Sierra Leone was SLL4,500,000 per annum^{xi}, equivalent at today's rates to just over US\$1,000.

Terms negotiated for government support to the mine breached the country's own Minerals Act, which was designed to prevent the granting of unfair concessions to particular mining companies. Details including the way in which royalties were calculated and the low rate of tax on mining profits were criticised by local and international activists as reported by the National Advocacy Coalition on Extractives (NACE) (2010). Despite this, in the company's 2009 annual report, the Chairman, Colin Knight, notes "*the ongoing support and commitment to both London Mining and the project by the Government and more broadly, the people of Sierra Leone as a whole*"^{xii}.

In the case of Southern countries, not only is there a wealth disparity, but also a gap in terms of capacity to design and negotiate effective taxes. Very often individual companies reach specifically tailored tax agreements with the taxing authorities of Southern countries, a phenomenon which is relatively unusual in Europe. This means that increased economic activity fails to deliver revenue to the state, or as Bird and Zolt (2007) put it, "*The leading edge of growth may become the bleeding edge of the fiscal system*". Such agreements also reduce the legitimacy of the taxing authority, impact on its ability to negotiate future agreements with other investors, and create an unhelpful ethos of opacity around company taxes which encourages evasion in the population as a whole. They also result in multinational firms having a tax advantage over smaller, locally based firms. This systematically stunts the development of an entrepreneurial middle class in the country, with long-term knock-on impact on economic development.

McNair (2010) describes how the issue of power asymmetry feeds into the wider question of transfer pricing, which is discussed at greater length below. He reports that because some countries, notably the UK, Japan and the US are very aggressive in their pursuit of multinational firms which understate their income in their jurisdictions, these firms are now taking steps to allocate more revenue to those countries in order to avoid potential litigation. This has obvious implications for less powerful countries which are not in a position to take on the larger multinationals. However, there are signs of a fightback by some Southern countries. Global Tax Watch (2010) describes a landmark ruling against Vodafone by the Indian Income Tax Department, allowing it to tax a transaction concerning a domestic firm even though the transaction took place overseas. Similarly, a note by the IBM Governmental Programmes Initiative (see box, below) expresses frustration at actions by the Indian taxing authorities that show a "*failure to follow internationally accepted standards in treaty interpretation and transfer pricing*". Obviously, India has more power than many Southern countries, but nonetheless these are hopeful signs that countries can take back some of the power in negotiation with multinational firms.

The influence of multinationals – IBM

An interesting example of how multinational firms seek to influence policy is given by IBM's Finance, Taxation, and Corporate Governance team, part of the firm's Governmental Programmes Initiative.

At www.ibm.com/ibm/governmentalprograms/enter.html they identified their key priority objectives for 2009 as to:

- Maintain a competitive effective global tax rate.
- Negotiate key tax treaties to return benefit to IBM.
- Analyze and engage in tax reform efforts at the country or regional level to protect IBM's bottom line.
- Promote enhanced R&D and innovation tax credits.
- Ensure corporate financial reporting rules globally consistent and accurately profile the company's financial position.
- Prevent new regulatory burdens on our outsourcing business.
- Optimize IBM's investment decisions by using government incentives to maximize business return.

It is disturbing that a private firm finds it worthwhile to maintain a high-powered group to actively influence tax policy globally with the aim of maximising its own business return.

Tax competition

This is the practice of tailoring a country's tax system in order to make it as attractive as possible to incoming Foreign Direct Investment (FDI). This can be achieved by low rates, as in the case of Ireland, or by less transparent subsidies such as those offered by other countries. The focus can be on specific industries or named industrial zones within countries, or on the economy as a whole.

Obviously taxation is not the only, or even the primary factor taken into account by multinationals in making decisions on where to locate. Norregaard and Owens (1992) identify significant non-tax factors taken into account for relocation decisions, including the economic outlook in various markets, the cost of capital, the profitability of investments, the availability of finance and government grants and the quality of public infrastructure. We could add to that list language and education, the availability of a skilled workforce, political risk, cultural differences, logistical considerations and access to markets. This is not surprising – a low tax rate is only valuable if profit can be made in that jurisdiction. If the conditions are not right to make profit, then the tax rate is largely irrelevant. Bhinda and Martin (2009) report OECD research that tax incentives have at best a very marginal impact on decisions to locate.

This is however contradicted anecdotally by the vast industry of international tax planning, and by the priority given to corporate tax rates in the World Bank's "Doing Business" indicators. Since multinational firms are well placed to manage their tax liabilities, the tax rate in any one country may be less important than the impact of a particular relocation on the overall profitability of the group. This makes tax treaties (discussed below) at least as important as tax rates. Nevertheless, the tax rate still matters for location decisions, and researchers such as Devereux et al (2002) have found that the tax rate on offer by a particular country to be the biggest influence on the decision to locate there.

In practice, tax competition can most obviously impact on Southern countries by making it more difficult for them to attract foreign direct investment (FDI), with a knock-on effect on their economic development. The idea that Southern countries are not in competition for FDI to the same extent as Northern countries is not supported by even casual

empiricism. At an Open Forum event at the World Economic Forum in Davos in 2006, Leonor M. Briones of the Philippines argued that international tax competition, particularly from Hong Kong and Taiwan was directly impacting on the revenues of the Philippines. “*The tragedy is that countries are fighting each other to bring down the rate of taxation*” (Briones 2006). King and Barry (2009) also note the importance of FDI for the development of economic activity in Southern countries, stating “*the importance of FDI to developing countries as they move away from dependency on development assistance cannot be overstated.*” (King and Barry, 2009:110)

However, in general, tax policy-makers in Northern countries resist the idea that any tax competition in which they are engaged is directed at Southern countries. In Ireland, for instance, the Irish Minister for Overseas Development Peter Power defends Ireland’s tax competition on the basis of its transparency and its compliance with the EU Code of Conduct on harmful tax competition and OECD processes (Power 2010). It is arguable that countries whose competition is made on a less transparent basis, for example through subsidies etc, may defend themselves on the basis of having higher rates of tax. However, it appears that as Northern countries reduce the tax burden on multinational firms who invest there, Southern countries have no choice but to follow suit. For example, the European Commission (2010) notes that two thirds of all countries in sub-Saharan Africa have introduced tax incentives for foreign direct investment, with the lowest income countries doing so more frequently. They suggest that while these incentives are not particularly effective, they are costly in terms of revenue foregone. They also note that the differences in rates encourage corporations to shift profits from the Southern country to low-rate regimes, which in turn encourages a further reduction in rates, an effective race to the bottom. Given the low revenue from personal taxes discussed above, this can impact seriously on the overall revenue-raising capacity of Southern countries. This income shifting is discussed in more detail below.

Transfer pricing abuse

Large multinational companies have bases in many different countries, and can freely shift taxable income across borders by means of intra-group transfers, where one group company provides some goods or services to another for a price that is set internally. The setting of this internal price is called transfer pricing. Clearly, there is nothing illegal or unethical about a company trading with other firms within the same group. The difficulty arises when these transactions are priced in such a way as to shift income artificially. This is an illegal practice called transfer pricing abuse.

Diewert et al (2004) estimate that in 2000, 37% of US imports and 31% of US exports were between related parties. Yet, despite the widespread use of transfer pricing, it is notoriously difficult to tell when the transfer price is set at a fair level, and so the scale of transfer pricing abuse is difficult to assess. Pak and Zdanowicz (2002) study this issue, focussing on the US import price per item of common commodities in 2002. They isolate a number of examples of abnormal transactions, including prefabricated buildings imported from Trinidad at a price of \$1.20 each, and battery-powered smoke detectors imported from Germany at a price of \$3,500 each. Clearly these are anecdotal in nature, but they illustrate the possible scale of abuse.

Because Ireland has such a low corporate tax rate, it is tempting for multinational firms which have a subsidiary there, and another in a high-tax country to use aggressive transfer pricing practices to shift income into Ireland, where it will face a lower rate of tax. Section 4 (below) illustrates with pro-forma calculations how exactly such artificial pricing can be used to reduce the tax burden of a multinational firm which has a base in Ireland, and in the process impoverish the taxing authority of a Southern country.

Arm's-length pricing

In order to combat this kind of abuse, the general principle applied by taxing authorities is that of arm's-length pricing. In this context, "arm's-length" means that any transaction between group companies should be on the same terms that would apply if it were conducted between unrelated firms. An arm's-length "correct" price range for a freely traded item such as the smoke detector in the Pak and Zdanowicz (2002) example is relatively easy to establish. It is far more difficult to benchmark an appropriate price for services, particularly those which are not provided outside of the group at all. Common examples are management charges, interest on internal debt, or patent royalties. McCaughey (2010) points out that unrelated companies can also make opaque deals that suit their individual tax positions, a form of false invoicing that amounts to fraud.

Given the narrow field of vision available to each individual taxing jurisdiction, and the panopticon view of the multinational firm, it is relatively straightforward for the firm to manage the location of its earnings so as to minimise the overall tax paid by the group. This abuse is not always easy to detect, particularly for taxing authorities in the global South which have more limited capacity. The European Commission in April 2010 highlighted its concern about the impact of possible transfer pricing abuse on Southern countries *"A number of developing countries claim that their capacity to mobilise domestic revenues is affected by international tax evasion and avoidance, in particular because of asset and profit shifting to and through attractive and/or non-cooperative tax jurisdictions. Since multinational corporations are not required to disclose their financial data on a country-by-country basis enterprises may try to lower their tax liability in developing countries notably through transfer pricing practices."* (EC 2010). This concern at EU level about potential transfer pricing abuse is echoed by practitioners in countries of the global South. For example, McCaughey (2010:6) quotes a former tax consultant at a large international accountancy firm in Maputo as saying *"Mozambique is losing a lot of money in tax to international operations. ... Government audits [lack] capacity for deep analysis of transfer pricing arrangements. It is almost impossible for them to find examples of transfer pricing abuse."*

Given the potential damage to countries in the South of transfer pricing abuse, and the difficulty of monitoring it, it is important that Northern countries avoid creating the conditions that are conducive to an increase in the practice. It is in this context that the tax justice movement is calling for country by country reporting, so that abuses can be more clearly flagged and investigated.

Secrecy

Secrecy in international financial transactions or lack of transparency poses two main problems for Southern countries. On a global level, transfer pricing abuse is facilitated by tax havens and other countries which do not cooperate in exchanging information on tax. The European Commission notes that *"Freely moving capitals together with the existence of non-cooperative jurisdictions that shroud financial activities in secrecy in a context of insufficient international tax cooperation make it difficult for tax authorities to assess tax liabilities"* (European Commission 2010). This poses problems for all countries, but the difficulty is greatly exacerbated by the lack of skills and resources of taxing authorities of many Southern countries.

Tax havens and secrecy jurisdictions – some definitions

The definition of a tax haven is the subject of debate, with most countries resisting the label and many civil society groups applying it widely. The OECD requires four conditions to name a country as a tax haven:

1. nominal or zero taxes;
2. a lack of transparency;
3. laws or practices that prevent the effective exchange of tax information with other governments;
4. no requirement for substantial real presence in the country^{xiii}.

Low rates are clearly identifiable, but conditions two and three are arguably more damaging in the way in which they facilitate capital flight. Increasingly, the tax justice movement speaks of secrecy jurisdictions rather than tax havens, defining them in Murphy (2009) by a tendency to:

1. knowingly create regulation to benefit non-residents
2. create a deliberate, and legally backed, veil of secrecy to hide the identity of non-residents making use of its regulation

The OECD developed a set of standards for exchange of information, and in 2009 the G20 formally recommitted to these. However, the standard stops short of *automatic* exchange of information, which means that the taxing authority seeking information must make a request. While many jurisdictions are very cooperative in this respect, tax officials in one country may not be aware of the sort of information which is reported – and thus available for exchange – in another. Without adequate training of officials in both jurisdictions, information may not pass freely from one country to another. Automatic exchange of information would be a significant improvement.

On a local level, a lack of transparency in negotiating tax terms with incoming multinational firms also causes problems. When tailored deals are made with large companies locating in the country, this reduces the overall legitimacy of the taxing authority and its level of accountability to the population. It also weakens the negotiating position of the government for future dealings with the same firm, or with others. Once it is known that the tax rules on the statute book are essentially an opening position rather than the law, the ability of the state to collect these taxes is greatly diminished. Finally, the negotiation in secret of tailored deals for specific companies or industries creates high risk for corruption.

Challenges to the status quo

Current challenges to the international status quo come from three main sources: individually powerful countries such as the US, who feel that they are losing out on tax that they feel should be most properly remitted in the home country of the firm; groups of countries such as the EU or OECD which seek to reduce competition between their members by reducing competition internally; and bodies such as the UN or non-profit groups within the tax justice movement which seek some form of justice or equity in the system. Southern countries have a growing voice in the last group, which is a welcome development.

Isolation and double tax treaties

Multinational firms operate globally, and move their capital and their products freely throughout the world. Countries' cooperation in the area of tax has lagged far behind this growth in the power and reach of companies. Aside from exchange of information discussed above, the main way in which countries cooperate internationally in the area of tax is by negotiating international tax agreements, commonly known as *double tax treaties*. Most OECD countries have a wide range of such treaties, which aim primarily to eliminate double taxation.

In simple terms, where a particular transaction or stream of income is in some way international, more than one country may have some basis on which to seek to tax it. For example, a resident of Ireland who earns money abroad may be taxed in Ireland under the resident rules, but may also face tax in the country in which the income is earned. A double taxation agreement is a way of sorting out which country has the primary and which the secondary 'taxing rights' in cases such as these. In the absence of a double tax treaty, the income could be taxed twice. Instead, the usual way in which the treaty would operate is that the taxpayer would pay tax at the higher of the two possible rates, with a credit in one country for the tax paid in the other.

Double tax treaties are usually negotiated on a bilateral basis, between individual countries. There are two basic templates in use: the OECD model is the most commonly used by Northern countries, while the UN model is favoured by Southern countries. Double tax treaties cover the issue of withholding taxes, a point of particular importance to Southern countries and one on which the OECD and UN model differ. Since Southern countries tend to be low-cost, they are more likely to attract investment in manufacturing plants than in the area of research and development (R&D). It is common for the manufacturing companies within an international group to pay some level of royalty for the technological know-how involved in designing and testing the product. Where the R&D has been carried on in a Northern country, the stream of royalties will flow from Southern countries to Northern countries. While some level of payment for intellectual property is widely considered an appropriate way of rewarding the skilled work of design and of encouraging new product development, the level of royalties paid can often far exceed what is reasonable, and the ability to tax the stream of royalties can be a contentious area.

As long as the R&D company does not licence any manufacturing outside of the group, royalties of this kind are difficult to benchmark using the arm's-length principle. This makes intellectual property payments the most difficult to police from a transfer pricing abuse point of view. Because it is so difficult to monitor, it is tempting for multinational firms to set the royalty level in a way that is based more on tax manipulation than on the appropriate reward for innovation. These payments can easily be used to drain profit from a Southern country in which manufacturing is taking place to a Northern country which has a favourable tax treatment of patent royalties. One basic safeguard would be to allow the Southern country which is the source of the payment stream to withhold some tax on the payments. The OECD model double tax treaty in general does not allow for such a withholding tax, whereas the UN model does.

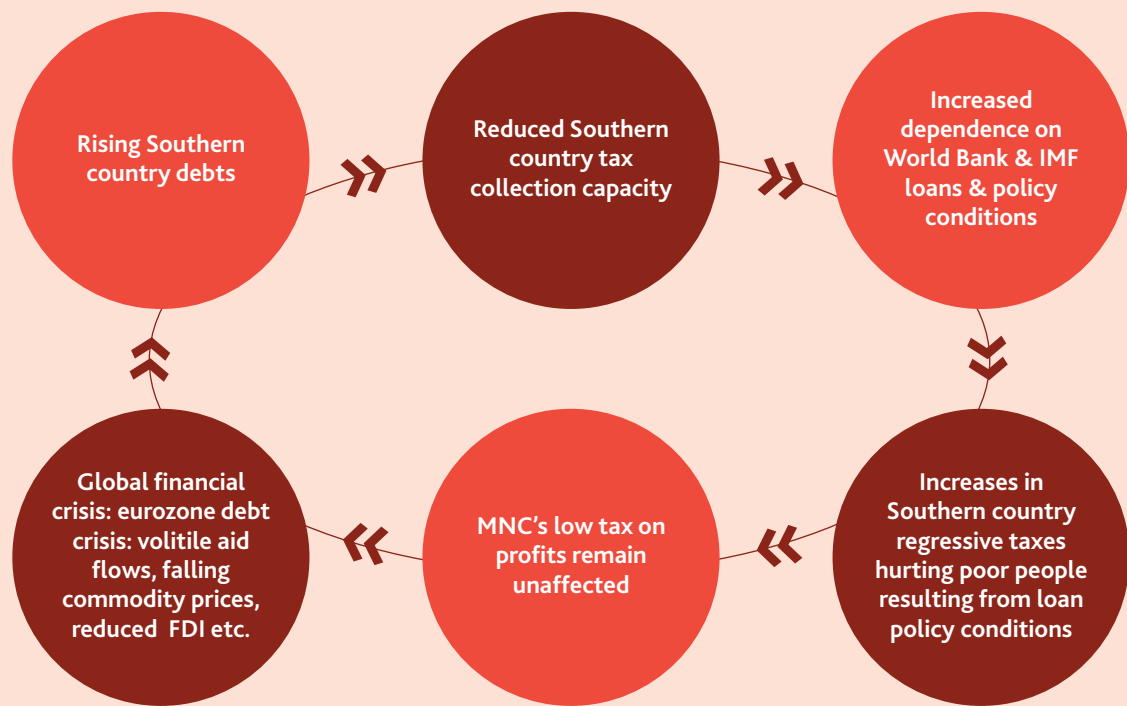
King and Barry (2009) recommend tax-sparing agreements rather than tax treaties based on the UN model. Tax sparing usually operates in the context of an investment from the North into a Southern country, and generally applied to passive income such as interest, dividends or royalties. In brief, it attaches a fictional tax credit in the home country of the investor to income repatriated from the Southern country. In the case where the Southern country has offered significant tax breaks such as tax holidays, or low rates, then the incentive for investors from higher-tax countries to invest is clear. Effectively, they get a double benefit from the low rates offered by the South. One obvious difficulty around tax sparing is that they have no incentive effect when the Southern country declines to offer low rates. Furthermore, an OECD publication on the issue in 1998 noted that "*tax sparing is not necessarily an adequate tool to promote economic development*" (OECD 1998:42). Finally, tax sparing agreements are rarely reciprocal. They effectively embed some inequality into the relationship between the two home and host country of the investment, in a way that a tax treaty would not. For these reasons, the UN-model tax treaty is favoured.

Making the links - trade, debt and taxes

The links between taxes, international trade and sovereign debt are worth briefly exploring at this stage. All three are pressing matters for Southern countries, and individually the issues surrounding them are well documented. The interactions between them, however, can be insidious. This section sets out seven areas of overlap between the three factors which warrant further discussion, and should where possible feed into policy decision-making.

1. When a country is burdened with high levels of debt, the payments to service this debt deplete the public purse and increase the burden of taxation on the population. When much of the domestically-generated revenue is going to service international loans, there is reduced investment in infrastructure, and this inhibits the overall growth of the economy, creating a spiral down into poverty from which it is difficult to recover.
2. More subtly, with high debt and reduced investment in the tax administration as outlined above, it is easier for a country to collect its taxes around the borders than from the population as a whole. Border tariffs and customs duties concentrate the tax-collecting effort in only a few locations. Since many Southern countries have a traditional dependency on agricultural and unprocessed products, this focus on border points creates a dependence on trade tariffs for domestic revenue. As noted above, this exacerbates the potential damage to domestic revenue capacity triggered by sudden trade liberalisation imposed by the WTO.
3. Another possible consequence of high sovereign debt is a country relying on a bail-out from the IMF or World Bank. In general, these institutions oppose trade tariffs, and very often make the phasing out of customs and border duties a condition of their involvement. In this way, the initial debt burden leads directly to an externally-imposed alteration of the domestic tax system.
4. Following such an enforced phase-out, and still lacking the infrastructure to generate significant corporate activity or the capacity to tax the informal economy, Southern countries commonly resort to a sales tax or consumption tax of some kind, frequently encouraged by the IMF or World Bank. This by default is regressive, because a tax on spending will always be borne disproportionately by the poor who need to spend most of their income to survive. While the tax can be tweaked, for example by exempting basic foodstuffs and necessities, it is difficult to make a sales tax truly progressive.
5. While individual citizens of a Southern country may be hard hit by a sales or consumption tax, one influential group which remains unaffected is foreign-owned companies which have set up operations there. In a VAT-style tax, they can usually claim back input credit for their expenses within the country, while not paying local VAT on their exports. As long as Southern countries are heavily dependent on sales or consumption taxes, they do not impose high taxes on multinational firms.
6. The recent financial crisis has triggered sovereign debt crises of varying degrees of severity in a number of Northern countries, including several in the Euro zone. These problems impact indirectly on debt issued by Southern countries, increasing the credit premium on interest rates on sovereign debt in general and reducing the pool of available capital to renew or top up international loans.
7. The recent international fiscal crisis has also impacted severely on Southern countries. The main impact is a sudden and severe loss of revenue arising mainly from lower levels of domestic economic activity, falling commodity prices, currency volatility and reduced inflows of foreign direct investment, remittances international aid and tourism. In turn, this puts pressure on an already strained taxation system, and risks triggering a spiral into greater national debt which could keep some countries in poverty for years to come.

Making the links - trade, debt and taxes



2.3: Summary

To sum up, the main tax challenges facing Southern countries on a domestic level centre on the difficulty in taxing the informal economy, loss of revenue through externally-imposed trade liberalisation, very low levels of personal income tax, a culture of tax avoidance and evasion, corruption, poor local law enforcement and complexity. All of these difficulties mean that Southern governments will be under-resourced, and so even more dependent than otherwise on foreign aid. Taxation gathered within the borders of the country is by far the most sustainable way to fund the infrastructure of the country. More fundamentally, a weak taxation system challenges democracy building possibilities in the global South. In the presence of corruption, capital flight and widespread evasion, potential taxpayers lose confidence in the administration. There is a spiralling effect: the less taxpayers believe in the system, the less they pay, and the more the government is free to treat their contribution with some contempt. This presents a serious challenge to civil society in Southern countries.

Internationally, tax collection in Southern countries is threatened by tax competition and transfer pricing abuse, both of which are indirect products of the power of multinational firms relative to smaller countries, an inadequate level of tax treaties, poor exchange of information and a lack of transparency in international tax matters. As discussed above, for full transparency, the exchange of information between taxing authorities should be automatic rather than on request. This is because without automatic information exchange, the taxing authority which makes the request may not be aware of what kinds of records are available, and so might not get the information best suited to tackling their loss of revenue.

3.

Ireland, tax and development

Ireland impacts on issues of tax and development at many levels. There is the impact of Ireland's tax policies on Southern countries, particularly regarding Ireland's tax rate, Ireland's transfer pricing legislation, Ireland's tax treaty network and Ireland's intellectual property incentives. In addition, there is Ireland's participation in international bodies which impact on Southern countries, and Ireland's work directly building the capacity of the domestic revenue systems of selected Southern countries. Each of these is dealt with in turn below.

3.1: Impact of Ireland's tax rates

Ireland has to a large extent built its economic strategy on taxes, specifically on the policy of a low rate of tax for companies locating there, and a wide range of international tax treaties which facilitate the movement of capital through the jurisdiction. Historically, Ireland initially offered a zero tax rate to exporting firms, and from 1981, a rate of 10% for companies carrying out manufacturing activities or located within particular zones such as the Shannon Free Zone or the International Financial Services Centre (IFSC). While these low rates were on offer to specific categories of firms, the headline corporation tax rate was relatively high, running from 50% to 40%. When the 10% rate proved internationally unsustainable due to pressure from the EU in the late 1990s, Ireland's response was to allow the special rates of 10% to be phased out gradually, but to reduce the overall headline rate of tax on trading income to 12.5%. This is the maximum rate applying to the trading income of any firm which is taxed in Ireland^{xiv}. Having such a low corporate tax rate involves some risks, not only for Ireland, but also for countries competing for foreign investment, which may be indirectly forced to offer similar incentives, or whose pool of taxable income may be drained through aggressive transfer pricing abuse on the part of multinationals which also operate in Ireland.

Ireland has used its low corporation tax rate as the primary means of attracting in foreign direct investment. The strategy has been effective in times of global economic expansion, but carries some risks. Those companies for which tax is a major driver of location decisions may be more likely to allow tax considerations to influence other corporate decisions, and so there is a greater risk that companies located in low-tax countries will engage in transfer pricing abuse. Ireland's international reputation depends, therefore, not only on its ability to attract FDI, but equally on its ability to effectively police transfer pricing abuse across its borders.

3.2: Ireland's transfer pricing rules

As noted above, it is not difficult for a large international company to shift income around from one group company to another to ensure that income is maximised where tax is minimised. As Ireland has such a low corporation tax rate, multinational firms may be tempted to manage their internal pricing to shift income into Ireland, and thus reduce their total international tax liabilities. A Department of Finance spokesperson at the May 2010 meeting of the Joint Oireachtas (i.e.: parliamentary) Committee on Foreign Affairs (JCFA 2010) observed that data on this process is notoriously difficult to obtain, as there is rarely a third-party transaction on similar terms which could be used to establish a benchmark or arm's-length price.

The Irish Revenue Commissioners argue that they do not encourage this in any way. Speaking at the May 2010 meeting of the Joint Oireachtas Committee on Foreign Affairs, a Revenue Commissioners official acknowledged that aggressive transfer pricing by multinationals to shift income into Ireland would boost Irish tax revenue, but added: *"Ireland has absolutely no truck with, nor does it defend or advocate such abuses. We want a straight application of the international arm's length standard in the determination of profits here."* At the same meeting, a Department of Finance official said *"We work very closely with our treaty partners to ensure abusive transfer pricing does not occur. If we, or any of our treaty partners are concerned about individual cases there are in place mechanisms including the mutual assistance procedure to ensure that the issues involved are dealt with by the revenue authorities."*

Despite this aspiration, and bearing in mind the difficulty in collecting objective data on this, there is ample anecdotal evidence that in some cases, income is shifted into Ireland in an artificial way in order to apply Ireland's low corporation tax rate to income which could arguably be more correctly taxed elsewhere. For example, Honohan and Walsh (2002) raise the question in relation to two dozen companies manufacturing organic chemicals which record huge profits with very few employees in Ireland, they ask *"But what are we to make of an industry where the share of labor in net output is as low as 1.7%, and where net output per worker has been as high as \$2.5 million, or 1.8 million Irish pounds in 1998?"*

Example – Round Island One

Writing in the Wall Street Journal, Simpson (2005) describes how Round Island One Ltd., a little-known Irish subsidiary of Microsoft, was used by the group to save over \$500 million in US taxes, and to partially shield Microsoft's multi-billion dollar profits from worldwide taxes. Simpson describes how this structure impoverishes Southern countries as follows. *"Through a key holding, dubbed Flat Island Co., Round Island licenses rights to Microsoft software throughout Europe, the Middle East and Africa. Thus, Microsoft routes the license sales through Ireland and Round Island pays a total of just under \$17 million in taxes to about 20 other governments that represent more than 300 million people."*

Following this report, the two subsidiaries cited, Round Island One and Flat Island applied to change their status from limited to unlimited companies, removing the requirement that they file details with the Irish Companies' Office. This move shows the importance of opacity to the tax schemes of multinational firms, and so indirectly demonstrates the potential of automatic information exchange between taxing authorities, or public country-by-country reporting as tools to combat them. It also shows the moral hazard created by Ireland's low tax rate, and the propensity of large multinationals to take advantage of this in unanticipated ways.

The problem is far more widespread than a single example can convey. For instance, Collins (2010) raises questions about questionable transfer pricing practices in a wide range of transactions in and out of Ireland. Sullivan (2010) in testimony before the US Congress Committee on Ways and Means argued that *"In fact, in many cases lax transfer pricing rules make the effective tax rate negative. That means the U.S. Treasury is not just giving investment in Ireland a tax holiday. That means the U.S. treasury department is subsidizing investment in Ireland."* Concern has been expressed at parliamentary level and beyond in Ireland. As Senator David Norris asserted at the May 2010 meeting of the Joint Oireachtas Committee on Foreign Affairs that "[transfer pricing abuse] *has been demonstrated and there is no question or argument about it. It is not just that [MNCs] may do it; they routinely do so. That is my position. This is part of the nature of the beast*".

Ireland is by no means unique in this. The Netherlands, for example, has a system of incentives for intellectual property and holding companies that has attracted many of the world's largest firms to locate there. Most of the new entrants into the EU offer very low corporate tax rates. These areas of concern require examination, in particular to ascertain the current or potential future negative impact of these tax policies on Southern countries.

The Irish International Financial Services Centre (IFSC)

The Irish IFSC was founded in 1987 through the introduction of tax incentives including low rates, rent and rates allowances and access to the international treaty network for licensed financial services firms located in a designated area near the North Wall area of Dublin. Most tax incentives expired in 2005, and since that date investment funds operating in Ireland have paid tax at the standard Irish rate of 12.5%, and enjoy a range of exemptions on dividends, interest and capital gains regardless of where in the country they are located. At the time of writing half of the world's top fifty banks and top 20 insurance companies had located in the centre, and more than a thousand international operations and managed funds were approved to trade from the IFSC^{xv}.

More than 20,000 people are employed in the centre, and much of the activity there is mainstream banking. However, given the level of transactions, the opaque nature of transfers and the tax incentives available, the IFSC merits particular attention in the area of transfer pricing.

It is worth looking in more detail at the precise procedures which are in place in Ireland to tackle this issue. Finance Act 2010 introduced transfer pricing provisions which will apply to all transactions between associated companies for accounting periods beginning after January 1, 2011. The legislation grants the Irish Revenue powers, where the price is not seen to be at arm's-length, to adjust the price retrospectively to a level that they feel is appropriate. Critically, however, it only allows for this adjustment to be made to either overstated expenses within the Irish entity, or understated trading receipts.

This means that arm's-length pricing will only be retrofitted in the case where transfer pricing has had the effect of shifting profit out of Ireland. Since the corporation tax rate is very low at 12.5%, it is far more likely that multinationals with a base there would seek to maximise the amount of profit recorded in Ireland by shifting profit into the country. In this case Ireland's new transfer pricing laws will have no impact. The new rules do not provide any basis for challenging companies seeking to transfer profit into Ireland from other countries. This means that the legislation provides only for defending Ireland's tax base, and ignores the way in which Ireland's system could be abused to undermine the tax bases of other countries, including Southern countries. The onus for detection of transfer pricing abuse remains firmly on the country which is potentially losing revenue to Ireland, despite the fact that their taxing authority may not have the capacity to deal with it.

In response to a question on this issue, the representative of the Revenue Commissioners speaking at JCFA (2010) said *"Multinational investment in Ireland is typically sourced from high-rate jurisdictions that have tremendous expertise and capacity in respect of transfer pricing. States such as Germany, Japan and the US are well able to monitor what the subsidiaries of their companies are doing here. They are well able to ensure that the subsidiaries operating here are staying in line with this international standard"*. While this argument has merit, it ignores the fact that an Irish subsidiary may be owned by, for example, a US parent, but may also have related companies within the group operating in Southern countries. Transfer mis-pricing is not just a problem between the Irish subsidiary and its parent. It can more easily be imposed between Ireland and a Southern country, by means, for example, of an inflated patent royalty. Ireland's apparent reliance on the taxing authorities of other countries to police this issue could be problematic in the case of under-resourced Southern countries.

There is also a demonstrated lack of enthusiasm on the part of at least some of Ireland's legislators for more active policing of transfer pricing in Ireland. For example, John Deasy, parliamentarian with Special Responsibility for Overseas Development Aid in the 30th Dáil (parliament), observed at JCFA 2010 that *"If [multinationals] shift profits and transfer price (sic), that is a problem for the US administration and not for us. I do not have a difficulty with that."* The problem with this attitude is that the same rules which impact on the US administration can also impoverish Southern nations.

3.3: Ireland's tax treaties

At the time of writing, Ireland had 61 signed double tax treaties in place, mostly with OECD countries covering direct taxes such as income tax, corporation tax and capital gains tax. The only African countries on the list are South Africa and Zambia, with a new treaty coming into force shortly with Morocco^{xvi}. Ireland has also signed Tax Information Exchange Agreements with 16 jurisdictions. The negotiation of a new tax treaty is a slow and painstaking process, as it involves a detailed study of the corresponding country's tax regime, a political agreement on both sides to negotiate, the negotiation of terms, possible translation of the agreement and subsequent legal re-examination by both parties, ratification into law and signing. Accordingly the Irish Revenue officials need to prioritise the countries with which they seek to open treaty negotiations. So far they have concentrated on OECD countries, those within the EU, potential EU entrants, and those countries with which Ireland either has a high volume of trade, or expects to do so in the future. In drawing up the list of potential treaty partners, they consult with the Departments of Foreign Affairs and of Finance. They are happy to negotiate with Southern countries as long as there is the political will to engage on both sides, but it is noteworthy that Ireland has very few active treaties with African countries.

Southern countries tend to have a very slim set of tax treaties, which makes them less attractive for foreign direct investment, and also leaves them vulnerable in the negotiation of terms with new investors because of the lack of certainty around the tax treatment of international transfers. It would be helpful to the development of the tax capacity of Southern countries if Ireland could prioritise the negotiation of transparent and fair treaties with them following the UN model, perhaps beginning with the Irish Aid priority countries. This could perhaps be initiated by Irish Aid through the normal consultation between Revenue and the Department of Foreign Affairs.

An encouraging aspect of Ireland's treaty negotiations is that for all new treaties, Ireland has insisted on an exchange of information clause being included^{xvii}. However, as noted above, the exchange of information is not yet automatic, and without a thorough knowledge of what is reported, tax officials may not know exactly what they can ask for from another country. It is hoped that the practice of insisting on information exchange continues and where possible is extended to automatic exchange of information.

3.4: Intellectual property incentives

Collins (2010) notes that intellectual property transfers between related companies present the greatest challenge to national taxing authorities seeking to police transfer pricing in multinational firms. The reasons for this are straightforward. Where a firm in Ireland is supplying goods not only to related companies but also to unrelated third parties, it is easy to establish what the arms length price should be. For example, a computer manufacturer should sell its goods to a wholly-owned wholesaler in France at the same rate that it sells to an unrelated wholesaler in Germany.

However, where charges are made between group companies for patent royalties, management charges or other intangibles, there is unlikely to be a similar transaction with a third party by which the price can be benchmarked. It is difficult to dispute the rate at which these transfers are made, because there is no arm's-length price established by the market. This makes the pricing of such intangible services a convenient and opaque method for multinational firms to shift income from one jurisdiction to another, often to avail of lower tax rates in the target country.

Ireland's intellectual property rules

Ireland has introduced a set of intellectual property rules which create an incentive for the designation of business expenses as R&D expenses by allowing generous tax credits, in excess of the standard corporation tax rate, for R&D expenditure. This is paired with a total exemption from taxation of patent royalty income up to a level of €5,000,000 per year. The idea is to encourage the development of high-value industry in Ireland, and the support of a knowledge economy, which is clearly a legitimate aim.

However in the same way as Ireland's commitment to a low corporate tax rate creates a moral hazard for multinationals operating there, Ireland's tax rules on intellectual property exacerbate this hazard. Given that intangible group interactions are the most opaque and difficult to police from a transfer pricing perspective, and that the Irish tax rules actively incentivise firms located there to designate their group interactions as intangible, Ireland has a moral obligation to monitor these carefully, and ensure that its rules are not being abused at the expense of Southern countries. Section 4 below demonstrates in a simplified pro-forma way how Ireland's tax system could be used for transfer pricing abuse, at a cost to the tax capacity of a Southern country.

3.5: Ireland's participation in international bodies

Ireland has been an active participant in many international bodies dealing with the issues of tax and development, most of which in one way or another are connected to the OECD or EU. Significant involvements in this area include:

- Irish Aid is a member of the OECD Development Assistance Committee (www.oecd.org/dac), an international forum which brings together the UN, the World Bank and donor countries to address the needs of poor countries in meeting the UN Millennium Development Goals. Irish Aid is one of only 24 governments participating.
- The Irish Revenue Commissioners have been involved directly in helping to address the problems faced by Southern countries around taxation. Most notably, they have engaged in a programme of assistance to the Rwanda Revenue Authority (RRA) under a Memorandum of Co-operation signed in March 2008, and recently extended until 2012. This is a skills and information-sharing programme which aims to strengthen the ability of the RRA to collect tax domestically with a focus on sharing the Irish Revenue's

risk-based method of selecting taxpayers for closer scrutiny. It has created a mentoring relationship, which has significantly helped the RRA's ability to collect taxes, and has also been a useful learning experience for the Revenue personnel involved, at a minimal cost supported by Irish Aid (Gillanders 2010). While there are obvious concerns on the human rights record of the Rwandan government, the ability of this model of intervention to enhance the domestic capacity to raise revenue is nonetheless noteworthy.

- Irish Aid is an active development partner of the newly-formed African Tax Administration Forum (ATAF) which grew from a 2008 conference entitled "Taxation, State Building and Capacity Development in Africa", held in Pretoria, South Africa. Given the Irish Revenue cooperation with the Rwanda Revenue Authority, this is a potentially very useful link, which could be used to enhance the tax capacity of a wide range of African countries.
- Officials from the Department of Finance have engaged with the OECD Committee on Fiscal Affairs (CFA), an international body dealing with such issues as harmful tax competition, tax evasion and secrecy and transfer pricing. It is noteworthy that in January 2010 this committee held its first joint meeting with the Development Assistance Committee (DAC) on the subject of tax and development. This led to the formation of an Informal Task Force representing a wide range of stakeholder groups, which met in May 2010. The Task Force is now working on 3 main issues relating to tax and development, namely transfer pricing, exchange of information and country by country reporting. At the May 2010 meeting of the Joint Committee on Foreign Affairs (JCFA 2010) the Department of Finance spokesperson indicated that they support this work, including the research on country-by-country reporting. However while Ireland is open to the idea of country by country reporting, Irish officials have not yet come out either in favour of or against this initiative.
- Irish Aid works with the Association of European Parliamentarians with Africa (AWEPA) with particular focus on financial support for AWEPA's work in both the East African Legislative Assembly and the Southern Sudan Legislative Assembly. As part of this programme, Irish Aid work with AWEPA to assist the East African Community Customs Union, thereby building tax capacity in the region. However, it is worth noting that at the time of writing, the East African Community has not yet signed the EPA recently negotiated, and that "*a number of regional bodies including the East African Business Council and the East African Legislative Assembly have denounced the EPA in its current form saying it does not address East Africa's development needs.*"^{xviii}
- Irish Aid also works with the Investment Climate Facility for Africa (ICF), a forum for public-private partnership launched at the World Economic Forum in Cape Town in 2006. It aims to create a suitable climate for investment in Africa, and works, inter alia on issues of taxation and customs. As well as development groups such as Irish Aid and its equivalent bodies in other European Countries, ICF is backed by such companies as Shell, SAB Miller, Anglo American and other large multinational firms. Much of the work on taxation centres on simplifying and streamlining tax compliance. Given the different agendas of the backers of ICF it is not entirely clear how the relative benefit of these efficiencies will be shared between the governments in question and the multinational firms operating there.
- The Revenue Commissioners now have a policy of including a clause on exchange of information as a prerequisite for the negotiation of all new tax treaties. While this is obviously welcome, it is worth noting that this does not extend to automatic exchange of information which would be more useful to weakened tax administrations in Southern countries.

- Ireland is very active on the organising committee of the Global Forum on Transparency under the auspices of the OECD. This forum aims to conduct peer reviews on countries' policies and procedures for exchange of information on tax matters. Ireland is among the first cohort of countries to be reviewed under this process, which will be concluded in 2011. At that time the report on Ireland will be published.
- The UN Tax Committee, or more formally the UN Committee of Experts on International Cooperation in Tax Matters is the preferred international forum of a number of NGOs in the tax justice area. As reported by Eurodad (2008), the reason for this widespread support is *"to shift these debates from the OECD, currently in charge of these issues, to the UN - which is not only more inclusive and universal, but also more prone to give the type of technical assistance that developing countries need on these issues"* (Eurodad 2008). Unfortunately, Ireland does not have any representation on this committee.

3.6: Summary

For several decades now, Ireland has carefully used its tax system as a tool to attract foreign direct investment. There is widespread political party consensus on the merit of this, resulting in Ireland having a very low corporate tax rate, and specific rules on intellectual property including the tax exemption on patent royalties and the tax credit for R&D expenditure. While these tax measures are intended simply to attract investment, they can be used in an unexpected way by multinational firms to divert taxable income from Southern countries, as further illustrated in the next section. Ireland's rules on transfer pricing, while meeting the international minimum standard, are relatively weak and are not effective in countering aggressive tax schemes put in place by multinational firms.

At the same time there are very positive aspects, notably the inclusion of information exchange in new double tax treaties and Ireland's involvement in a number of international bodies. It would be good to see the treaty provisions amended to automatic exchange of information, and to see the network of tax treaties extended to cover a wider range of Southern countries. Ireland's involvement in international bodies dealing with tax and development is also very useful, and could be expanded to good effect. In order for Ireland's policies to be coherent, it is important that steps are taken to close off possible international tax loopholes which could indirectly undermine the work of Irish Aid in facilitating and supporting development in Southern countries.

It has been suggested^{xix} that there is a contradiction between the promotion of Ireland as a low-tax location in an effort to attract foreign direct investment and any enthusiasm on the government's part for greater transparency and accountability in the area of transfer pricing or country by country reporting. In a narrow sense, there is no conflict between the two positions. However, there is certainly a mixed signal being sent to businesses operating in the country, increasing the need for clarity on the tax rules, and vigilance on possible abuses. Given the importance of tax in the branding of Ireland internationally as a location for foreign direct investment, it is critical that this is addressed.



4.

Pro-forma Tax Computations

This section illustrates in a very simplified way how transfer pricing could be used by a multinational firm to shift income from a country with a higher rate of corporation tax to Ireland, and shows the resultant tax saving to the company. A fictional company has been used as an illustration of the possibilities for abuse of Ireland's transfer pricing model and because of the lack of adequate access to information on companies in Ireland in this area. This is relevant to development because it applies to the situation where a Southern country resists the race to the bottom in terms of tax rates, but secures foreign direct investment despite this, because of low wages and operating costs. Even in this situation, where, for instance, manufacturing has moved to the Southern country, they can still lose the ability to effectively impose tax on the profits generated in their low cost facilities because of the way in which Ireland's low corporate tax rate interacts with transfer pricing regulations and intellectual property incentives.

Three examples are given. The first illustrates in very simple terms how transfer pricing can be used aggressively in the case of an Irish-based manufacturing company selling goods cross border, with a certain amount of work done in processing the goods in both Ireland and the Southern country. These could be some assembly or manufacturing, software localisation, or even something as simple as packaging. The second example expands this by adding a patent royalty on intellectual property developed by the Irish firm. Finally, a more complex international scheme known as the "double-Irish" is briefly described.

In the first two cases, it is assumed that the group has a base in Ireland, and also in a fictitious Southern country, Ruritania. The Irish tax rate is taken at 12.5%, and the tax rate in Ruritania is set, for illustration, at 35%. All of these examples show how the Irish tax system as it currently stands, even with the new transfer pricing legislation, can be used by a multinational firm to deplete the tax revenue of a Southern country in which it also has a base.

4.1: Simple transfer pricing on sales

In this example, an Irish software manufacturing company produces one million units per year, at a cost of €4 per unit. These are sold on to a group company in Ruritania paying tax at 35%, which will do a minimal amount of further work on the software and sell the units on at a price of €21 per unit. Overheads in Ruritania are for simplicity set at €1,000,000 per year.

Clearly, there is an overall gross profit to be made of €17 per unit, or €17,000,000 per year. After deducting the Ruritanian overheads, this will give a net annual profit to the group of €16,000,000. How and where this is taxed depends on the rate at which the goods are sold from the Irish to the Ruritanian firms, as follows:

Table 2: Goods sold from Ireland to Ruritania (€'000)

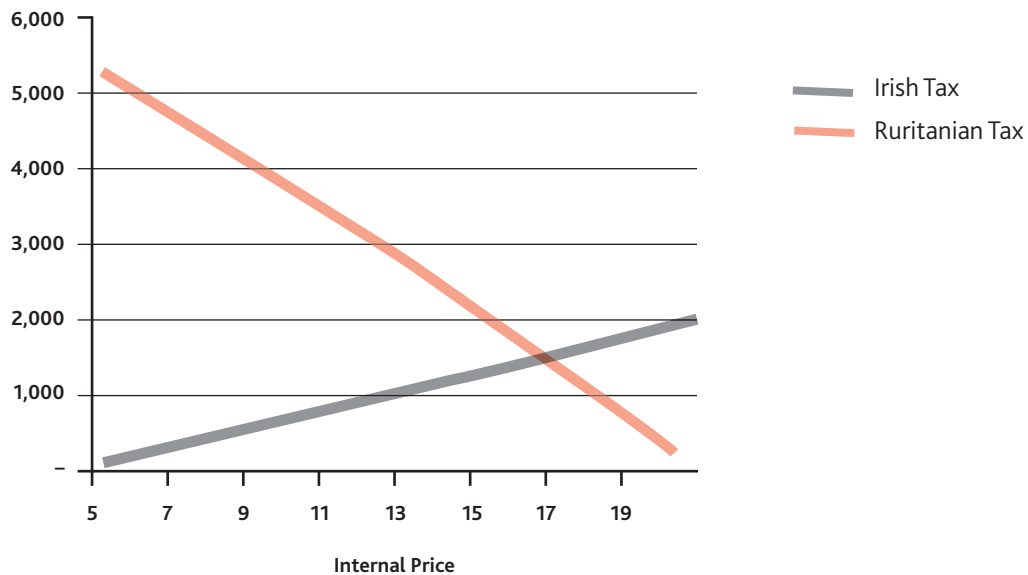
Internal Price	€5	€8	€11	€14	€17	€20
Irish Co Sales	5,000	8,000	11,000	14,000	17,000	20,000
Irish Costs	4,000	4,000	4,000	4,000	4,000	4,000
Irish Profit	1,000	4,000	7,000	10,000	13,000	16,000
Taxed at 12.5%	125	500	875	1,250	1,625	2,000
Irish post-tax earnings	875	3,500	6,125	8,750	11,375	14,000
Ruritanian Sales	21,000	21,000	21,000	21,000	21,000	21,000
Ruritanian cost of goods	5,000	8,000	11,000	14,000	17,000	20,000
Ruritanian overheads	1,000	1,000	1,000	1,000	1,000	1,000
Ruritanian profit	15,000	12,000	9,000	6,000	3,000	-
Taxed at 35%	5,250	4,200	3,150	2,100	1,050	-
Ruritanian post-tax earnings	9,750	7,800	5,850	3,900	1,950	-
Overall Group Profit	10,625	11,300	11,975	12,650	13,325	14,000
Overall Group tax rate	34%	29%	25%	21%	17%	13%

As the internal transfer price increases from €5 per unit to €20 per unit, the overall tax paid by the group in the two countries falls from an average rate of 34% to a mere 13%, as more and more profit is shifted into Ireland. The difficulty for the Ruritanian taxing authority is establishing the fair price at which goods should be sold between the two group companies. As long as both firms do some level of work on the product, however minimal, the group can argue that there are no commercially like sales in the market which could be used to establish an arm's-length benchmark.

Let us further assume in this fictitious case that the Irish firm does very minimal work on the software, and a fair internal price would be in the region of €8 per unit, although the actual price used is €17. Under the new transfer pricing rules, the Irish revenue are not empowered to intervene to revise the price downwards to what is fair, because, as explained in section 3, the new transfer pricing legislation only allows for this adjustment to be made to either overstated expenses within the Irish entity, or understated trading receipts. Effectively, the Irish taxing authorities can only impose arm's-length pricing when profits are being shifted out of Ireland, a relatively uncommon situation given the low Irish corporate tax rates.

The graph opposite shows how as the internal price increases, the overall tax take in Ireland also goes up, at the expense of Ruritania.

Figure 1: Transfer pricing illustration 1



In fact, as Ireland's tax take rises to a relatively modest €2,000,000 per year, Ruritania loses more than €5,000,000. Effectively the gain from transfer pricing manipulation is divided between the multinational firm engaging in this questionable activity and the low-tax country, in this case Ireland.

4.2: Patent royalty income

The second example builds on the same basic facts, but further assumes that most of the manufacturing work on the product has been shifted away from Ireland to the low-cost Ruritania. Reflecting this reality, the internal transfer price from Ireland is set at a reasonable €8 per unit. In addition, however, the Ruritanian manufacturing company pays a royalty to the Irish firm for the use of patented technology employed in the manufacturing process there.

Table 3 overleaf shows the overall group tax position at different rates of the royalty.

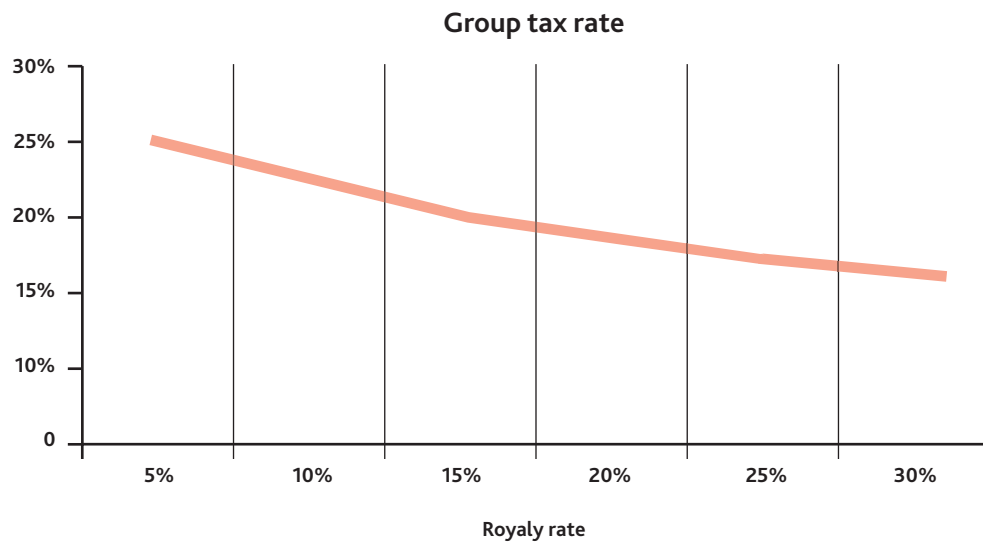
Table 3: Adding a patent royalty

Royalty as % of selling price	5%	10%	15%	20%	25%	30%
Irish Co Sales	8,000	8,000	8,000	8,000	8,000	8,000
Irish Costs	4,000	4,000	4,000	4,000	4,000	4,000
Irish Trading Profit	4,000	4,000	4,000	4,000	4,000	4,000
Taxed at 12.5%	500	500	500	500	500	500
Irish Patent Income	1,050	2,100	3,150	4,200	5,250	6,300
Taxed at zero% /12.5%*	-	-	-	-	31	163
Total Irish Tax paid	500	500	500	500	531	663
Irish post-tax earnings	4,550	5,600	6,650	7,700	8,719	9,638
Ruritanian Sales	21,000	21,000	21,000	21,000	21,000	21,000
Ruritanian cost of goods	8,000	8,000	8,000	8,000	8,000	8,000
Ruritanian Overheads	1,000	1,000	1,000	1,000	1,000	1,000
Patent Royalty paid	1,050	2,100	3,150	4,200	5,250	6,300
Ruritanian profit	10,950	9,900	8,850	7,800	6,750	5,700
Taxed at 35%	3,833	3,465	3,098	2,730	2,363	1,995
Ruritanian post-tax earnings	7,118	6,435	5,753	5,070	4,388	3,705
Overall Group Profit	11,668	12,035	12,403	12,770	13,106	13,343
Overall Group tax rate	27.1%	24.8%	22.5%	20.2%	18.1%	16.6%

*0% on the first \$5,000,000 per annum, 12.5% thereafter

Since the patent relates to R&D work carried on in Ireland, the patent royalty income is tax free in Ireland up to a threshold amount of \$5,000,000 per year. Thereafter it is taxed at 12.5%^{xx}. Figure two below illustrates how the overall group tax rate falls as the royalty rate is increased.

Figure 2: Impact of royalties on group tax rate



The rate at which this royalty is set is obviously quite opaque, and difficult for any one taxing authority to unilaterally challenge. This example shows how even with a reasonable transfer price on the goods themselves, the addition of a patent royalty can reduce the overall group tax rate from 27% to 17%. Used in combination, aggressive policies on both transfer pricing and royalty payments can radically deplete the tax revenue of a Southern country hosting a multinational firm which has an R&D base in Ireland.

The patent royalty exemption is one of two main measures in Ireland designed to encourage innovation and the anchoring of multinational activity through research and development units. The other is an R&D tax credit which gives generous credits against Irish tax for development expenditure. Of the two, the patent royalty exemption is the easiest for multinational firms to manipulate, and the most likely to form part of international tax avoidance schemes. It is also, in the opinion of the authors of the 2009 Commission on Taxation Report, the least likely to contribute actively to an expansion of real research and development activity in Ireland. This is supported by the advice in Haccius (2004:761) that *"It must not be assumed that Ireland is necessarily a safe haven for royalty income. Ireland will often be a convenient stepping stone in a multinational plan for the exploitation of intellectual property rights in a tax efficient manner, but will not be a satisfactory end destination for royalty income unless the Irish resident company receiving that income carries on an identifiable "trade" [sic] of exploiting those intellectual rights"*. Indeed, the 2009 Commission on Taxation Report recommends discontinuing the relief from Irish tax of patent royalty income, while extending the relief for foreign withholding taxes on royalties paid into Ireland and for R&D activities. That would certainly improve the overall transparency and fairness of Ireland's tax system, vis-à-vis Southern countries. It would also produce a saving in terms of foregone tax estimated in Collins (2010) as coming to €84 million per annum.

4.3: The double-Irish

In general, aggressive transfer pricing schemes are far more complex than the simple pro-forma examples given above. For example, Brown Gianni (1997) sets out a comprehensive list of circumstances in which transfer pricing may be used to manage the tax liabilities of a group of companies. As well as the simple sale of goods, these include shared facilities, transfer of assets, intra-group services, loans, leases, licenses and royalties. Drucker (2010) describes an interesting scheme known as “The Double-Irish”. This is reported as widely used, and he cites the particular case of a pharmaceutical group which employed it to reduce their effective rate of tax on profits shifted into Ireland down to between 2% and 3%. This scheme is described in detail in Darby and Lemaster (2007) as a common way to exploit the interaction between the Irish tax rules and those of the US. Under the Double-Irish scheme, a US firm establishes two Irish subsidiaries. The first of these is incorporated in Ireland but managed and controlled in a no-tax location such as Bermuda. This in turn will control a second subsidiary which is incorporated and resident in Ireland, and will usually have some real substance in the form of manufacturing or other economic activity. Figure two below shows the structure.

Figure 3: The double-Irish structure



The BermuCo will be regarded by the Irish tax authorities as resident in Bermuda, and so falling outside of the remit of the Irish tax authorities. However, the group can elect under US tax rules to have the two subsidiaries, BermuCo and ManuCo treated effectively as one single Irish entity for US tax purposes. Under US rules, all transactions between the two subsidiaries will be ignored.

The next steps is for BermuCo to enter into an intellectual property licensing agreement with its US parent, and to licence the Irish manufacturing company to produce some product in return for the payment of an internal group royalty or management charge. The product could be as simple as software localised for the European market, or something assembled or manufactured in Ireland. The royalty may be routed through The Netherlands in order to avoid withholding taxes. This payment from the Irish firm to BermuCo will naturally reduce the taxable income in Ireland, while increasing the income “taxable” at zero% in Bermuda. However, it will be difficult for the Irish Revenue to challenge the rate at which it is charged under arm’s-length rules because there is no equivalent third party transaction by which it can be benchmarked. The US taxing authorities find it even more difficult to challenge this structure if the group has successfully elected to have the two subsidiaries treated as one economic entity.

This example illustrates the importance of monitoring how Irish domestic tax rules can be abused by complex international structures, with an overall loss of tax to all the governments involved. This need for vigilance is heightened by Ireland’s low tax rate and what Darby and Lemaster (2007) call Ireland’s “*smart and welcoming business and tax policies*”. In this case, all the taxing authorities affected are well-resourced, highly-skilled, and do not suffer from any of the structural disadvantages that plague Southern countries. Despite this, Ireland loses some tax income, the US loses a great deal, and Bermuda gains no tax revenue from the operation. The tax authority of a Southern country has little chance of avoiding loss in this kind of a situation. The only winners are the multinational firms, and the law and accounting firms which advise them.



5.

Mozambique

In order to illustrate the abstract issues discussed above with concrete examples, this section examines Mozambique in some detail, looking at the overall economy, Irish Aid's priorities in the country, the tax system and how it is impacted by the common problems of Southern countries. Mozambique was chosen because it is an Irish Aid priority country, and has an interesting range of economic interactions with Ireland. With that latter point in mind, this section also examines the activities of Kenmare Resources as a well known Irish plc operating in Mozambique.

5.1: Context and recent history

Following independence from Portugal in 1975, Mozambique went through two civil wars which killed over a million people and displaced twice that number, devastating infrastructure and leaving over half the population in absolute poverty. In the 2009 United Nations Human Development report (based on 2007 figures), Mozambique is ranked at 172 out of 182 countries on a scale capturing longevity and health, access to knowledge and a decent standard of living. The CIA Factbook^{xxi} on the country reports an infant mortality rate of over 10%, a life expectancy of only 41 years and GDP per capita of just US\$900. There is a high rate of HIV infection, and an adult literacy rate estimated at around 50%. Clearly then, there is a significant need for development.

The economy has grown rapidly over the last 15 years, largely driven by industry, most obviously large, foreign-owned projects such as an aluminium processing operation called Mozal and several extractive firms including Irish-owned Kenmare Resources. Poverty remains a problem in rural areas. It is worth noting that poverty is estimated in Mozambique at a very basic level, defined as not having the means to consume 2,150 calories per day, or to access some non-food needs such as housing. Irish Aid (2007) notes that in 2005 this required an income of somewhere below \$0.78 per day. Still, in 2005, more than half the population fell below this threshold. Given this level of poverty, is it essential that the undeniable mineral wealth of the country is translated in some way to development potential for the population as a whole.

5.2: Irish Aid in Mozambique

Irish Aid's overall goal in Mozambique is to contribute to poverty reduction by supporting the development, implementation and monitoring of pro-poor policies within Mozambique. One of four strategic objectives identified by Irish Aid as their means to achieve this goal is "*Capacity strengthening of Government and civil society partners to implement pro-poor policies and programmes.*" (Irish Aid, 2007). Support for the tax capability of Mozambique falls clearly within this remit. This is consistent with the Mozambican government's own plan to tackle poverty, the Plano de Ação para a Redução da Pobreza Absoluta or PARPA. This plan, which was updated in 2005,^{xxii} includes the target of increasing the domestic tax take, and the revenue from foreign-owned firms operating in the country. Despite the tax take from foreign firms being specifically highlighted in the plan, a senior Mozambican tax official interviewed for this report does not see the corporation tax take from very large multinationals as very important. Instead, he takes the view that their presence in the country is in itself enough, as it alleviates unemployment, and generates taxes at second hand through the wages of their employees. Since Mozambique is struggling to cover more than 15% of its GDP through tax collection, this may not in the future be considered enough of a contribution from those utilizing the mineral wealth of the country.

As well as working to support reform of the public service and an increase in state capacity, Irish Aid is also one of a group of 19 key foreign donors known as G19 which provide funding to the government of Mozambique. Given that tax revenues only bring in roughly 50% of what is needed to meet state expenditure^{xxiii} this income from G19 is essential in alleviating poverty and maintaining health and education.

5.3: The Mozambican tax system^{xxiv}

The Mozambican taxing authority is the Autoridade Tributária de Mocambique (ATM) which was established following an extensive overhaul of the tax system from the late 1990s on. The main taxes are a corporate income tax, income tax on individuals, Value Added Tax (VAT) and customs and stamp duties. The country is largely reliant on VAT, which brings in more than twice as much revenue as corporate income tax or individual income tax.

Liability to corporate tax is based on residence, which is established by reference to the locus of management and control of a company. Resident companies are taxed on their worldwide income, while non-resident companies pay tax on income arising in Mozambique. The standard rate of corporation tax is 32%, but far lower rates apply in designated Rapid Development Zones or Industrial Free Zones. Special incentives also apply to some industries, notably mining, tourism, agriculture and oil. The taxing authority has the power to impose arm's-length pricing for transactions between related companies or individuals. Income tax is also levied based on residence, and expatriates have no special concessions in this area. The rate on employment income is also 32%.

The standard rate of VAT is 17%, with a rate of zero% for exports, some basic foodstuffs, etc. Insurance, health and welfare and certain banking operations are exempt from VAT, as is the import of goods for use in mining and in designated Industrial Free Zones. The European Commission (2010) reports that the introduction of VAT was a condition of their debt relief under the Heavily Indebted Poor Countries (HIPC) programme. Nathan Associates (2004) reports that since the introduction of VAT in 1999, the county has been gradually phasing out import duties. Damme et al (2008) reports that the way in which VAT refunds are processed, and the severe problems with refund delays have created incentives for corruption among tax officials. They also cite reports that the introduction of VAT in Mozambique has perversely led to increased prices for *'zero-rated items, such as medicines, wheat flour, and mosquito nets.'*

A tax official interviewed for this report under conditions of anonymity confirmed that Mozambique faced most of the classic problems of southern countries in respect of tax collection, specifically highlighting the informal economy with an unbanked population, corruption, complexity in the tax system, widespread tax evasion and not enough tax officials to adequately impose taxes. Nathan Associates (2004), seeking to highlight private sector concerns about the tax reform in Mozambique observed that in 2004, *"The new tax laws are too complex for local conditions. Tax rates are too high. The tax base is too narrow. Tax administration is inefficient, arbitrary and prone to corruption [and] public information on the tax system is highly inadequate, and public-private dialogue has been insufficient"* (Nathan Associates 2004).

For convenience, the problems faced by Mozambique are presented under the same headings used in section two above, although these are grouped where it makes sense to address them together. The main issues addressed are the informal economy, low revenue from personal taxes, attitudes to tax which result in low levels of compliance, complexity, gaps in capacity, trade tariffs and liberalisation, corruption, the deficient rule of law, capital flight, power, tax competition, transfer pricing, secrecy and isolation and double tax treaties.

The informal economy

A tax official interviewed for this report estimated that only 11% of all businesses in Mozambique paid tax. One tax advisor with a large international accountancy practice based in Maputo estimated that the informal economy represents over 43% of urban income and 33% of Gross Domestic Product, and that the problem is far more widespread in rural areas. She linked this to a lack of infrastructure, explaining that while most people in urban areas had a bank account, there were no figures for the country as a whole. Coe et al (2009) estimate that up to 95% of the population of Mozambique may be unbanked, meaning they have no bank account or other formal relationship with a financial institution. Given that three people including Carlos Cardoso, a prominent investigative journalist, were murdered between 1997 and 2001 while investigating bank corruption^{xv}, a lack of confidence among the people in the banking system is not surprising. There are some recent initiatives in the area of mobile banking which have the potential to address the problem.

A United Nations Development Programme Report (Amurane 2007) found that the informal sector in Mozambique is mostly made up of women with no access to capital. As well as poor access to capital and means of saving, the UNDP report identifies relatively high taxes on small business as a disincentive to traders leaving the informal sector. This poses two problems. Outside the banking system, traders are unable to secure their income through access to savings and reinvestment, and so are trapped in poverty. They also operate unofficially, paying no tax, which creates a need for the taxing authorities to seek more and more revenue from the reduced pool of taxpayers, in order to fund basic services for the population. In turn this drives up small business taxes, reducing the likelihood that traders will leave the informal sector, creating a spiral of poverty on an individual and a national level.

This year the government has launched a citizens' education programme, to advise the population of their rights and obligations around tax matters, encourage the documentation of transactions and to link tax with citizenship as well as infrastructure. This is a positive step, since as noted by the European Commission (2010) "*promoting taxation is also about explaining the purpose of taxation to the populations in developing countries*". However it may need to be accompanied by reduced taxes for micro-businesses in order to move them from the informal sector. USAID (2009) express confidence that a Simplified Tax Scheme (ISPC) passed in 2009 should help to reduce the barriers to formalisation.

Attitudes / Complexity / Gaps in capacity

With such low compliance rates, there is clearly an expectation among a large proportion of the population that taxes are not something that needs to concern them. This places the bulk of the population outside of the tax-accountability loop, with serious impacts on the relationship between the government and its citizens, and the strength of civil society. As a post-colonial country, Mozambique suffers from a pro-evasion attitude being common in the population. This should be mitigated by the taxpayer education programme and new simplified tax laws.

One tax advisor said "*Tax evasion is widespread. It is estimated that only 10% of the workforce of the country's (estimated 10 million people) pay taxes, and tax revenues represent only 15% of Gross Domestic Product.*" She contended that the reason for this was essentially political. "*The problem is not the lack of officials but the lack of political will to implement it as this is not a good election platform in any country.*" Another tax expert disagreed, arguing that non-compliance was largely a matter of education. "*To most ordinary people [in Mozambique] all the tax laws are complex.*"

Interestingly a Mozambican tax official said that the biggest single thing that European countries could do to help the tax capacity of Mozambique was to work with them to increase capacity. "*Training and assistance are crucial to improve the performance of our tax officials*". Given Ireland's experiences with the Rwanda Revenue Authority described above, this may be an area in which a contribution could be made.

Trade tariffs/Liberalisation

Mozambique recently went through a period of trade liberalisation and now has relatively low import tariffs. While this is a disincentive to smuggling and promotes investment, it poses an immediate challenge to vulnerable domestic companies struggling to compete with cheap imports. Taxes on exports of basic raw materials could also help local industry by ensuring a good supply for local processors, and so promote added-value industry. A good example is the cashew-processing industry in Mozambique, which was once a key employer and added value to a basic, local agricultural product. Under the direction of the World Bank, export tariffs on raw nuts were phased out from 1996. By the turn of the century, The Washington Post reported that more than half the workers in cashew factories had lost their jobs (Jeter 2000). This knock-on effect adds a lower economic base and increased unemployment to the problems already faced by the Mozambican authorities of lower income from tariffs.

The phasing out of tariffs was accompanied by the introduction of VAT, which, as noted by Nathan Associates (2004) is effectively levied on the poor and those in the informal sector who are at the end of the production line. As long as they remain unregistered, they do not obtain any input credit for VAT paid. The prospect of charging VAT on goods and services if registered may also act as a disincentive to registration for informal traders, further narrowing the tax base. Mozambique is a signatory to the Southern African Development Community (SADC) EPA, and thus has committed to the EU to further trade liberalisation and limiting their use of export taxes.

Corruption and deficient rule of law

Spector et al (2005) also describe the scale and scope of corruption in Mozambique as a cause for alarm, concluding that it is at a level that threatens democracy in the country. The murder of the investigators of bank corruption referred to above highlights the deficient rule of law, perhaps not helped by the general culture of secrecy around tax, particularly in how tax deals are negotiated with mining companies.

Nathan Associates (2004) note that because tax inspectors personally shared in fines and penalties imposed, this created an incentive to negotiate settlements on an individual basis with taxpayers, "*leading to unpredictable tax bills, arbitrary fines and corrupt practices.*" This practice of striking individual deals with taxpayers extended to multinational investment until 2003, with many mining companies having negotiated their corporate tax rate with the government in a non-transparent manner. While low tax rates are used in many countries including Ireland as a means of attracting foreign direct investment, the opaque manner in which individual arrangements are reached is a cause for concern as it creates a fertile environment for corruption and reduces the overall confidence of the population in the tax system, and exacerbates the problem of avoidance and evasion.

A Mozambican tax advisor^{xxvi} interviewed for this report said "*Corruption grows in Mozambique because the responsibility of Government to the country's citizens and respect of the law is not enough. This system is facilitated by a lack of independent oversight of the Assembly, by a judicial system that puts politics above the law and lack of transparency. Although there are some laws and regulations on paper as the framework for good governance, in practice only a few are implemented and there are no operative control mechanisms to ensure that this framework works in a fair and transparent way. The corruption works for the elite level and for the administration executives and staff.*"

Capital flight

Locally-based academics and officials within Mozambique agree that capital flight was not likely to be a serious issue for Mozambique, mainly because the levels of income, even among the elite, are low (Stack 2010). This does not, however, take account of asset-stripping or capital flight on the part of large companies operating within Mozambique.

Power, tax competition and transfer pricing

Mozambique is a poor country which has gone through considerable civil strife, and is in a weakened position in negotiating with large companies for potential investment. In the past it has imposed very low taxes on large firms coming from outside the country.

Mozal, for example, is an aluminium smelter close to Mozambique's capital, Maputo. It is owned by a consortium led by an Australian firm, BHP Billiton which owns 47.1% of the shares, and including Mitsubishi Corporation (25%) and the Industrial Development Corporation of South Africa (24%). The Mozambican government owns 3.9% of the company. The smelter imports raw alumina from BHP Billiton's plant in Western Australia, and produces refined aluminium ingots, which are overwhelmingly exported from Mozambique. Production runs at more than 250,000 tons of aluminium ingots per year, on one of the lowest costs bases worldwide.

However, in common with Kenmare Resources (see below) the company pays very minimal Mozambican taxes. The reason for this is summarised by one tax advisor as follows: *"These projects have been authorized under the regime of the industrial free zones. Mozal is a huge investment project which involves employment and exportation of all production. For huge investment projects the Government grants special conditions as an attraction for further medium size and smaller projects to invest in Mozambique (reduction of taxes and repatriation of capital are granted). The idea behind these projects was to change the perception of Mozambique as an investment friendly country"*.

Unlike a mining company which must locate in the country where the raw material is to be found, Mozal imports its raw material and refines it before exporting the finished product. There is no compelling reason for this work to be done in Mozambique in the absence of fiscal and other incentives. The relative power of Mozal and the Mozambican government results in a very good deal for the company, and limited tax collection opportunities for the country. Mozal does not pay tax. The tax official interviewed explained the rationale as follows *"Mozal is an enterprise which is in a free trade zone and it has a special treatment because workers pay their income tax"*.

As well as taxes, the government facilitate Mozal in other ways. Aluminium smelting is not a very clean process, the major concerns being emission levels of fluoride and dust. Mozal operates well within World Health Organisation (WHO) guidelines for fluoride, and within the national Mozambican guidelines for dust. These are four times higher than the WHO target of 50 microns per cubic metre, and are a concern to such local environmental groups as Livaningo^{xxvii}. A recent bone of contention reported by Fauvet (2010) is the decision of the Mozambican government to allow the smelter to emit smoke from its 60-metre-tall chimneys without filters for six months commencing in late 2010, so as to allow production to continue uninterrupted while seriously degraded filters are replaced. Protesters against this have limited access to data, and are unable to effectively influence corporate behaviour, consistent with the findings of a weak civic society in Mozambique reported in Francisco et al (2008).

The government is clearly behind the Mozal smelter which is seen as important for regional development, and is keen to facilitate its operations in whatever way is necessary. The tax official in Mozambique interviewed for this report said that Mozal was seen as making a tax contribution mainly through the tax paid by its employees on their incomes, rather than tax on the company profits.

Secrecy

While the tax rates on offer to companies operating in the various Industrial Free Zones of Mozambique are publicly available, the details of the full fiscal package on offer to entice them to locate in the country are not so transparent. Again taking Mozal as an example, Davie (2010) reports that as well as low taxes, the company has been supplied with very cheap electricity by Eskom, the South African state supplier. The deal was made secretly, and when the details became public, it caused some controversy at a time when large parts of South Africa were suffering rolling blackouts due to the inability of Eskom to maintain a steady supply. This sort of non-transparent subsidy erodes public confidence in the government's dealings with multinational enterprises, and their ability to regulate and tax them. One tax advisor

noted, however, that as a matter of overall policy the Mozambican government has been seeking to reduce these opaque benefits on offer to incoming multinational firms in an effort to overcome the problems associated with them.

Isolation and double tax treaties

Mozambique has very few double tax treaties, with only six in operation or under negotiation at the time of writing. These are with Portugal, Italy, the United Arab Emirates, South Africa, Mauritius and India. These are mainly held with nearby countries, the former colonial power and with Italy which was a very important player in the peace process. As the holder of so few double tax treaties, Mozambique runs the risk of international isolation. Furthermore, in the absence of a workable tax treaty, multinational firms locating in a country are more likely to negotiate one-to-one agreements with the host government on how they will be taxed. Such agreements tend to be opaque, and difficult for to challenge. A wider network would help countries such as Mozambique to develop a more transparent international tax system.

In summary, Mozambique is making rapid progress towards a fairer and more transparent system, and Nathan Associates (2009) says "*The Principal features of the tax system accord well with best practices for developing countries.*" One tax advisor based in Maputo agrees, noting that "*the tax system is quite modern and based essentially on the OECD model*". However, it still retains most of the classic problems affecting tax collection in Southern countries: corruption, the informal economy, complexity, a narrow tax base imposed through the reduction of export taxes and trade tariffs, a culture of evasion, gaps in the capacity of tax officials, deficient rule of law, etc. The impact this has on the people of Mozambique is evident not only in terms of poverty and lack of infrastructure, but also in the weakness of civil society highlighted by Francisco et al (2008) which is symptomatic of reduced accountability of government and a lack of empowerment among the population. Significantly, large, foreign companies continue to pay very little tax in the country.

5.4: Kenmare in Mozambique

Kenmare Resources is an Irish-registered company floated on the London and Dublin stock exchanges^{xxviii} which operates the Moma Titanium Minerals Mine in the North of Mozambique. The mine produces titanium minerals ilmenite and rutile as well as the zirconium mineral zircon which is used in the ceramics industry. Ilmenite and rutile are used as feedstock to produce titanium dioxide pigment (90%) and titanium metal and welding electrodes (10%). Titanium dioxide pigment is in turn used in the manufacture of paints, other coatings and plastics, as a whitener for paper, as well as in a number of other applications, including cosmetics, food additives, ceramics, inks and textiles. The reserves are very rich: Armitage (2008) quotes Michael Carvill the CEO of Kenmare as predicting "*well over 100 years worth of mining*".

Kenmare is by any standards a successful company. While it has made net losses over the last few years, these are primarily attributable to the fact that the mine has been ramping-up production volumes. The global recession has been a contributory factor, as demand for their products hinges directly on international demand for paint and plastics. Losses are expected to continue through 2010, but Davy Stockbrokers predict a return to profit in 2011 and positive outlook thereafter based on increases in both demand and price in the market for titanium-based products^{xxix}. Another factor cited by Davy is the growing production levels at the Moma mine, where overall output increased by over 60% in 2010 over the previous year's figures.

Kenmare Moma Associação de Desenvolvimento (KMAD)

As described in Abuodha (2002), titanium mining is a messy, water-based process which can be very damaging to the environment and has met with local and international protests in other African countries. However, Kenmare's Moma mine has met no such opposition. This is despite the fact that the population of a village in the mining area had to be resettled, as did a number of families living in the path of power-lines built by the company to bring electricity to the relatively remote area in which the mine operates.

This may be due to the high level of local engagement of Kenmare, and the priority which they place on their relationship with the local community. The company has established an award-winning^{xxx} development association (KMAD) which works with local leaders to develop projects of benefit to the area. In an interview with the author of this report, the company's representative was very clear on this sense of responsibility and on the company's aim to ensure that the mine benefits all the people living in the locality. This was not negotiated with government, as confirmed by Mulligan (2007)^{xxxi}. Unlike, for example, Tullow Mining in Uganda, Kenmare does not work in conjunction with Irish Aid, mainly because of the remote location of the mine. However, through KMAD they have established a wide range of projects including the establishment of poultry and fish enterprises which supply the mine but also sell produce independently, the expansion and upgrading of local schools, agricultural improvements such as irrigation schemes and the restocking of livestock, healthcare with a focus on HIV/Aids, savings and credit schemes and sports. The project is described by Kennard (2010) as "*one of the success stories of this trend of corporate concern about reputation in the mining industry*". Given this high level of community engagement, it is disappointing that taxation is not seen as part of the social contract between the company and the community. While there is little doubt that Kenmare's and KMAD's presence in Mozambique benefits the local population and the economy, this benefit is not secured and is not transferable to other mining companies which might locate in the area over the next 100 years of mineral production. Davy Stockbrokers predict that by 2011 the company will be generating annual revenue of \$142,500,000, and making an annual profit before tax of \$33,000,000. Mozambique has a statutory tax rate of 32%. Even a relatively low tax of one third of this rate could yield significant revenue for the Mozambican government over the coming decades.

The company's website lists the favourable tax treatment afforded by the Mozambican government as one of the top ten factors to make the project a low cost one. To date, profits have been negligible. The company has invested in excess of US\$500 million over a 20 year period and is only now getting to a stage where the mine is operating at close to full production and approaching profitability. The 2009 annual report states that "*The fiscal regime applicable to the mine allows for a 50% reduction in the corporate tax in the initial ten year period of production following start-up and charges a royalty of 3% based on minerals sold.*"

The report goes on to explain that the mine has been designated with Industrial Free Zone (IFZ) status, which means that it pays no corporation tax, import duties, export duties or Value Added Tax for the first six years. After that date, a turnover tax of 1% is levied. The inter-relationship between these two positions has the net effect that the company, while fully complying with local regulations, has never paid tax on the profits from the Moma mine in Mozambique.

CSR as a voluntary tax

One could argue that expenditure on CSR can amount to a form of voluntary tax which is applied to benefit the population, and that this achieves the same effect as paying tax to the central government. There are, however, a number of flaws with the "voluntary tax" line of thinking.

The most obvious problem is the simple fact that it is voluntary, rather than imposed by government. Because CSR initiatives are unenforceable there is no way to ensure that they continue into the future. Secondly, the voluntary nature of the CSR initiatives creates a power imbalance with the local community. The "good behaviour" of the company is entirely at their discretion, and so no rights are conferred on local stakeholders. For local context, Harmann (2003) and Harmann and Kepulis (2004) describe how among mining companies in Southern Africa, CSR is rarely linked to real accountability to the local community, and so presents real challenges for the mining companies themselves. Thirdly, unlike a tax on profits, each CSR initiative is unique to the particular firm which operates it, and cannot be extended to other companies which might operate in the area in the future. This can contribute to the overall risk of dependency among the local population, although it is noteworthy that this is something that most multinationals seek to avoid. Finally, simple "doing good", however well thought out, cannot replace the more comprehensive provision for the needs of a population which is served by an efficient tax and redistribution system. This is not a reflection on the efforts of companies engaging in CSR, but rather on the sustainability of this philanthropic model overall for local development.

6.

Challenges for Ireland

Conclusions and Recommendations

In recent decades, Ireland's economic success or failure has been pinned to its ability to attract and retain foreign direct investment from overseas. Ireland's tax system is seen as a key means to achieve this, and so has been largely tailored to the needs of multinational firms. While the intention is not to compete with Southern countries for investment or to use tax rules to draw revenue from them, nonetheless Ireland's tax system is open to abuse by multinational firms in a way that directly or indirectly damages the tax take of Southern countries.

This is clearly undesirable, and in conflict with Ireland's commitment to supporting coherence in its development cooperation policy. This commitment to policy coherence is cited in the 2006 White Paper on Irish Aid as "*Ireland will work for a coherent approach to development across all Government Departments.*" (White Paper, 2006:9) The Paper goes on in Part VI to explain that coherence is intended to mean more than simply checking if Ireland's international policies are in conflict with its development cooperation policies. "*It is also about harnessing the potential across Government for ideas and actions which can contribute to sustainable global development and to the objectives of Irish Aid.*"

There are a number of steps Ireland could take which would go some way to resolve the situation while at the same time not compromising competitiveness for international investment. Some of the eleven points below focus directly on taxation, on Ireland's system and that of other countries. Other recommendations aim to undo the collateral damage caused by Ireland's commitment to low corporation tax rates. None are particularly costly, and many could result in a net economic benefit to Ireland in the future. For convenience, they are grouped broadly as domestic issues and those with more international scope. It is important to note that they do not come at any significant cost, and require very little other than political will to implement.

Recommendations – On a national level

1. Adjust the transfer pricing regime to grant powers to the Revenue Commissioners to adjust transactions which boost Irish profits as well as those which deplete them.

As set out in section 3, the incoming transfer pricing rules allow Irish tax officials to tackle transfer pricing abuse only when an Irish firm is claiming an inflated tax deduction, or artificially reducing taxable income. Given the low Irish corporate tax rates, as demonstrated in section 4 above, this leaves open the position where the Irish tax system is used by a multinational firm to deplete the resources of a low income country. Closing this loophole would be consistent with the OECD (2008) recommendation that Northern countries work to ensure that multinational firms pay their fair share of tax, and would strengthen the case that Ireland is a well-regulated non-tax-haven jurisdiction.

2. Maintain vigilance on companies operating in Ireland without a large economic presence, particularly those with large intra-group transfers.

With improved exchange of information between taxing authorities, it should become easier to identify groups which are abusing the system, and with enhanced powers on transfer pricing, appropriate action can be taken by the Irish taxing authorities.

3. Continue to provide a steady and predictable stream of aid to Southern countries, targeted at measures which improve the state capacity to collect revenue.

Irish Aid has already achieved excellent results in the area of governance, and the capacity of a state to raise taxes is a key part of this. Governance is one of four cross-cutting issues for Irish Aid, and their work in this area needs predictable and steady funding in order to be effective.

4. Continue to set an international example of the links between tax and accountability and governance by working towards a situation in which all Irish workers in Southern countries pay tax locally.

The fact that all staff in the Embassy of Ireland in Uganda now pay PAYE to the Uganda Revenue Authority is a welcome development in this regard.

5. Abolish the tax exemption on patent royalty income, as recommended by the 2009 Commission on Taxation report.

This will produce a considerable tax saving to the Irish exchequer, and dampen the level of transfer pricing abuse around intellectual property.

Recommendations - On an international level

6. Continue to work with the taxing authorities of Southern countries to expand their capacity following the model established with Rwanda.

If possible, the cooperation between the Irish Revenue and the Rwandan Revenue Authority should be extended to other countries in the region in cooperation with Irish Aid.

7. Negotiate tax treaties with Southern countries on a multi-lateral basis using the UN model as the template.

The treaty negotiation and agreement process is a long one, and many Southern countries have a very thin network. This makes it more difficult for them to attract foreign direct investment, and leaves them open to harsh terms if treaties need to be agreed at short notice in order to facilitate a major investment. By agreeing fair treaties now rather than waiting until the volume of trade demands it, Ireland can set a precedent for fairness in tax matters for Southern countries. It would continue the Irish Revenue's growing tradition of engagement with the taxing authorities of Southern countries, and also place Ireland in a strong position economically to engage in trade with Southern countries as they become more internationally active.

8. Use Ireland's influence within OECD, EU, World Bank and IMF to support Southern countries in designing and strengthening their own tax systems and in continuing to impose trade tariffs and customs duties where necessary.

Stijns (2010) summarises the relevant academic literature as recommending "*that taxes should be levied at low and relatively flat rates on bases that have been broadened through the elimination of exemptions and other loopholes*". As long as most of the economy remains informal, it will be all but impossible for Southern countries to move away from trade tariffs and still raise enough revenue to meet the needs of their people.

9. Enhance the level of information exchange between the Irish Revenue and other taxing authorities.

The inclusion in new tax treaties of a clause on exchange of information is very welcome in this regard. While there are data protection and human rights issues that need to be addressed, this needs to be extended to older treaty partners, and the exchange of information should be automatic rather than on request.

10. Proactively advocate for the introduction of country by country financial reporting for multinational corporations by the International Accounting Standards Board (IASB).

This issue is under consideration by the OECD task force on tax and development and at EU level, and Ireland's input on the precise form of country by country reporting which would be most useful would be welcome.

11. Strengthen Ireland's position on international tax evasion through enhanced tax transparency and improved measures to combat capital flight.

Arguably, Ireland's low tax rates give the impression that as a country it is interested in helping multinational firms to avoid paying tax elsewhere. This branding problem needs to be addressed by active participation in measures designed to reduce capital flight from Southern countries, and enhance their capacity to raise revenue domestically. As well as helping the welfare of people in Southern countries affected by international tax avoidance, this will strengthen Ireland's reputation, and enhance its ability to attract foreign direct investment.

In September 2010, the Irish Minister for Foreign Affairs addressed the UN General Assembly High Level Plenary Meeting on the Millennium Development Goals, and used the occasion to *"reaffirm Ireland's commitment to the ideals, aspirations and specific targets set out in the MDGs. They reflect our values as a people. We remain determined to work in partnership for their achievement."*

It is clear that international tax evasion and capital flight are seriously depleting the tax revenues of the global South. It is also clear that Ireland's tax system can be used by multinational firms as a vehicle to facilitate this and that there is more Ireland could do to stop this. In order to achieve policy coherence on development, it is essential that Ireland take steps to close gaps in the tax system which could allow multinational firms to use the Irish tax system in a way that impoverishes Southern countries. Even if Ireland does not actively participate in capital flight whether legal or illicit, the Irish government has a moral responsibility to ensure that its tax rules are not supporting a practice which impoverishes hundreds of millions of the world's poorest citizens, in direct contravention of its own stated values as a people. To use a very basic metaphor, Southern countries are clearly being robbed. Ireland needs to make sure that its tax system does not become the getaway car.



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Appendix 1: World's largest economies ^{xxxii}

Rank	Company	Industry	Sales/GDP (\$bil)	Rank	Company	Industry	Sales/GDP (\$bil)
1	United States		14,256.28	27	Denmark		309.252
2	Japan		5,068.06	28	Thailand		263.889
3	Germany		3,352.74	29	Toyota Motor	Consumer Durables	263.42
4	France		2,675.92	30	Chevron	Oil & Gas Operations	255.11
5	United Kingdom		2,183.61	31	Finland		238.128
6	Italy		2,118.26	32	Portugal		227.855
7	Brazil		1,574.04	33	Ireland		227.781
8	Spain		1,464.04	34	Hong Kong SAR		210.731
9	Canada		1,336.43	35	Israel		194.825
10	Australia		997.201	36	Malaysia		191.463
11	Mexico		874.903	37	General Electric	Conglomerates	182.52
12	Korea		832.512	38	Singapore		177.132
13	Netherlands		794.777	39	Romania		161.521
14	Turkey		615.329	40	Philippines		160.991
15	Indonesia		539.377	41	Volkswagen Group	Consumer Durables	158.4
16	Royal Dutch Shell	Oil & Gas Operations	458.36	42	ENI	Oil & Gas Operations	158.32
17	Poland		430.197	43	Sinopec-China Petroleum	Oil & Gas Operations	154.28
18	Exxon Mobil	Oil & Gas Operations	425.7	44	HSBC Holdings	Banking	142.05
19	Wal-Mart Stores	Retailing	405.61	45	ArcelorMittal	Materials	124.94
20	Norway		382.983	46	Deutsche Bank	Financial	124.78
21	Austria		381.88	47	AT&T	Telecommunications	124.03
22	Taiwan Province of China		378.969	48	Honda Motor	Consumer Durables	120.27
23	BP	Oil & Gas Operations	361.14	49	Hewlett-Packard	Technology	118.7
24	Venezuela		337.295	50	Generali Group	Insurance	118.39
25	Greece		330.78				
26	Argentina		310.065				

Appendix 2: Acronyms and Abbreviations

ATAF	African Tax Administration Forum
ATM	Autoridade Tributária de Mocambique
AWEPA	Association of European Parliamentarians with Africa
CEO	Chief Executive Officer
CFA	Committee on Fiscal Affairs
CSR	Corporate Social Responsibility
DAC	Development Assistance Committee
EPA	Economic Partnership Agreement
EU	European Union
FDI	Foreign Direct Investment
G20	Group of 20 ^{xxxiii}
GDP	Gross Domestic Product
HIPC	Heavily Indebted Poor Countries
ICF	Investment Climate Facility for Africa
IFSC	International Financial Services Centre
IMF	International Monetary Fund
NGO	Non-Governmental Organisation
OECD	Organisation for Economic Co-operation and Development
PARPA	Plano de Ação para a Redução da Pobreza Absoluta
R&D	Research and Development
RRA	Rwanda Revenue Authority
SADC	Southern African Development Community
UNDP	United Nations Development Programme
USAID	United States Agency for International Development
VAT	Value Added Tax
WHO	World Health Organisation

Appendix 3: Endnotes

- i See <http://evl.fi> for details
- ii Sir Charles Trevelyan was the British civil servant in charge of famine relief in Ireland in the 1840s. He took an unsympathetic line towards the local population. Corn grown in Ireland was stored for export rather than distributed, and a well-known Irish folk song commemorates the deportation of a young man for stealing "Trevelyan's corn".
- iii For a useful summary of evidence on the links between taxation accountability see OECD (2008a)
- iv The Yaounde Declaration on Taxation and Development, signed in September 2010, is available online at <http://www.taxjustice.net>
- v References are included in the bibliography.
- vi See the section on Mozambique for an example of this
- vii Available online at www.doingbusiness.org
- viii This is an Irish parliamentary committee
- ix Source: African Economic Outlook
- x As disclosed in the company's 2009 annual report
- xi Source: <http://allafrica.com/stories/200808260398.html>
- xii London Mining Company 2009 Annual Report, Chairman's Statement. Available online at <http://www.londonmining.co.uk>
- xiii Source: http://www.oecd.org/document/23/0,3343,en_2649_33745_30575447_1_1_1_1,00.html
- xiv It is worth noting that while trading income is taxed at 12.5%, a rate of 25% applies to non-trading or investment income.
- xv Source: www.ifsc.ie
- xvi A full list together with notes on recent developments is available at <http://www.revenue.ie/en/practitioner/law/tax-treaties.html>
- xvii A recent example is the DTA signed with Singapore on October 28, 2010, which provides for exchange of information on request.
- xviii See <http://www.bilaterals.org/spip.php?article18147> for a fuller discussion
- xix *Inter alia* by Joe Higgins, MEP, at JCFA 2010
- xx Note that the Irish Revenue could argue that this is a passive stream of income in the hands of the Irish company, and tax it at 25% rather than 12.5%.
- xxi Available online at <https://www.cia.gov/library/publications/the-world-factbook/geos/mz.html>
- xxii Parpa II runs from 2006 onwards
- xxiii According to a Mozambican government official interviewed for this report
- xxiv The material in this section was obtained by direct interviews with Mozambican tax officials, Southern African academics, and Mozambican tax advisors, as well as review of secondary sources including Deloitte (2010), KPMG (2009), USAID (2009) and Nathan Associates (2004), as well as and local English-language press such as the South African Mail and Guardian (www.mg.co.za)

- ^{xxv} A case study on the murders is available online at http://www.ipocafrika.org/index.php?option=com_content&view=article&id=72&Itemid=65
- ^{xxvi} The advisor requested anonymity
- ^{xxvii} <http://www.livaningo.org.mz/>
- ^{xxviii} Although in early August 2010 Kenmare's Dublin Stock Exchange listing was reclassified from a primary to a secondary one, to facilitate UK nationality for inclusion in the FTSE indices, thus giving a wider exposure to the shares. The company retains its Irish-incorporated status
- ^{xxix} Analysis at www.davy.ie/
- ^{xxx} Both a Nedbank Capital Green Mining Award 2009 and the Chambers of Ireland Best International CSR Programme 2009
- ^{xxxi} Mulligan quotes Kenmare's CEO Michael Carvill, referring to the work of the Development Association KMAD, as saying "We could have secured the contracts at Moma without doing all that, but we wanted to. The Government never pressurised us to do it."
- ^{xxxii} The country information is sourced from the IMF World Economic Outlook database (IMF(2010) and the company information is from Forbes (De Carlo 2009). All data is from 2009.
- ^{xxxiii} Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, México, Russia, Saudi Arabia, South Africa, Korea, Turkey, the United Kingdom, United States and European Union



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