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# Approaches and Impacts

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# Introduction

Tax policy has been at the heart of policy advice from the International Financial Institutions (IFIs) to developing countries for the last twenty years. Tax reforms became an increasingly important part of the structural adjustment programmes promoted by the World Bank and the IMF in developing countries from the late 1980's.<sup>1</sup>

Until early 2011 neither the IMF nor the World Bank had published an official account of their approach to tax policy in developing countries, despite the fact that this thinking underpinned the technical assistance they provide to developing countries and shapes conditions attached to loans.

The lack of official public communication on tax policy advice by the IFIs has markedly changed with the publication of the recent Fiscal Affairs Department (FAD) paper.<sup>2</sup> In March 2011 the FAD of the IMF, which has responsibility for developing the IMF's advice on tax policy and administration, published an extensive paper, 'Revenue Mobilization in Developing Countries,' which sets out the organisation's views for how developing countries could improve their revenue mobilisation.<sup>3</sup>

This paper reviews existing literature on the IFIs approach to tax policy reform during the last decade. NGO and academic research suggest that the IFIs have used technical assistance and policy advice to encourage developing countries to reform their tax systems according to a consistent template of interlinked policy prescriptions. This set of policy reforms has been called a 'consensus' on tax policy which has been referred to by numerous authors.

The term 'tax consensus' can be used in two ways – it refers to the policies that are frequently recommended by the IFIs on tax reform in developing countries; such as reducing trade tariffs, introducing VAT, improving tax administration and removing exemptions. In addition authors have criticised these policies and the way they have been introduced and so the term 'tax consensus' can infer these criticisms.

However, the literature examined predates the new IMF paper, and this new paper does change the analysis. The paper responds to many of the criticisms made of the tax consensus, such as 'one size fits all,' and the lack of attention to the equity impacts of reform advice. For instance the paper says that "political and social views on the proper degree of progressivity vary widely, the traditional role of the external advisor then being to describe and assess alternatives." Thus it recognises that the role of the IMF is to inform and respond to government in developing countries.

Here we examine the criticisms that have been made of IFI tax policy advice and the extent to which the new IMF has responded to them. We elaborate on the key policies using the comments of the recent IMF paper.

The first section of this paper examines the policy reforms promoted by the IMF in particular and what has been said about the tax consensus. The second section examines the different mechanisms through which the IMF and the World Bank have influence over developing country governments and the tax policies that they set. These mechanisms have increasingly moved from structural adjustment and hard conditionality attached to loans, to policy advice given through

1 Javad Khalilzadeh-Shirazi and Anwar Shah, 'Tax reform in developing countries. What constitutes successful tax reform?' *Finance and Development*, June 1991

2 Fiscal Affairs Department, 'Revenue Mobilization in Developing Countries' IMF, March 2011

3 Fiscal Affairs Department, IMF, 2011, *op. cit.*

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technical assistance, prior actions and benchmarks agreed with governments in advance of loans and indicators produced by the World Bank and IFC. The third section presents existing research on the impacts of IMF tax policies advice particularly looking at the impacts of VAT, trade liberalisation and whether IMF advice has contributed to tax competition.

# 1. IFI tax policy advice

## 1.1 Is there a pattern to IMF tax reform advice?

The “One size fits all? IMF tax policy in sub-Saharan Africa” report by John Marshall<sup>4</sup> examines specific IMF tax policy recommendations spanning the period 1998-2008. It is based on an analysis of official IMF policy documents for 18 sub-Saharan African economies with a mean of 12.4 policy documents analysed per country. The policy documents include Poverty Reduction and Growth Facility (PRGF) papers, Policy Support Instrument (PSI) documents and Article IV consultations which are either directly or indirectly linked to disbursement of loans. The recommendations in them therefore have considerable weight with developing country governments.

Marshall identifies key features of IFI policy advice as;

- Reductions in the rate of corporate and to a lesser extent, personal income taxation
- Trade liberalisation (reduction of both export and import taxation)
- The introduction or expansion of sales tax (and a value added tax VAT, in particular), often including an element of regional harmonisation
- The need to reduce the number of incentives and exemptions across the tax code
- Significant structural overhauls to the tax administration

The analysis shows the frequency with which IMF recommendations match the policies of the tax consensus. At the same time Marshall compares the contents of Poverty Reduction Strategy Papers (PRSP), which despite likely influence from the IFIs in the drafting process, are meant to reflect the development priorities of developing countries themselves.

In this section we present the findings of the ‘One size fits all report’ in terms of the frequency that certain recommendations are made by the IMF and examine the IMF’s official policy on them using what is said in the recent paper recommendations and include views that come across from IFI staff articles.

### Value Added Tax (VAT)

IMF country reports strongly supported the introduction or expansion of sales taxes (VAT in particular), in sub-Saharan Africa, often including an element of regional harmonisation. This is reflected in 33 per cent of the IMF papers examined by Marshall endorsing an increase in the VAT base with a meagre 11 per cent seeking to expand sales taxes, demonstrating that generally VAT is preferred to sales taxes.<sup>5</sup>

A study by Damme, Misrahi and Orel also provides empirical evidence on IMF advice on tax matters by looking at a sample of 54 IMF Article IV reports published between 2005 and 2008 from a sample of 10 Low-Income Countries and 10 Middle-Income Countries. They found that, “VAT was recommended or endorsed by the IMF in 90 per cent of the overall sample and 80 per cent of the consultations advised a decrease in tax exemptions.”<sup>6</sup>

Support for a VAT is one of the most distinctive and prevalent features of IFI tax policy advice in developing countries. Support for introducing VAT was present in a 1991 paper written by

4 John Marshall ‘One size fits all? IMF tax policy in Sub Saharan Africa’ Christian Aid, occasional paper N°2, April 2009

5 *Ibid.*

6 Damme Lauren, Mishari Tiffany and Orel Stephanie, “Taxation policy in developing countries. What is the IMF’s involvement?” Bretton Woods Project, April 2008”

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Khalilzadeh-Shirazi and Shah which proposed that VAT should form an important element of an agenda for sales tax reform in developing countries.<sup>7</sup>

The 2011 IMF paper recognises that the IMF has been responsible for the introduction of VAT: “The Fund has been active in its promotion, and VAT adoption and implementation continue to be a significant part of its technical assistance (TA).”<sup>8</sup>

In a section entitled ‘The common elements of strategies for reform’, they list:

- Replacing inefficient production or sales taxes, after adequate preparation of both the administration and taxpayers, by a simple VAT—including to catalyze administrative reforms.
- Levying a VAT on a broad base, with a high threshold (the level of turnover at which registering for the tax becomes compulsory) and avoiding multiple rates, to realize its potential as a reasonably efficient source of government finance.

The most important question around the IFI’s promotion of VAT is their approach to the equity implications of the indirect tax, and whether they allow for exemptions which may reduce the tax burden on the poorest.

#### **Reducing trade tariffs**

Emran and Stiglitz wrote in a 2005 paper, “[O]ver the last few decades, a general consensus regarding the indirect tax reform in developing countries has emerged that spans academic economists and policy practitioners. A reduction in the trade tax with a compensating or revenue-enhancing increase in VAT has been the centre piece of such a reform and it has been implemented in a large number of developing countries under the structural adjustment and stabilisation policy conditionalities of the IMF and the World Bank.”<sup>9</sup>

Marshall found that across the range of taxes, trade liberalisation (reduction of both export and import taxation), was the most frequent recommendation in terms of changes to tax rates: 60 per cent of IMF papers argue for import-tariff reductions and 22 per cent advocate lowering export-tax rates. There are pertinent differences between IMF and PRSP papers, with the IMF papers showing noticeably more enthusiasm for reducing both import and export taxes. Just 4 per cent of government owned PRSP papers recommend cutting export tariffs compared to over 20 per cent of IMF papers.<sup>10</sup>

The recent IMF paper shows both support for trade liberalisation and recognition of the reduction in revenues it entails, “Trade tax revenues, still important to many developing countries, are set to continue to decline (...) Further liberalisation (...) mean that the trend will continue. While the efficiency and growth implications of this are welcome, the fiscal challenges can be significant.”<sup>11</sup>

IMF staff, Tanzi and Zee have advised reducing all nominal tariff rates by the same proportion and that the subsequent revenue losses can be avoided through a clear cut strategy: first reducing the scope of tariff exemptions and then compensating for the tariff reductions on excisable imports by

<sup>7</sup> Javad Khalilzadeh-Shirazi and Anwar Shah, 1991, *op. cit.*

<sup>8</sup> Fiscal Affairs Department, IMF, 2011, *op. cit.*

<sup>9</sup> M. Shahe Emran and Joseph Stiglitz, ‘On selective indirect tax reform in developing countries’, *Journal of Public Economics* 89 (2005)

<sup>10</sup> John Marshall, 2009, *op. cit.*

<sup>11</sup> Fiscal Affairs Department, IMF, 2011, *op. cit.*

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a commensurate increase in their excise rates, and finally adjusting the rate of the general consumption tax (VAT) to meet remaining revenue needs.<sup>12</sup> The recent IMF paper also recognises that income tax may be part of the solution saying that “IMF case studies (2005) suggest that successful replacement [of lost trade taxes] has been associated with using a range of instruments, including the income tax.”<sup>13</sup>

#### **Reduction in exemptions**

Marshall found that reductions in the number of incentives and exemptions across the tax code was a frequent recommendation in relation to every type of tax which received attention from the IMF papers: it was recommended in 38 per cent of papers related to CIT, 28 per cent in relation to import tariffs, 21 per cent in relation to VAT and 22 per cent in relation to natural resource taxes.<sup>14</sup>

This is often an attempt to ensure that there are not special provisions for interest groups which are inefficient and cost the government substantially through tax expenditure. However some of these exemptions particularly VAT exemptions on basic goods would have been introduced in order to relieve the tax burden on low income households.

Marshall writes that, “The IMF strongly supports a uniform rate and removing exemptions for most goods, or all goods in the case of Ethiopia.”<sup>15</sup> In practice the IMF has sometimes advocated to remove exemptions from VAT which are aimed at the poorest, for example in 2006 the IMF suggested to Zambia that in the 2007 national budget the government should reintroduce VAT on exempt items, such as food and other agricultural products, water and sewerage, domestic transportation, mosquito nets, books, magazines and newspapers.<sup>16</sup> Section 3 explores in more detail what research has found about the distributional impacts of VAT and the IMF’s position on exemptions and reduced rates.

#### **Improving tax administration**

The most frequent recommendation across all the papers examined by Marshall was for structural overhauls to the tax administration: a focus on improving the existing administrative system and thereby alleviating the revenue constraints resulting from ineffective capacity. This recommendation also met with unequivocal support from domestic governments who commit to improving efficiency across nine of ten tax categories in their PRSPs.<sup>17</sup>

Administration continues to be a core focus of the IFIs technical assistance on tax. In the FAD paper the first four of fourteen common elements of strategies for reform are concerned with improving the capability of revenue administration. The measures recommended include to, “implement voluntary compliance and self-assessment (...) strong control of the largest taxpayers, in a dedicated office (...) implementing policies and procedures that limit opportunities for rent seeking.”<sup>18</sup>

<sup>12</sup> Vito Tanzi and Howell Zee, ‘Tax policy for developing countries’, in IMF Economic Issues, No 27, March 2001

<sup>13</sup> Fiscal Affairs Department, IMF, 2011, *op. cit.*

<sup>14</sup> John Marshall, 2009, *op. cit.*

<sup>15</sup> *Ibid.*

<sup>16</sup> <http://bit.ly/epX37e> 26 December 2006

<sup>17</sup> John Marshall, 2009, *op. cit.*

<sup>18</sup> Fiscal Affairs Department, IMF, 2011, *op. cit.*

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Tanzi and Zee summarise the problems facing the establishment of an efficient tax system in developing countries. They find that the four main challenges are: the high proportion of informal sector work, the lack of a well-trained and resourced revenue staff, the inability to generate reliable statistics which prevents policymakers from assessing the potential impact of major changes to the tax system and the economic and political power of the rich which often allows them to prevent fiscal reforms that would increase their tax burdens. The statement by Tanzi and Zee that “in developing countries, tax policy is often the art of the possible rather than the pursuit of the optimal,”<sup>19</sup> is an important aspect of IFI advice to developing countries. They are aiming to make their advice wise to the political and administrative context. Similarly Shirazi and Shah state that “the broad goal of tax reform is to secure an efficient tax system based on taxes that are politically feasible and administratively practicable, and produce sufficient revenue with a minimum of economic distortion.”<sup>20</sup>

#### **Corporate Income Tax (CIT)**

Recommendations for reducing corporate income tax rates were common in IMF papers. Marshall found that reducing CIT rates was stressed in 16 per cent of IMF papers along with an emphasis on enhancing collection; 44 per cent of papers recommended enhancing the base.<sup>21</sup> Marshall writes that “it seems likely that this approach is reflected in the 12 per cent point average reduction in statutory CIT rates experienced across sub-Saharan Africa since 1990, and may continue with sub-Saharan African rates remaining relatively high in the global context.”

Tanzi and Zee recommend taxing labour instead of capital arguing that “small countries should not levy source-based taxes on capital income.” This is based on the argument that capital is highly mobile compared to labour (thus, more difficult to tax).

An IMF paper by Alexander Klemm<sup>22</sup> follows this line of theory stating that to take the principle of taxing labour not capital to its conclusion would mean going as far as *abolishing* corporate income tax: “The complete abolition of corporate income tax would be the most direct application of the theoretical result that small open economies should not tax capital income (...) In the extreme case of perfectly mobile capital and immobile labour, this is clearly optimal. Moreover, any necessary increase in personal income taxation would not harm employees, as they also bore the corporate income tax.” Although he recognises that the abolition of corporate income taxes might well be fraught with administrative and political problems.

The recent IMF paper fails to explain the factors that lead the IMF to advise governments on the CIT rates that they set. Instead the paper presents the downward trend in statutory rates of CIT as something which has taken place without its involvement. It does however recognise the importance of this tax, “The revenue challenges that such downward pressures could pose are a greater concern for developing than advanced economies: the CIT raises about 17 per cent of total tax in the former, compared to 10 per cent (pre-crisis) in the OECD.”

For the first time however, the IMF officially recognises the challenges faced by developing countries due to profit shifting by multinationals which undermines the ability of the government to

19 Vito Tanzi and Howell Zee, 2001, *op. cit.*

20 Javad Khalilzadeh-Shirazi and Anwar Shah, 1991, *op. cit.*

21 John Marshall, 2009, *op. cit.*

22 Alexander Klemm, ‘Causes, benefits and risks of business tax incentives.’ IMF working Paper January 2009

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raise corporate income tax on these companies' profits. It states as one of its common elements of strategies for reform, "Strengthening capacity to deal with profit shifting by multinationals, while recognizing the extreme difficulty of doing so."<sup>23</sup>

#### **Personal Income Tax (PIT)**

Personal income tax was found to be a less significant issue in country reports than CIT, addressed in 10 per cent of the papers. Enhancing the base for mobilisation is a frequent recommendation particularly in poverty reduction strategy papers (PRSPs) which more closely reflect the domestic government's opinions.<sup>24</sup>

In the past Tanzi and Zee emphasised the need to simplify personal income taxes in many countries, "Effective rate progressivity could be improved by reducing the degree of nominal rate progressivity, the number of income brackets and reducing exemptions and deductions. Indeed, any reasonable equity objective would require no more than a few nominal rate brackets in the personal income tax structure."<sup>25</sup> However the IMF paper on domestic revenue mobilisation reflects that "Top statutory rates of PIT have been cut and rate structures simplified, but with no discernible behavioural impact." Instead it raises the possibility of raising thresholds for PIT in order to better focus on high income individuals.<sup>26</sup>

The recent IMF paper reports that a 'global' income tax, "a progressive charge on the sum of income from all sources" has failed for many reasons; instead they note that "many lower income countries have schedular systems – taxing different types of income separately." They write that some advanced countries have moved to a schedular taxation, the 'dual income tax' (DIT) applying a progressive tax to labour income but a lower uniform rate to capital income. They recommend that "movement towards explicit and more coherent schedular taxation – with limited discrimination between different types of income – can be a practical option towards greater effectiveness."<sup>27</sup>

Tanzi and Zee show a comparison of the ratio of income to consumption taxes in industrial and developing countries which indicates that economic development tends to lead to a relative shift in the composition of revenue from consumption to personal income taxes.<sup>28</sup> This suggests that the tax reform advice of the IMF is likely to emphasise raising more revenue from consumption taxes rather than personal income tax until a country has reached a certain level of development, probably involving a high percentage of the population working in the formal rather than informal sector.

#### **Property and wealth taxes**

Marshall and Cobham find that the IFI tax consensus ignores the use of property and wealth taxes, which may be politically difficult to levy, but can be strongly progressive and may be an optimal policy in the case of market distortions. These taxes were mentioned in less than 5 per cent of the papers examined by Marshall.

<sup>23</sup> Fiscal Affairs Department, IMF, 2011, *op. cit.*

<sup>24</sup> John Marshall, 2009, *op. cit.*

<sup>25</sup> Vito Tanzi and Howell Zee, 2001, *op. cit.*

<sup>26</sup> Fiscal Affairs Department, IMF, 2011, *op. cit.*

<sup>27</sup> *Ibid.*

<sup>28</sup> Vito Tanzi and Howell Zee, 'Tax Policy for Emerging Markets: Developing Countries', *National Tax Journal* Vol LIII, No 2, 2000

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In a paper on resource mobilisation and state performance Jonathan Di John lists four reasons why property taxes can be very beneficial. These reasons include that that “urban property tax provides one of the few mechanisms through which progressive taxation can be developed in LDCs.” Di John goes on to point out that “Until now, urban property taxes have not received sufficient attention because IMF reforms focus on national taxation reform, and not municipal tax reform; and also because urban property tax reform requires long run investments in capacity, which is often downplayed compared to the quicker returns initiating VAT can produce.”<sup>29</sup>

However, the recent IMF paper is in favour of real estate taxes stating that they “can be efficient and equitable and particularly suitable for local governments.” The paper recommends that real estate taxes contribute to local government revenues rather than national, and recognises that they are progressive taxes.

#### **Excises**

Marshall writes that, “The use of excises – taxes on a few key products – to address social externalities and raise revenue (...) has proved popular in the tax consensus.”<sup>30</sup> Tanzi and Zee propose that excise taxes should be “highly selective, narrowly targeting a few goods on the grounds that their consumption entails negative externalities on society; tobacco, alcohol, petroleum products, motor vehicles, etc.”<sup>31</sup>

The recent IMF paper reiterates this saying that “Levied on a few key items, excises can serve both revenue and, in some cases, wider social ends.” It recommends that “There is scope in many countries to raise significant additional revenue from excises without adverse distributional effects.”

### **1.2 IFIs’ assessment of tax incentives**

Since the 1980’s globalisation and greater capital mobility have led many developing countries to adopt the policy of competing with one another to attract foreign investment and other capital flows. One of the main forms taken by this competition has been the granting of tax holidays and other tax deductions to investments by foreign and multinational companies. Tax incentives are popular in developing countries because they do not involve direct payment of scarce public funds. The problem is that the tax expenditure is usually not calculated by the developing country, and therefore the overall benefit or loss to the country cannot be easily established.

It is important to determine the benefits of foreign direct investment (FDI) particularly if governments are offering tax breaks to attract companies. There has been some debate about the extent of benefits to a country of attracting FDI. A 2001 G-24<sup>32</sup> paper has questioned the benefits of FDI, arguing that “there is weak evidence that FDI generates positive spillovers for host economies (...) there is little evidence at the firm or plant level that FDI raises the productivity of domestic enterprises.”

Although not prevalent in the literature, there seems to have been an assumption among civil society that the IFIs have supported the policy of offering tax incentives to attract FDI. While the IFIs do encourage countries to attract FDI (this in large part the basis for the IFC), IFI staff papers

29 Jonathan DiJohn, “Taxation, resource mobilisation and state performance,” Working paper no. 84 Crisis states research centre, November 2010

30 John Marshall, 2009, *op. cit.*

31 Vito Tanzi and Howell Zee, 2001, *op. cit.*

32 Gordon H. Hanson, “Should countries promote Foreign Direct Investment?” G-24 Discussion paper N°9, February 2001.

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and the recent IMF paper show that in general they strongly caution developing countries against offering tax incentives.

The recent IMF paper states that “Incentives pose concerns of effectiveness, leakage, governance and spillovers.’ It warns that, “Signalling a willingness to provide special tax treatment invites special pleading and corruption; and the demand for incentives, particularly tax holidays, may in part be a response to, and so entrench, corruption in the tax administration.” The paper also refers to evidence quoted in other IMF papers that “Business surveys repeatedly find that while taxation matters for foreign investors, other considerations – such as good infrastructure, quality and cost of labour, and good governance – matter more, (for instance, McKinsey 2003).”<sup>33</sup>

Demonstrating that this view is sustained throughout the IFIs, and is not unique to the IMF, a paper by Jaques Morisset, lead economist at the Foreign Investment Advisory Service, a joint facility of the International Finance Corporation and the World Bank says, “The impact of tax incentives on foreign direct investment appears ambiguous (...) Both analysis and surveys have confirmed that tax incentives are a poor instrument for compensating for negative factors in a country’s investment climate.”<sup>34</sup>

The IMF does not however categorically rule out any form of incentive. Tanzi and Zee write that “tax incentives can be justified if they address some form of market failure, most notably those involving externalities. For example, incentives targeted to promote high technology industries that promise to confer positive externalities on the rest of the economy are usually legitimate.”<sup>35</sup> According to Keen and Mansour a free zone (FZ) can help to provide high quality infrastructure and services for export companies and foreign investment, and enable export companies to more easily obtain remission of import duties and refund of VAT without the other incentives that often accompany a free zone.<sup>36</sup> An IMF paper by Klemm encourages a cost benefit analysis before adopting any tax exemption to ensure that it is suited to the specific circumstances.<sup>37</sup>

Papers by Klemm and Tanzi and Zee suggest that a better strategy is to set a low, stable corporate income tax rate to attract FDI from developed countries. The view of Jaques Morisset is that, “International investors look favourably on a country offering a low statutory tax rate, especially one well below the international norm of 35–40 per cent [now 25 per cent<sup>38</sup>]. A low corporate rate signals that the government is interested in letting the market determine the most profitable investments. But this approach can reduce tax revenues, at least during a transitional period, (in the longer run the simplicity of the tax system may attract more investors increasing the tax base and thus compensating for the initial reduction.)”<sup>39</sup>

33 Fiscal Affairs Department, IMF, 2011, *op. cit.*

34 World Bank Group, Private sector and infrastructure network “Tax incentives”, Public policy for the private sector, N° 253, February 2003

35 Vito Tanzi and Howell Zee, 2001, *op. cit.*

36 Michael Keen and Mario Mansour, ‘Revenue Mobilization in Sub-Saharan Africa: Challenges from Globalization’, IMF Working Paper, July 2009

37 Klemm, 2009, *op. cit.* For more detail on the relative advantages and disadvantages of various types of incentives by IMF staffer Klemm see Annex Table 1

38 The international norm he cites has substantially lowered since this report, and is unlikely to have been that high in 2003. According to KPMG the international average corporate tax rate was 28 per cent in 2005 and in 2010 was 25 per cent. KPMG’s corporate and indirect tax survey, 2010

39 World Bank Group, February 2003, *op. cit.*

### 1.3 Corporate taxation and profit-shifting by multinational enterprises

The IMF previously has not publicly recognised the challenges posed to developing countries by the potential for tax avoidance inherent in the sophisticated transfer pricing techniques of multinational corporations or through the provisions of double taxation treaties. However the recent IMF report picks up on both these challenges and picks up on the proposal of country by country reporting.

The report notes developing countries' "heavy reliance on multinational enterprises, whose adroitness in tax planning poses increasing challenges", and reveals that "multinational companies have opportunities for profit-shifting through intra-group transactions, financial arrangements and corporate structuring (that) ... (e)ven the most advanced tax administrations struggle with." Consequently the authors point out that "strengthening capacity and legislative framework is important, but, absent fundamental changes in international tax policies, there are no easy solutions."<sup>40</sup>

The report also notes that double tax treaties may well be to the detriment of, and thus completely unappealing to, developing countries: "the low withholding taxes [for dividends and interest payments] common in double tax treaties (DTTs), for instance, can weaken a last line of protection for weak administrations. The sheer transaction costs of negotiating DTTs can be a severe drain, which could perhaps be eased by developing multilateral treaties."<sup>41</sup>

In terms of what the IMF can do to help developing countries overcome these challenges the report does not make any firm commitments. It recognises that "advanced country decisions can ease the difficulties of developing countries (...) but can also risk deepening them," but it does not set out any way in which the IMF itself will influence the actions of developed countries. In terms of capacity building needed to better deal with transfer pricing and double tax treaties it highlights that "a realistic balance must be struck between the additional revenue to be gained in this area – by increased administrative efforts in relation to transfer pricing, for instance – and that from strengthening more prosaic aspects of administration."

The World Bank and IFC are engaged in offering technical assistance to developing countries on transfer pricing in the 'Global Tax Simplification Program.'<sup>42</sup> However given that these two organisations are behind the Doing Business Indicators, which we show in section 2 give countries a better score the lower their overall tax rate on business, it is unlikely that their technical assistance will be truly focused on enabling countries to claim the full tax bill due to them.

One of the solutions that civil society have put forward to help developing countries raise the revenues due to them from multinational companies is country by country reporting. This option is now being discussed by the OECD, the EU and possibly the G20. One rationale behind country by country reporting is that it would ensure that governments could see not only how much tax multinationals are paying in their country in relation to the profits made, it would also enable them to compare that to the company's operations in other countries including low tax jurisdictions,

<sup>40</sup> Fiscal Affairs Department, IMF, 2011, *op. cit.*

<sup>41</sup> *Ibid.*

<sup>42</sup> [http://www.taxcompact.net/transfer\\_pricing\\_study.html](http://www.taxcompact.net/transfer_pricing_study.html)

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thus making it possible to identify where transfer mispricing might be taking place. There is no legal basis under OECD transfer pricing documentation rules for a tax authority to access this information for the fellow subsidiaries of a company under investigation. The IMF paper picks up on this idea, listing country by country reporting under the heading of “initiatives to further foster transparency in tax relations” that “merit close examination.” It states that “this highly technical issue bears further study and international discussion” and “can spur greater needed thinking regarding the best ways to promote greater transparency within the existing international tax architecture.”<sup>43</sup>

At a recent IMF conference on domestic revenue mobilization involving developing country revenue officials, ministers of finance, IMF and World Bank staff, there was significant reference to the desire to tackle the challenge of transfer pricing by developing country revenue authorities but the IMF did not indicate that it would devote much of its technical assistance advice to the issue. There are a number of other international organizations that have historically been more involved with transfer pricing; the OECD which designed the arm’s length pricing rules as the means to regulate transfer pricing, and the UN which is a more legitimate forum for the engagement of developing countries.

The IMF is instead focusing heavily on the need for countries to be transparent about any tax exemptions offered to investors as well as to thoroughly cost those exemptions and make the information public. This was something that they raised at the conference on numerous occasions and had clearly lodged in the minds of developing country revenue officials as a priority issue to address. This is frequently an area where tax policy and investment promotion policy are at odds in developing countries. In its paper the IMF points to the need for ‘quantification and analysis of tax expenditures,’ saying that “by indicating the revenue costs of preferential tax arrangements, tax expenditure analyses inform and stimulate analysis and debate as to whether they generate offsetting social benefits.” In addition its guidelines for a ‘regional agreement on corporate taxation’ include a strong push for transparency of incentives stating that “the investment incentive system of each country, including its laws, regulations, guidelines, and administrative procedures, shall be transparent and readily available.”<sup>44</sup>

### **1.4 What is meant by the tax consensus?**

Commentators have used the term ‘tax consensus’ to describe the IFIs approach to tax policy.

Mick Moore writes of the “*Washington Consensus* reforms. These reforms, promoted in particular by international financial institutions, are built around a few core elements. These include: reductions in trade taxes; the introduction, where feasible, of VAT; fewer attempts to change market signals through the tax system; more emphasis on administration and administrative feasibility; and, most important for the present purposes, the general simplification of taxation systems – fewer taxes, fewer rates for individual taxes, fewer exemptions, and less discretion on the part of the tax collector and therefore a reduction of the attendant incentives for corruption.”<sup>45</sup> He describes the consensus as a set of policies that have been repeatedly recommended by the IFIs

<sup>43</sup> Fiscal Affairs Department, IMF, 2011, *op. cit.*

<sup>44</sup> *Ibid.*

<sup>45</sup> Moore, M.P. “Taxation and the Political Agenda, North and South” Forum for development studies, 2004

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to developing countries highlighting the practical priority of improving tax collection through administrative improvements, with the intention of increasing revenue collection.

Alex Cobham's definition of the tax consensus focuses on the underlying economic theory of how tax should be levied in countries and links the theory to resulting policy prescriptions. According to him, the core principle of the tax consensus is that of neutrality; that taxes should not be beneficial or detrimental for different sectors of the economy and society, regardless of their situation – and should therefore not be used by governments as a public policy tool to redistribute wealth or to promote certain social and economic goals. "The key components of the consensus that has become dominant are these: first, to aim for neutrality of the tax system; second, to pursue redistributive goals (if any) via expenditure not taxation; and third, to achieve revenues of the order of 15-20 per cent of GDP (although revenues in the EU-15 average in excess of 30 per cent). Tax neutrality, that the tax system should not distort production or consumption decisions, leads in practice to lower pressure on direct taxation, to trade liberalisation in the interests of efficiency, and to much greater emphasis on sales taxes to provide revenues."<sup>46</sup>

An IMF paper by Vito Tanzi and Howell Zee from 2001 identified key principles underpinning the IMF's approach to tax reform. This included neutrality; the design of the tax system should be as neutral as possible so as to minimise interference in market allocation processes, and simplicity; it should also have simple and transparent administrative procedures.<sup>47</sup>

### **1.5 Critiques of IFI tax policy and their responses**

There have been several critiques of IFI tax policy advice which are explored here in more depth. Given that the Fiscal Affairs Department (FAD) of the IMF has largely been charged with developing the content of tax policy advice on behalf of the IFIs these critiques have been directed at the IMF. The IMF paper addresses the different roles of the Bank and the Fund, "in practice the Fund has for several years been more prominent on tax policy issues and strategic revenue administration advice, and the Bank in financing and managing large administrative reform projects."<sup>48</sup>

Critics have argued firstly that the IMF has recommended the adoption of VAT too widely and without enough attention to the specific conditions in a country such as the political and administrative context or to the distributional impacts of a change to the tax regime. Secondly that the IFIs have imposed a set of policies with concerning regularity suggesting that there hasn't been adequate independence of governments to direct their own tax reforms. And lastly that IFI tax policy advice has not focussed adequately on ensuring that a country's overall tax system is progressive. These concerns have all been addressed in the recent IMF paper.

<sup>46</sup> Alex Cobham, "The tax consensus has failed!" Recommendation to policymakers and donors, researchers and civil society", in The Oxford Council of Good Governance, *Economy recommendation N° 9*, Jan 2007

<sup>47</sup> Vito Tanzi and Howell Zee, 2011, *op. cit.*

<sup>48</sup> Fiscal Affairs Department, IMF, 2011, *op. cit.*

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#### VAT

Bird and Gendron write that the IMF's support for the introduction of VAT has been a cause for its spread, "The principle reasons for the rapid spread and success of VAT are twofold. The first reason is undoubtedly the early adoption of VAT in the EU and the perceived success of both the EU and its VAT. The second is the key role played by the IMF in spreading the word to developing countries (...) The consistent support and advocacy of this form of taxation by the IMF in emerging countries, first in Latin America, and then around the world, introduced the idea of VAT and facilitated its adoption even by countries with much less developed economic and administrative structures."<sup>49</sup>

Bird and Gendron also write that "several conditions are needed for the success of such a major tax reform as adopting and implementing VAT." In terms of the model of VAT and its sensitivity to different contexts they write that, "Although the Fiscal Affairs Department (FAD) has never formally set out its own model of VAT for a developing country, its preferences have, over the years, been set out in some detail in a series of important publications."

The IMF has recommended trade liberalisation and the introduction of VAT in parallel as a means to recoup the trade revenues lost. This approach has been criticised largely on the basis that VAT has been thought to be regressive. Calari for instance says "the general line taken by the IMF has been to recommend more emphasis in integrating regressive or otherwise non-business related tax reforms as measures accompanying trade reforms."<sup>50</sup>

The evidence for whether VAT is regressive is mixed. Nevertheless there are a number of methods used around the world in order to reduce the burden of the tax on low income households involving zero-rating, exemptions and multiple rates. The IMF recommends however that countries introduce VAT at a single rate with no exemptions and this often translates into practice. Damme, Mishari and Orel highlight the lack of autonomy developing countries have, "Owing to the high dependence of LDCs on IMF programmes in obtaining aid and loans, it is not surprising to see that many implemented the IMF guidelines of uniform VAT rates and few exemptions."<sup>51</sup>

Bird and Gendron find that, "VAT in all countries has in many ways been shaped by concern about distributional issues. Indeed it is striking that the conventional 'expert' opinion that the fewer rates and exemptions the better seems to have had less influence in some EU countries than in some of the recent VAT adopters in the developing world who are more susceptible to expert (usually FAD) guidance."<sup>52</sup> Section 3 looks in more depth at the distributional impacts of VAT and the importance of exemptions.

#### 'One size fits all'

In a paper which analyses overall progress made by low-income countries in raising domestic revenues to meet the MDGs, McKinley and Kyrili from SOAS have little good to say about consensus tax policies. They conclude that "the reigning consensus on tax policies has contributed to the general stagnation of revenue in low income countries since the early 1990s. Much of the tax advice has been ill-suited to the economic conditions in such countries.

49 R. Bird and P-P. Gendron 'The VAT in developing and transitional countries', Cambridge UK, 2007

50 Aldo Calari, "The fiscal impact of trade liberalisation," in 'Tax Justice: Putting Global Inequality on the Agenda' eds Matti Kohonen and Francine Mestrum, Jan 2009

51 Damme Lauren, Mishari Tiffany and Orel Stephanie, 2008, *op. cit.*

52 R. Bird and P-P. Gendron 'The VAT in developing and transitional countries', Cambridge UK, 2007

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Unrealistic expectations have been placed on the revenue potential of domestic indirect taxes, premature reductions have been made in trade taxes, and needless weakening has been approved for direct taxes. Consequently there appears to be a pressing need for a fundamental re-evaluation and re-design of prevailing policies.”<sup>53</sup>

In its recent paper, the IMF has defended itself against the charge of a one size fits all approach to tax policy advice. It asserts that it is appropriate to have common ‘broad strategies for reform’ but that they also respond to individual country contexts in advising the detail and sequencing of reform measures. “Some tax practices are indeed close to universally appropriate: establishing firm control of the largest taxpayers, for instance. Beyond that there are certainly commonalities in broad strategies for reform, reflecting the generality of underlying economic and organizational principles. But the timing, relative importance, and precise design of appropriate tax reform measures varies substantially. Advice has repeatedly stressed, for instance, the need for substantial administrative reform in advance of VAT adoption. Sometimes addressing severe non-compliance is an overwhelming priority, leading to a focus on strengthening enforcement actions before moving to medium-term reforms. And countries’ idiosyncrasies affect the substance of advice (...) Political and social views on the proper degree of progressivity vary widely, the traditional role of the external advisor then being to describe and assess alternatives.”<sup>54</sup>

Clearly there is some disagreement between the IMF’s description of itself and the criticism levelled at it by outside observers. This is the case in relation to the attention it has given to administrative reform before VAT adoption, with some commentators finding that IMF advice has resulted in VAT being adopted too quickly and without the necessary understanding of businesses such as in Sierra Leone.<sup>55</sup>

The problem is that after decades of no official position on its approach to tax policy advice and the fact that very few countries publish the technical assistance reports produced by the IMF, outside observers do not have concrete evidence to substantiate that the approach the IMF paper describes (i.e. responding to specific country contexts and recognising the autonomy of governments to decide on the type of reforms they want to adopt) is taking place.

### **Neutrality and redistribution**

Other critiques question the assumptions which the IFI consensus largely relies on, including the principle of tax neutrality.

Christopher Heady, head of tax policy and statistics at the OECD says the theoretical basis of the recommendations made by the IFIs on tax rest on two assumptions: first, that the economy will deliver an efficient allocation of resources in the absence of distortionary taxes; and second, that there are a wide variety of tax instruments available to the government.<sup>56</sup> According to Heady these assumptions are in some respects clearly inappropriate for developing countries. Firstly, the widespread presence of market failures means that the pre-tax economy will not be efficient and that basic economic theory therefore implies that many non-neutral tax options should be

<sup>53</sup> Terry McKinly and Katerina Kyrill, “Is stagnation of domestic revenue in low-income countries inevitable?”, CDPR SOAS Discussion paper 27/09, October 2009

<sup>54</sup> Fiscal Affairs Department, IMF, 2011, *op. cit.*

<sup>55</sup> Oxfam International, Background Note, ‘concerns on IMF lending program in post-conflict Sierra Leone,’ 2010

<sup>56</sup> C. Heady, ‘Taxation policy in low-income countries’, quoted in John Marshall, 2009, *op. cit.*

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considered. Secondly governments typically do not have a range of instruments to address goals of revenue mobilisation and redistribution. The inability of many governments to make cash transfers to households, for example, means the distributive implications of tax cannot be ignored, and so many non neutral tax and/or subsidy options should not be taken off the table. Cobham highlights that redistribution, which should be addressed by IFI policy advice on the basis of equity implications, has no clear place in the consensus policies.<sup>57</sup>

In comparison to the analysis of IMF recommendations from studies such as Marshall's, the recent IMF tax paper suggests that the IMF is giving more attention to the relationship between tax and redistribution than it has in the past.

In the paper equity is identified as one reason for the introduction of real estate taxes, "their progressivity arises from the positive correlations between property ownership, income and wealth." While the paper does show a preference that equity concerns be addressed through the spending side (specifically in relation to VAT), the paper recognises that IMF tax reform advice has not given sufficient attention to address these equity concerns in the past. The paper states that, "the precise measures to address any equity concerns from proposed tax reforms – alleviating poverty is of course in itself a primary reason to impose these taxes – are often left unspecified," and that, "more can be done to identify the specific spending measures to allay [distributional] concerns."

Overall the IMF paper shows that the policies of the tax consensus as identified by the commentators that have used this expression have not been reneged on. IMF tax policy advice still supports ongoing trade liberalisation and removal of trade tariffs. It still supports the use of VAT as the main mechanism to raise revenues to the 15 – 20 per cent mark and now that VAT has been introduced in the majority of developing countries the emphasis is on broadening the base, improving efficiency through more quickly refunding inputs and streamlining through removing exemptions. There is still a strong focus on administration through the introduction of large taxpayer units and reducing opportunity for corruption. An emphasis on reducing the corporate and personal tax rates has decreased with countries having now reduced their rates to more competitive levels and IMF policy advice is more heavily focussed on reducing tax incentives for FDI.

However while the key policies of the tax consensus may not have changed much, some of the principles that have been associated with the tax consensus in the past are no longer so clearly maintained. Strict neutrality has been slightly moderated as the paper shows the IMF is willing pay attention to the equity concerns of governments and on occasion to allow for exemptions to improve the fairness of VAT. One size fits all has been strongly linked with the idea of the tax consensus, (as with the Washington consensus), yet as we have seen the IMF now appears to be conscious of the need to ensure the autonomy of governments to direct their own policy.

57 Alex Cobham, 2007, *op. cit.*

## 2. Mechanisms of influence

### 2.1 IMF conditionality and policy advice

In Marshall's<sup>58</sup> study of IMF recommendations in policy documents spanning the period 1998-2008 he charted the frequency with which the policies associated with the tax consensus had been made to a sample of 18 sub-Saharan countries. The policies he screened for were changes to the rate and base of direct taxes; corporate and personal, trade taxes, indirect taxes, the tax base and administration. He found that the frequency of IMF recommendations were in line with policies associated with the tax consensus, "a shift away from direct taxation (the taxation of income and profits) and from trade taxation, and towards consumption taxation."

The results showed that "the prescriptions of the tax consensus had been endorsed fairly uniformly across the sample, with almost all the recommendations applied to the majority of countries at least once". There were relatively few papers available from before 2002 and so Marshall also concluded that "where import tariff, incentive reductions and expansion of the VAT base had become less prevalent, this probably reflects structural adjustments that took place at an earlier stage."

The precise nature of these recommendations, whether they are formal conditions, benchmarks or prior actions, is not made clear by the study. However, given that they were found in Poverty Reduction and Growth Facility (PRGF), Policy Support Instrument (PSI) papers and Article IV consultations which are either directly or indirectly linked to disbursement of loans, they would carry significant weight for influencing the policy reforms of developing countries. Governments would strive to meet recommendations and benchmarks in order to secure the loans offered. This influence is augmented by the attention given by other donors and investors to IMF reports.

### 2.2 Technical Assistance from the World Bank and the IMF

Tax reforms recommended by the IFIs have often been implemented with the advice of foreign advisors. In an article by World Bank staff on developing country tax reform, successful tax reforms in Colombia and Malawi were "partly (...) attributed to the trained core of local experts that worked closely with foreign advisors".<sup>59</sup>

One of the principle functions of the Fiscal Affairs Department (FAD) at the IMF and the World Bank is to provide technical assistance to developing countries. This assistance often includes reforming the structures and systems of revenue departments, and training staff from developing country revenue authorities in new methods. The IMF paper sets out that "In FY11 there will be around 35 HQ-led missions on tax policy issues, and around 61 in revenue administration (...) the great bulk continues to be to developing countries."<sup>60</sup>

The IMF is launching a new topical trust fund supporting technical assistance to members on tax policy and administration. This new multi-donor trust fund starts operations in May 2011 and will provide about US\$30 million over five years to finance technical assistance for strengthening tax systems in 15-20 low- and lower-middle income countries. According to the IMF, "The trust fund will address the weaknesses at the heart of low revenue-collection rates, including weak and fragmented administrative structures, poorly designed operational processes, and unclear

58 John Marshall, 2009, *op. cit.*

59 Javad Khalilzadeh-Shirazi and Anwar Shah, *op. cit.*

60 Fiscal Affairs Department, IMF, 2011, *op. cit.*

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accountability.”<sup>61</sup> Alongside the topical trust funds the IMF also provides short term support through seven regional technical assistance centres, all of which have a specialist advisor on revenue administration.

An example of technical assistance on tax from the World Bank is included in Ghana’s Economic Governance and Poverty Reduction Credit 2009 which details that, “Work on the taxation of extractive industries has also begun and, *with World Bank technical assistance*, a paper will be presented in 2009 to Cabinet with recommendations for improvements.” Any further detail about what that technical assistance would consist of was absent. The Bank subsequently launched an oil and gas capacity building project in November 2010 which includes US\$1 million for technical assistance to build the capacity of the Ghana Revenue Authority to tax oil and gas companies operating in the country. This includes policy development consultancy, advisers, trainers and workshops, meaning that the World Bank will have considerable influence over the development of the policy framework for taxing the oil and gas sector.<sup>62</sup>

Although technical assistance in these areas may be of very high quality and usefulness to governments, there is little public transparency on its policy content. The analysis by Damme, Mishari and Orel looks at a representative sample of IMF Article IV reports for low and lower middle income countries.<sup>63</sup> They find that technical assistance has been given in 80 per cent of the cases, but very little detail about its content are provided. “The Article IV Consultations include a list of technical assistance provided to the given country, but these lists only include the date, IMF department, the mission topic, and sometimes, the length of the mission. (...) The IMF’s official Independent Evaluation Office (IEO) suggested that a wider dissemination of technical assistance reports is needed (2005).”<sup>64</sup>

One of the fears about the tax policy advice delivered through technical assistance is that it is not home grown, but that the role taken on by the IMF as an ‘external advisor’ becomes one in which they carry through a reform agenda which is not owned by the permanent revenue officials. This can be exacerbated when the length of the technical assistance mission is limited to a couple of weeks as they sometimes are.

### **2.3 World Bank and IMF advice and conditions in the mining sector**

As explained in the first section, the IFIs seem to clearly oppose the use of tax incentives as a way to attract FDI into developing countries. Yet, recent NGO research<sup>65</sup> shows that in practice, their advice has not always followed these principles, especially when it comes to the mining and extractive sector.

The World Bank and the IMF have played a key role in shaping mining sector taxation in developing countries, especially since the 1990s through their policy advice and conditions attached to loans and debt relief. An NGO report, ‘Breaking the curse’,<sup>66</sup> explains that since the 1990’s

61 IMF press release, December 17 2010, <http://bit.ly/fjy6BF>

62 Ghana Oil and Gas capacity building project, 29th November 2010, <http://bit.ly/gUHwNJ>

63 Damme Lauren, Mishari Tiffany and Orel Stephanie, 2008, *op. cit.*

64 *Ibid.*

65 SAW, TWN Africa, Tax Justice Network Africa, ActionAid and Christian Aid, “Breaking the Curse. How transparent taxation and fair taxes can turn Africa’s mineral wealth into development,” March 2009.

66 *Ibid.*

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most mining codes in sub-Saharan Africa have considerably lowered taxes in order to attract FDI and that this shift has been promoted by the World Bank in all its client countries in Africa, as a means to revitalize the mining sector. From the mid 1990s onwards, the World Bank “played a key role in the formulation of new legal mining frameworks in a number of African client countries with less institutional capacities, including Tanzania, Ghana, Zambia, Sierra Leone and the DRC.”<sup>67</sup>

World Bank advice on mining taxes has been very influential in many African countries over the years. In Tanzania, the World Bank funded the Mineral Sector Development Technical Assistance Project, intended to promote fiscal reforms to attract private capital into the mineral sector. In 1997 two laws were passed that reduced tax rates and customs duties on certain imports and legalised the repatriation of profits. The new Mining Act that followed in 1998 was the direct outcome of a five-year World Bank funded sectoral reform project.<sup>68</sup>

A TJN Ghana report found that in Ghana the new mining law of 1986 was heavily sponsored by the World Bank and IMF as part of a broader programme of structural adjustment. It found that “Among the most important aspects of the new legislation were the reduction of state involvement in mining activities, major reductions in various taxes and a dramatic increase in capital allowances. A new mining law was promulgated in 2006 which maintained most of those changes while reducing the maximum royalty rate and eliminating the additional tax on windfall profits.”<sup>69</sup>

The IMF’s Guide on Resource Revenue Transparency has set a standard for managing the revenues from extractives. The IMF guide provides key information and recommended methods for public management of revenues earned from the extractive industries calling them ‘good practices’. It highlights that “transparency can help establish and maintain credibility in regard to the collection and distribution of resource revenue. This was one of the motivations behind the creation in 2002 of the Extractive Industries Transparency Initiative (EITI)”<sup>70</sup>

The IMF Guide explains that, “oil production provides the most dramatic illustration of the problems posed by resource riches for developing countries: very large, quickly growing, but time-limited production and revenue flows, combined with a high degree of volatility because of fluctuating world prices. When administration is weak, ownership of such wealth provides ample scope for inefficient policies, discretionary behaviour, and outright corruption, all of which could contribute to poor growth performance and eventual dissipation of national oil wealth”<sup>71</sup> The Guide puts forward advice on the openness of the legal framework and fiscal regime, clear documentation of resource revenues, and effective accounting and audit of revenue flows.

A Handbook produced by the Bank Information Centre breaks down the text of the Guide into more accessible language so that it can be used by civil society groups to hold governments and private companies accountable for the exploitation of natural resources. The handbook points out that “the IMF’s Guide is a staff product: it is not approved by the IMF Board, and therefore does

67 *Ibid.*

68 *Ibid.*

69 Wilson Prichard, Institute of Development Studies, University of Sussex with Isaac Bentum of A, A & K Consulting, “Ghana Report: Taxation and Development in Ghana: Finance, Equity and Accountability,” Tax Justice Network and ISODEC, April 2009

70 IMF, Guide on Resource Revenue Transparency, 2007

71 *Ibid.*

not have “official” status. The IMF does not require that the Guide’s standards be maintained, or even accepted, by client governments.”<sup>72</sup>

The ‘breaking the curse’ report found that the World Bank has improved its support for transparency in the extractive sector since the establishment of the EITI and now helps to finance resource-rich client governments to implement the initiative. Although the report also found that World Bank engagement on transparency was not consistent.<sup>73</sup>

## 2.4 The IFC-World Bank Doing Business indicators

The World Bank and the International Finance Cooperation (IFC) encourage lower levels of taxation in their recommendations to improve the investment climate in developing countries. One of the instruments used by the World Bank Group to advise countries on their investment climate is its annual Doing Business report, launched in 2003 as a co-publication of the World Bank and the IFC, its private sector affiliate. The Doing Business report ranks countries based on the ‘ease of doing business’. Although this is supposed to be a merely indicative publication it has a real influence on countries that “get desperate to climb up those rankings because they reason that the higher up they are in the ranking, the more FDI is going to seek the country.”<sup>74</sup>

The paying taxes indicator rates the “ease of paying taxes” based on a model of a medium sized business in each of 183 countries and is one of ten indicators in the Doing Business report.<sup>75</sup> The paying taxes indicator is composed of three equally weighted elements: 1) the number of tax payments required per year, 2) the time required to file returns, and 3) the total tax rate (TTR) as a percentage of commercial profit. Components of the TTR include corporate taxation, labour contributions (e.g., social security, health care, unemployment insurance), and “other” taxes (e.g., environmental taxes). The lower the score for each of these criteria is deemed to be better, demonstrating where it is easiest to pay tax.

While it is sensible to encourage tax administration for users to be simple in terms of number of payments and time taken, the implication that the lower the rate of tax the better is a fairly blunt policy prescription that exerts one-size-fits-all pressure on developing countries to keep corporate income tax rates low. The top ten countries for paying tax in 2010 included many low tax jurisdictions: the Maldives, Qatar, Hong Kong, United Arab Emirates, Singapore, Ireland, Saudi Arabia, Oman, New Zealand and Kiribati. It is worth noting that five of the six top performing countries are tax havens (all but Qatar) and five of the top ten are oil emirates.

The report’s message has been that, in addition to reducing the burden of tax compliance, countries should reduce the amount that they tax businesses. Simeon Djankov, the senior World Bank economist who created the Doing Business series, described the philosophy quite crudely, “There is a good rule in setting taxes, the poorer the country the lower the tax burden. This is for two reasons. First, poorer countries waste more tax money through corruption. Second, lower tax

72 Bank Information Centre, *Handbook for Advocacy on Extractive Industry Revenues: Good Practices and the IMF’s Guide on Resource Revenue Transparency*, June 2008

73 SAW, TWN Africa, *Tax Justice Network Africa*, ActionAid and Christian Aid, 2009, *op. cit.*

74 Caliaro 2009, *op. cit.*

75 Besides paying taxes, the report provides quantitative measures of regulations in nine other areas: starting a business, dealing with construction permits, employing workers, registering property, getting credit, protecting investors, trading across borders, enforcing contracts, and closing a business.

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burdens for businesses lead to more economic activity.”<sup>76</sup> Although he doesn’t define how ‘low’ a tax burden would be suitable for businesses, this approach directs low income countries wanting to build up their domestic tax base to rely on indirect taxes. This is not a suitable approach for a country wanting to reduce its reliance on aid.

From the perspective of the trade liberalisation agenda reducing taxes on export gains, Caliarì points out it is worth asking to what extent it is beneficial for a developing country to increase exports and export orientated FDI if the revenues cannot be appropriated domestically.<sup>77</sup> This is just as relevant to the whole debate on keeping corporate income tax low in order to attract FDI.

In addition to the Doing Business report, the World Bank-IFC and PricewaterhouseCoopers (PwC)<sup>78</sup> publish the “Paying Taxes” report. This is a more in-depth and detailed version of the paying taxes chapter of the Doing Business report using the same data but exploring more of it. The report also ranks the top reformers; countries which made the most headway in simplifying tax payment procedures and lowering the total tax rate. It provides more detail on the trends in changes to each of the tax indicator components around the world, as well as looking at trends over the past six years since the Doing Business report was established. It also uses the data to explore policy issues such as ‘the effects of corporate taxes on investment and entrepreneurship’ in the 2011 report, providing some short studies of tax reform in specific countries.<sup>79</sup>

According to the 2011 report between June 2, 2009 and June 1, 2010 “40 economies made it easier for business to pay taxes compared to 45 the previous year”. It reports that reducing rates of profit tax is still the most popular reform, but easing the compliance burden is equally important for business.<sup>80</sup>

A 2008 report by the Bank’s Independent Evaluation Group (IEG) on Doing Business<sup>81</sup> concluded that it was “of particular concern [that] the paying taxes indicator relies exclusively on a single firm to provide both the underlying methodology and the data for 142 countries”. That firm is PwC. The IEG also recommended that the paying taxes indicator needed to be changed because it involves “implicit judgements on complex issues of fiscal efficiency and equity”. The evaluation recommended, “Doing Business to reformulate the *paying taxes* indicator to include only measurements of regulatory burden such as the total cost of compliance”. The indicator has not been changed in line with this recommendation.

The IEG report also highlights that “Doing Business remains insufficiently transparent about the number and types of informants for each indicator, the adjustments its staff make to the data received from informants, and the changes made to previously published data and their effects on the rankings”. According to IEG, “the lack of transparency about [the indicators] undermines Doing Business credibility and goodwill.”<sup>82</sup>

76 Djankov, S. Taxes and the crisis. Doing Business blog post, 09/12/08, ‘Accounting for Poverty’ ActionAid 2009

77 Caliarì 2009, *op. cit.*

78 PricewaterhouseCoopers earned aggregated worldwide revenues of \$28 billion for fiscal 2008, and employed over 146,000 people in 150 countries. In the United States, it is the third largest privately owned organization.

79 World Bank-IFC & PwC, “Paying Taxes 2011: the global picture”, 2011

80 *Ibid.*

81 Doing Business: An independent evaluation: taking the measure of the World Bank-IFC Doing Business indicators, 2008 <http://bit.ly/g7xXMF>

82 *Ibid.*

Nancy Alexander highlights some of the main critiques of the “paying taxes” report;

- The paying taxes indicator rewards tax havens and oil emirates.
- The lower the overall tax rate as a share of a firm’s profit, the higher the country score.
- The IEG evaluation states that the lower corporate taxes, the greater the burden on the individual taxpayer which is not necessarily beneficial for the economy as a whole.

The paying taxes indicator overlooks the importance of each country’s fiscal requirement to raise revenue.<sup>83</sup>

## 2.5 Ex ante mechanisms: Country Policy and Institutional Assessments

*Ex ante* mechanisms cover an array of instruments that implicitly or explicitly require countries to adopt certain policies before they receive any loan or grant disbursement. The most important of these mechanisms are the Country Policy and Institutional Assessments (CPIAs), carried out yearly by the World Bank with the purpose of rating the policy and institutional environment in borrowing countries.

The Bank uses its CPIA to prepare an annual scorecard that rates its approximately 136 recipient countries, 82 of which receive assistance from the International Development Association (IDA), the World Bank’s funding arm for poor countries. This scorecard is used for a variety of purposes, from determination of funding allocations to measurement of the amount of debt a country can undertake without risking ‘debt distress’. The incentive to score well on all aspects of the CPIA is strong as the Bank believes that, in order for its aid to be used effectively, governments must be “good” performers. As a result, countries judged as the top performers receive approximately seven times as much as countries judged to be the worst performers.<sup>84</sup>

The CPIA description of the standard to get a top score on domestic revenue mobilisation is: “The bulk of revenues are generated by low-distortion taxes such as sales/VAT, property, etc. Import tariffs are low and relatively uniform, and export rebate or duty drawback are functional. There is a single statutory corporate tax rate comparable to the maximum personal income tax rate. Tax base for major taxes is broad and free of arbitrary exemptions.” These criteria are in line with conclusions drawn in section one about the key policy tenets of the IFI tax consensus, and suggest a limiting of the individual governments policy space on tax. Nancy Alexander comments that “sales taxes and the VAT are regressive. The shift should be from such taxes to income, property, and corporate taxes.”<sup>85</sup>

There may be nothing wrong with the combination of taxes promoted by the CPIA standard *per se*, but the imposition of a template in this way undermines the process of the tax system developing through interaction between the government and citizens in a given country. Harvard Professor Dani Rodrik raises the concern that by assuming an a priori definition of “good policies”, the CPIA fosters the “greatest risk to globalization...that national governments’ room for manoeuvre will shrink to such levels that they will be unable to deliver the policies that their electorates want and need in order to buy into the global economy.”<sup>86</sup>

<sup>83</sup> *Ibid.*

<sup>84</sup> Nancy Alexander, *The Country Policy and Institutional Assessment (CPIA) and Allocation of IDA Resources: Suggestions for Improvements to Benefit African Countries*, August 2010

<sup>85</sup> *Ibid.*

<sup>86</sup> D. Rodrik, “The cheerleaders threat to global trade,” *Financial Times*, February 2007, quoted by Alexander G-24 Policy Brief N°34

## 2.6 Investment Climate Assessments (ICAs)

ICAs are designed to systematically analyse the conditions for private investment in a country. They are broader and more detailed than the Doing Business indicators and are underpinned by a survey – World Bank Enterprise Surveys (also known as the Investment Climate Surveys). This survey constitutes another way in which the World Bank Group is measuring the tax system in developing countries and shaping the information that the private sector uses to make investment decisions.

The Enterprise surveys collect data on the following themes: regulation and tax, infrastructure, bureaucracy and corruption, technology and quality, human capital, corporate governance, crime and security, and financial services.<sup>87</sup> The business owner or top manager is usually the subject of a face-to-face interview. The results of these surveys are used in the design of and advocacy for investment-climate reform.

The tax element of these surveys measures:

- Average number of visits or required meetings with tax officials,
- Percentage of firms identifying tax rates as a “major” or “very severe” obstacle,
- Percentage of firms identifying tax administration as a “major” or “very severe” obstacle.

However the results of these surveys are not made public and only some of the investment climate assessments that they inform are made public.

<sup>87</sup> See full indicators description: <http://bit.ly/gAM9wF>

## 3. An overview of the impact of IFI tax policy advice on development

Wider literature has pointed to a systemic shift away from direct taxes and particularly trade taxes toward indirect and natural-resource taxation. Marshall finds that over the period 1992-2008 for a subset of 18 SSA countries, tax revenues have barely risen from a level of around 15 per cent of GDP. In terms of the composition of tax revenue he finds that “there has been a marked shift toward natural-resource and indirect tax revenues across SSA, generally at the expense of trade revenues. Natural resources have grown in their contribution to government revenue streams, rising to 18 per cent of GDP in 2008 and nearly 60 per cent of total (non grant) revenues.” He also observes that “indirect taxes have registered some growth; principally concentrated in excises and potentially VAT.”<sup>88</sup> (See Annex Figure 1)

Avi-Yonah finds that in developing countries tax revenues as a share of GDP rose from 18.8 per cent (in 1975-1980) to 20.1 per cent (in 1986-1992). He says that this modest tax growth was financed primarily by an increase in VAT during the period while revenues from both individual and corporate income tax were flat or declined. The increase in overall tax to GDP ratio is very small however compared to the increase in developed countries where total tax revenue as a percentage of GDP went up sharply between 1965 and 1995 from 25 per cent to almost 40 per cent.<sup>89</sup>

### 3.1 The impact of VAT on developing countries

The proposed replacement of revenues from trade-related taxes by establishing value added and sales taxes raises questions of equity. IMF staffer A.S Gupta has written that “Since most of the taxes on goods and services are indirect taxes, they tend to be regressive in nature. As a result, they may exacerbate the inequality in income distribution and reduce the tax base.”<sup>90</sup> However there is a wide range of opinion and evidence as to whether VAT is regressive, as its distributional impacts depend on the exemptions and rates in place.

A TJN Ghana report notes that “remarkably little is known about the actual incidence of different types of taxes in developing countries. This alone has led many international tax experts to conclude that it would be wise to be cautious before assuming that income taxes are necessarily extremely progressive, that consumption taxes are necessarily extremely regressive or that a greater focus on income taxation is the best course of action.”<sup>91</sup>

A paper written for the World Bank Poverty and Social Impact Assessment (PSIA) explores some of these nuances in the incidence of indirect taxes, ‘A number of studies have found that replacing a sales tax with VAT has made the tax system more regressive (or less progressive). Although VAT is typically progressive, it is often less progressive than the sales taxes it has replaced, mainly because sales taxes have not been imposed on basic foods.’<sup>92</sup>

When implementing VAT there are numerous decisions to be made, including the rate, the number of different rates, the threshold for businesses and what should be exempted. It has been found in the past that the IMF recommends that there should only be one rate and no exemptions because

88 John Marshall, 2009, *op. cit.*

89 Reuven S. Avi-Yonah, ‘Globalisation and tax competition. Implications for developing countries’, in ECLAC review 74, August 2001

90 Gupta, A.S. “Accountability through tax revenue efforts in developing Countries” IMF Working Paper, 2007

91 Wilson Prichard and Isaac Bentum, 2009, *op. cit.*

92 Indirect tax and public pricing reforms, David Coady, <http://bit.ly/fgOEr8>

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multiple rates and exemptions result in higher administrative and compliance costs for the revenue authority.<sup>93</sup>

Critiques of the IFI's commitment to neutrality have highlighted that IMF tax policy advice has not incorporated equity concerns. However this statement from Tanzi and Zee who are IMF staff indicates that addressing equity impacts of tax reforms is has been seriously considered, "the important tax policy issue for developing countries is (...) spelling out clearly the objective to be achieved by any contemplated shift in the (tax) mix, assessing the economic consequences of the shift – in both efficiency and equity terms (...) and, implementing compensatory – possibly nontax (e.g. expenditure) measures, if those who are being made worse off by the shift are in the poorer deciles."<sup>94</sup> However the study of IMF Article IV reports by Damme, Misrahi and Orel indicates that this intention doesn't often translate into practice.

The study by Damme, Misrahi and Orel finds that while IMF officials are not unaware of distributional consequences of their tax advice, assessing the distributional impacts of tax advice in their Article IV reports has not been a priority. The IMF mentioned potential distributional impacts of their tax advice only in 25 per cent of the reports and only once in relation to a Low-Income Country. It therefore seems that this has been low on their agenda and they have focussed instead on increasing the tax take without ensuring that the pro-poor spending will be taken up by the government in order to compensate for any equity implications.

The views of the IMF on exemptions and reduced rates for VAT have been set out more clearly than previously in the IMF paper of March 2011. Although there are some inherent tensions in what they say, the view appears to be more accepting of exemptions and reduced rates than has been demonstrated by their practice in the past. The test will now be to see to what extent the IMF goes on to respect individual government's equity objectives and whether their tax reform advice is informed by analysis of tools for progressive spending.

93 Taxation in developing countries. What is the IMF's involvement? Bretton Woods Project, April 2008,

94 V. Tanzi & H. Zee, 'Tax policy for Emerging Markets: Developing countries', IMF Working paper No. 35, 2000

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#### **IMF view on VAT exemptions and reduced rates**

The recent IMF paper states, “Fund advice—largely followed—favors a broad base, single rate and fairly high threshold. These prescriptions (...) aim to (...) support equity objectives. They do not mean no exemptions: some (for financial services charged for as a margin, government agencies, basic health and education) are common to most VATs, often on technical (though increasingly challenged) grounds. Others (for staple foodstuffs) are driven by political and distributional sensitivities.”

But then they present the evidence showing that the distributional impact of exemptions and reduced rates are “inherently limited as distributional devices: even if the poor spend a larger proportion of their income on some item, the better off may spend absolutely more,” showing this to be the case from an OECD report in Mexico. They therefore say the poor can benefit from the elimination of exemptions when the additional tax revenue is used to finance targeted spending measures. Although they admit that they should do more on the spending side to address the equity impacts.

On rate differentiation they say that “Whether rate differentiation is desirable in any specific context depends on the government’s equity objectives and the precise instruments available to it for protecting the poor.”

A lot depends on the spending side – “A regressive tax may be the only way to finance strongly progressive public expenditure; conversely where the ability to target spending is relatively weak, progressivity on the tax side is a greater concern.”

Fiscal Affairs Department, ‘Revenue Mobilization in Developing Countries’ IMF, March 2011

VAT has been a source of many debates in Least Developed Countries (LDCs). Mick Moore recounts that “the introduction of VAT has been resisted quite strongly in some developing countries. For example, it led to large-scale protests or riots, and to some deaths, in Ghana and Uganda. Some of this resistance stems from a combination of bad political tactics on the part of government and a perception, at least partly accurate, that VAT is being introduced in poor countries at the behest of the international financial institutions. VAT was reintroduced relatively smoothly in Ghana once the government paid attention to political tactics and presentation.”<sup>95</sup>

The paper by Damme, Misrahi and Orel critiques the distributional effects of IMF backed policy changes in specific countries:

- According to the authors there is evidence that the IMF was directly involved in Bolivia’s major tax reform in 1986 and that in subsequent decades, the country’s tax system adopted the typical features of IMF tax policy advice, namely with the implementation of a single rated VAT of 10 per cent and the elimination of a personal income tax (PIT). The reforms seem to have compounded inequalities in revenue collection with Bolivia having one of the most regressive tax structures in the region. By 2006 the wealthiest quintile of the population provided 14 per cent of tax revenues, whereas the poorest quintile provided 25 per cent of the tax burden.

95 Moore, M.P. “Taxation and the Political Agenda, North and South” Forum for development studies, 2004

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- In 1998, Mozambique had to implement some IMF led tax reforms in order to benefit from the HIPC initiative. These included the implementation of VAT by 1999. Some USAID studies suggest that VAT implementation difficulties have led to an increase in corruption and the growth of the informal sector. It has also led to higher prices of zero rated products such as medicines, wheat flour and mosquito nets, with subsequent direct implications on the poor. Press briefings and IMF documents indicate that the IMF did not consider the distributional consequences of their advice during the VAT implementation, despite the government's recommendation of simplified taxation for small firms, which would have helped to formalise the market and address concerns about the VAT's complexity.

The study concludes that while the 'consensus' policies of the IMF may be sound from an efficiency perspective they are probably inappropriate for low income countries (LICs), which have different characteristics from European countries where VAT was designed."<sup>96</sup>

### 3.2 The fiscal impact of trade liberalisation

As explained above, an important element of the IMF tax policy advice has been lowering trade related taxes and the attempt to offset the subsequent revenue losses with the general implementation of VAT.

Yet, this reform entails serious consequences for developing countries, as trade related taxes represent a key source of income for most developing countries. Indeed, some estimates show that developing countries rely on trade related tariffs and taxes to finance around 30 per cent of their budgets (Caliari, 2009).<sup>97</sup>

Trade liberalisation has been a much contested issue, promoted by the governments of the OECD countries and the IFIs whose governance structures are dominated by these countries. The rationale for liberalisation is that by reducing trade barriers countries are able to import low cost items which will help them industrialise by purchasing the inputs needed to manufacture. However, many NGOs and academics have argued that most countries have industrialised under a state controlled program in which trade restrictions are an important tool to protect infant industries from international competition in order to initially develop a domestic market. Trade liberalisation advocates (including IFIs) have argued that tax losses are small, while others such as Caliari have found that "tariff losses for developing countries could outweigh the benefits by a factor of four."<sup>98</sup>

The capacity of developing countries to recover the trade liberalisation related tax losses is very limited. A 2002 report looking at 84 countries between 1970 and 1998 concluded that "low and middle income countries had experienced lower fiscal income as a result of a fall in trade related tariffs and income."<sup>99</sup> Similarly, the IMF themselves have found that of 125 countries studied, "Middle-Income countries had been able to recover between 35 and 55 cents per dollar of income from lost trade income, whereas lowest income countries had recovered basically nothing".<sup>100</sup> Caliari finds however that "far from rethinking its advice on trade liberalisation, the general line

<sup>96</sup> Damme Lauren, Mishari Tiffany and Orel Stephanie, 2008, *op. cit.*

<sup>97</sup> Aldo Caliari, "The fiscal impact of trade liberalisation." *Tax justice. Putting Global Inequality in the agenda*, ed. M. Kohonen and F. Menstrum, Pluto Press, 2009.

<sup>98</sup> Caliari 2009, *op. cit.*

<sup>99</sup> *Ibid.*

<sup>100</sup> T. Baunsgaard and M. Keen, "Tax revenue and (or?) trade liberalisation." Washington, DC, 2004 (version of 20 September).

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taken by the IMF has been to recommend more emphasis in integrating regressive or otherwise non-business related tax reforms as measures accompanying trade reforms.”<sup>101</sup>

Some attempts have been made to quantify these losses. UNCTAD has shown that tariff losses alone related to NAMA (Non-Agricultural Market Access) could reach up to US\$63.4 billion.<sup>102</sup> But absolute figures do not reflect the real impact of revenue losses, which should be compared to each country’s GDP suffering the losses. Caliarì explains that “even the percentage figures may not convey an accurate sense of the impact. For example, a less-than-10 per cent ratio [of trade tax income to total government revenue] may make the impact appear small, but there are countries in which this percentage of income is more than the government spends on health, education and other social priorities.”

Bhasin and Kobina<sup>103</sup> from the University of Cape Coast, in Ghana use the Computable General Equilibrium (CGE) model (which has been widely used to simulate the impact of macroeconomic policies on income distribution and poverty,) to demonstrate empirically the impact of the elimination of import tax and export tax accompanied by a 100 per cent increase in VAT on the incidence, depth, severity of household poverty and income distributions of households. They state that, “the elimination of trade taxes will reduce the revenue of the government by more than one-third (if the tax base is not enlarged) and as a result, public savings will be reduced.”<sup>104</sup> They find that the elimination of import taxes accompanied by an increase in VAT by 100 per cent could be used to reduce the incidence, depth, and severity of poverty, and improve the income distribution of households in low-income countries. But that the elimination of export taxes accompanied by an increase in VAT by 100 per cent increases the incidence, depth, and severity of poverty, and worsens the income distributions of households in low-income countries.

### 3.3 Tax competition and tax incentives

Jonathan DiJohn’s research on the political economy of taxation in Zambia, Rwanda, Mozambique, Uganda, Tanzania, DRC, Afghanistan, the Philippines and Columbia finds that, “there has been a decline in corporate taxes in most of our cases from an average of 35-40 per cent in the 1980s and early 1990s to around 25-30 per cent since the late 1990s.” He adds that “much of this decline in corporate tax rates have been the result of worldwide trends and influential IMF advice and conditionality, but has nevertheless enhanced the profits accruing to big businesses.”<sup>105</sup>

Nancy Alexander asserts that in addition to the tax cutting promoted by the Doing Business indicator, “the IMF facilitates or induces government actions that deplete and restrict fiscal resources including cuts in corporate and trade taxes and hawkish cuts in budget deficits, inflation rates, and wage ceilings.”<sup>106</sup>

While the IMF bears responsibility for its advice to reduce corporate tax rates, it seems that a lowering of the corporate tax rate has led to a broadening of the base potentially through

101 Caliarì 2009, *op. cit.*

102 Caliarì 2009, *op. cit.*

103 V. K. Bhasin and S. Kobina, “Impact of elimination of trade taxes on poverty and income distribution in Ghana,” Global Development Network, 2005

104 *Ibid*

105 J. DiJohn, 2010, *op. cit.*

106 Nancy Alexander, “Setting taxation benchmarks that reward tax havens and oil emirates: The Third Annual Volume by World Bank-IFC and PricewaterhouseCoopers (PwC): ‘Paying Taxes 2009: The Global Picture’”, Draft 2009

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attracting more foreign investment. Keen and Mansour have found that in the period 1990-2005 in SSA countries “the average statutory CIT rate has fallen markedly (from about 44 to 33 per cent), yet revenue has remained broadly unchanged, reflecting an increase in the implicit tax base (from 5.1 per cent of GDP to 8.6 per cent in 2005.)”<sup>107</sup>

As discussed in section 1.2, the IMF and World Bank appear to consistently advise against other aspects of tax competition such as tax incentives to attract FDI, which more clearly cause problems to the efficiency of the tax system compared to the lowering of CIT rates. However a 2009 IMF study by Klemm and Van Parys found that there has been increasing use of tax holidays in sub Saharan Africa, while the average length of the holiday shortens. They also found that some countries grant extensions of tax holidays even when this is not envisaged by law, so that the reported limit may not always be binding.<sup>108</sup>

As the practice of offering tax holidays and exemptions is not being encouraged by the IFIs, the study suggests a number of possible drivers behind such competition. One could be that “a country’s government takes another government’s tax policy as a yardstick to judge its own policy,” while another possible explanation is that “governments strategically interact to attract resources such as mobile capital.” The authors also suggest that “the possibility of countries simply following similar trends in their tax policy also remains a possibility that cannot be ruled out.”<sup>109</sup>

Avi- Yonah from the Economic Commission for Latin America and the Caribbean (ECLAC) summarises the origins and impact of tax competition on developing countries as follows: “The mobility of capital has led to tax competition (...) tax competition in turn, threatens to undermine individual and corporate income taxes; which remain major sources of revenue. (...) The response of both developed and developing countries to these developments has been first, to shift the tax burden from (mobile) capital to (less mobile) labour, and second, when further increases in the taxation of labour becomes politically and economically difficult, to cut government services.”

Revenues are needed to fund government-provided essential services such as health and education, which are regarded by many as the key to promoting development. Thus Avi-Yonah finds “if government service programmes are to be maintained in the face of globalisation, it is necessary to cut the intermediate link by limiting tax competition.”<sup>110</sup>

Avi-Yonah concludes, “the tax competition problem is essentially a problem of coordination and trust. Each jurisdiction would prefer to tax investors from abroad to gain the revenue, but is afraid that by doing so it would drive the investors to other jurisdictions that do not tax them. If there was a way to coordinate actions among the relevant jurisdictions, they all could gain added revenues without running the risk of losing the investment.” To sum up, “as a result of globalisation and tax competition, tax rules can no longer be set by countries acting unilaterally or by bilateral tax treaties (...) Thus, a multilateral solution is essential if the fundamental goals of taxation or other regulation are to be preserved.”<sup>111</sup>

107 Keen and Mansour, 2009, *op. cit.*

108 Klemm and Van Parys, *op. cit.*

109 Klemm and Van Parys, *op. cit.*

110 Reuven S. Avi-Yonah, ‘Globalisation and tax competition. Implications for developing countries’, in ECLAC review 74, August 2001

111 Avi-Yonah 2001, *op. cit.*

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In their recent paper the IMF also recognised the need for a multilateral solution, “Profit shifting by multinationals is an increasing concern; strengthening capacity and legislative frameworks is important, but, absent fundamental changes in international tax policies, there are no easy solutions.”<sup>112</sup> The IMF is one of a number of international organisations with a remit in this area, others are the UN and the OECD.

### **Conclusion**

There is an established view from those outside the international financial institutions that these institutions have established a ‘consensus’ set of tax policies that they recommend to developing countries. This view has been supported in literature by Cobham, Moore, Marshall and others.

Key underlying principles of this consensus have been neutrality and simplicity; that taxes should not be used to redistribute wealth because this would distort market signals, and that the number of taxes, tax rates and exemptions should be reduced. Key policies have been to promote trade liberalisation and alongside it to recoup the lost revenue from trade taxes through introducing VAT. In addition there has been strong emphasis on administration.

The recent IMF paper throws a new light on the tax consensus as well as on many of its critiques. Many things which seemed to be absent from IMF analysis of how developing countries should raise taxes have now been given a place in this paper. This includes addressing the equity implications of tax and the possibility of redistribution. The IMF paper says that, “alleviating poverty is of course in itself a primary reason to impose these taxes” and recognises that it must do more to address the effects of taxes on equity, “the precise measures to address any equity concerns from proposed tax reforms (...) are often left unspecified.” The IMF continues to favour a broad base and a single rate for VAT but the paper doesn’t completely oppose exemptions in VAT in order to reduce the tax burden on the poor. It recognises that where a government might want to deviate from a single rate the advisability of this “depends on the government’s equity objectives and the precise instruments available to it for protecting the poor.”

As a result of the clarification or softening of the IMF’s approach to the equity dimensions of tax, it seems that it may not be as committed to the principle of neutrality as it has been in the past and equity issues which are of great concern to civil society may be better addressed by the IMF in the future. The recognition of different country contexts suggest that it may take more time assessing the political and administrative context before offering advice. More research will need to be done to assess whether the attention to equity and government ownership articulated in the 2011 paper on revenue mobilisation is being translated into the policy advice that countries receive from the IMF and through technical assistance. Greater transparency of the content of technical assistance provided by the new IMF topical trust fund and by the IMF and World Bank generally would also be a good step toward building the contract between citizens and state on taxation issues.

Nevertheless other ways in which the IFIs influence developing countries tax policy decisions have not changed substantially. The World Bank’s CPIA continues to use a ‘one size fits all’ approach in order to rate what makes good tax policy and the Doing Business Indicator for tax continues to equate a low overall tax rate on business with a good score.

112 Fiscal Affairs Department, IMF, 2011, *op. cit.*

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In the effort to enable developing countries' to raise a greater proportion of their GDP in tax, more research would be valuable to examine why developing countries are increasing their use of tax holidays and investment incentives to attract foreign direct investment. The IMF paper usefully highlights the need for "strengthening capacity to deal with profit-shifting by multinationals, while recognising the extreme difficulty of doing so."<sup>113</sup> The recognition of the need for increased corporate financial transparency is welcome.

In conclusion, tax policy at the IFIs appears to be changing generally in a welcome direction. It remains to be seen how these policy changes will be built on and translated into changes in practice on the ground.

# Annex

## Glossary<sup>114</sup>

**Article IV consultations:** The IMF has a mandate under Article IV of its Articles of Agreement to closely monitor the exchange rate policies of its members. This requires a comprehensive analysis of the general economic situation of each member, as well as its main policy orientation. Article IV consultations take place usually once a year. After having visited the concerned country and met with the relevant officials, IMF staff submits a report to the Executive Board for discussion. The Board opinions are thereafter forwarded to the concerned country.

**Conditionality:** Economic policies or structural reforms that [borrowing] members agree to follow as a condition for the use of IMF and World Bank resources [loans] often called performance criteria or benchmarks.

**Country Policy and Institutional Assessment (CPIA):** Rates countries against a set of 16 criteria grouped in four clusters: (a) economic management; (b) structural policies; (c) policies for social inclusion and equity; and (d) public sector management and institutions. CPIA determines the level and composition of aid transfers to different recipients.

**Direct taxes:** Taxes that are charged on physical or legal persons directly upon their salary, profits, dividends, rents of other types of income.

**Excise tax:** These are taxes usually imposed on a limited range of goods, such as luxury goods, or on products that can have a harmful impact on the consumer and or society.

**Export tax:** Tax levied on exports of basic commodities entering into world trade, such as rubber, copper, palm oil, sisal, tea, cocoa and coffee

**Externalities:** Economic consequences beyond the specific beneficiary of the tax incentive

**Income taxes:** Taxes on income, profits, inheritance, payroll and capital gains are generally divided between taxes payable by individuals and corporations.

**Indirect taxes:** A form of tax charged upon transactions, usually on their gross value. Examples include sales taxes, value added taxes, goods and services taxes, stamp duties, land taxes, excise and customs duties, and levies of all sorts.

**Mining Code:** Legislation governing the mining policy in a country this may include the taxes applied to mining companies as well as any exemptions and customs regulations.

**Poverty Reduction and Growth Facility (PRGF):** IMF's low-interest lending facility for low-income countries. Concessional lending under the PRGF is administered by the IMF through the PRGF-ESF and PRGF-HIPC Trusts. Eligibility is based on the IMF's assessment of a country's per capita income.

114 Some but not all of these definitions are taken from the OECD glossary of tax terms <http://bit.ly/fWJHug>

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**Poverty and Social Impact Analysis (PSIA):** Analysis of the distributional impact of policy reforms on the well-being or welfare of the poor and vulnerable. In theory, PSIA should have an important role in the elaboration and implementation of poverty reduction strategies in developing countries, promoting evidence-based policy choices and fostering debate on policy reform options.

**Progressive tax:** A tax system in which, as incomes rise, the amount of tax paid increases in proportion to the income as well as in absolute amount, that is the percentage tax rate increases as the income rises.

**Property Tax:** A group of taxes imposed on property owned by individuals and businesses based on the assessed value of each property.

**Regressive tax:** A decreasing proportion of income is paid in tax as income increases.

**Sales Tax:** Tax imposed as a percentage of the price of goods (and sometimes services). The tax is generally paid by the buyer but the seller is responsible for collecting and remitting the tax to the tax authorities. This can include multi-stage cumulative taxes (also known as cascade taxes) where tax is levied each time a transaction takes place without any deduction for tax paid on inputs.

**Tax competition:** The pressure on governments to reduce taxes, usually to attract investment, either by way of reduction in declared tax rates or through the granting of special allowances and incentives.

**Tax compliance:** Payment of tax due without engaging in tax avoidance or evasion.

**Tax havens:** territory whose laws may be used to avoid or evade taxes. The Organisation for Economic Cooperation and Development defines them as jurisdictions where:

1. Non-residents undertaking activities pay little or no tax;
2. There is no effective exchange of taxation information with other countries;
3. A lack of transparency is legally guaranteed to the organisations based there;
4. There is no requirement that local corporations owned by non-residents carry out any substantial domestic activity. Not all of these criteria need to apply for a territory to be a haven, but a majority must.

**Transfer pricing:** A transfer price is the price charged by a company for goods, services or intangible property to a subsidiary or other related company. Abusive transfer pricing occurs when income and expenses are improperly allocated for the purpose of reducing taxable income.

**VAT:** Specific type of turnover tax levied at each stage in the production and distribution process. Although VAT ultimately bears on individual consumption of goods or services, liability for VAT is on the supplier of goods or services. VAT normally utilizes a system of tax credits to place the ultimate and real burden of the tax on the final consumer and to relieve the intermediaries of any final tax cost.

**Table 1 IMF working paper on tax incentives**

Causes, benefits and risks of business tax incentives, Alexander Klemm, 2009<sup>115</sup>

Incentive	<i>Investment incentives are more effective than tax holidays. However, these results are not fully reliable since most studies focus on one country only.</i>
<p><b>Tax holidays:</b> Temporary exemption of a new firm or investment from certain specified taxes, typically at least corporate income tax. Sometimes administrative requirements are also waived, notably the need to file tax returns. Partial tax holidays offer reduced obligations rather than full exemption.</p>	<p><i>“Despite their popularity, tax holidays are particularly harmful”</i> <i>“While it is possible to find circumstances under which certain tax incentives are justifiable, the case for most incentives remains doubtful (...) reduced corporate tax rates, rather than accelerated depreciation, may be the best substitutes for tax holidays”.</i></p> <ul style="list-style-type: none"> <li>- They attract short-term, footloose and rapidly profitable investments.</li> <li>- Unlikely to match authorities' priorities.</li> <li>- Costs are often not transparent because beneficiaries are exempt from filing tax returns.</li> <li>- Policy-makers do not have a clear idea of revenues lost.</li> <li>- Promote rent seeking behaviour from investors.</li> </ul> <p>It can be a useful tool when a government makes a major reform towards a more business friendly environment. “However this is more of a theoretical possibility than a strategy used in practice.”</p>
<p><b>Investment tax credit:</b> Deduction of a certain fraction of an investment from the tax liability. Rules differ regarding excess credits (credits in excess of tax liability) and include the possibility that they may be lost, carried forward or refunded.</p> <p><b>Investment allowance:</b> Deduction of a certain fraction of an investment from taxable profits (in addition to depreciation). The value of an allowance is the product of the allowance and the tax rate. Unlike a tax credit, its value will thus vary across firms unless there is a single tax rate.</p>	<p>They can easily be implemented in a transparent and automatic way. However:</p> <ul style="list-style-type: none"> <li>- Allowances will distort the choice of capital towards short lived goods and will encourage investment in physical rather than financial or human capital.</li> <li>- Distortion between the investment of new and established businesses as only the latter will have profits against which to set the allowance or credit.</li> </ul>

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<p><b>Accelerated depreciation:</b> Depreciation at a faster schedule than available for the rest of the economy. This can be implemented in many different ways, including higher first year depreciation allowances, or increased depreciation rates. Tax payments in nominal terms are unaffected, but their net present value is reduced and the liquidity of firms is improved.</p>	<p><i>“Has similar though much more limited implications as investment allowances and tax credits.”</i></p> <p>It does not change total deductions but brings them forward in time. Hence, the maximum benefit to a company is the time value of money. In case of initially unprofitable investment, there may be no benefit, as deductions will still only be taken in later years.</p>
<p><b>Investment subsidies</b> Providing public funds for private investments</p>	<p>Advantages:<sup>116</sup></p> <p>Easy targeting</p> <p>Disadvantages:</p> <ul style="list-style-type: none"> <li>- They involve out of pocket expenditure by the government upfront.</li> <li>- They benefit nonviable investments as much as profitable ones.</li> </ul> <p><i>“The use of investment subsidies is seldom advisable”</i></p>
<p><b>Reduced tax rates:</b> Reduction in a tax rate, typically CIT</p>	<ul style="list-style-type: none"> <li>- If applied for a limited time only they raise the same concerns as tax holidays.</li> <li>- If applied to the more mobile part of the economy it can be well justified by economic considerations.</li> <li>- Disadvantage of a split rate: there could be repercussions on international tax cooperation, because existing cooperation agreements often proscribe such practice.</li> </ul>
<p><b>Indirect tax incentives:</b> exemptions from taxes collected in the borders such as tariffs, excises and VAT on imported inputs</p>	<p><i>“Exemptions from taxes, especially those assessed at the border, should be second-best solutions”</i></p> <ul style="list-style-type: none"> <li>- Exemptions from VAT on imports are not necessary if tax law provides for VAT to be refunded on all goods including capital goods.</li> <li>- Similarly exemptions from excises on inputs should be generalised so that all firms benefit equally. In many cases the simplest solution is the abolition of excises in many capital goods.</li> </ul>

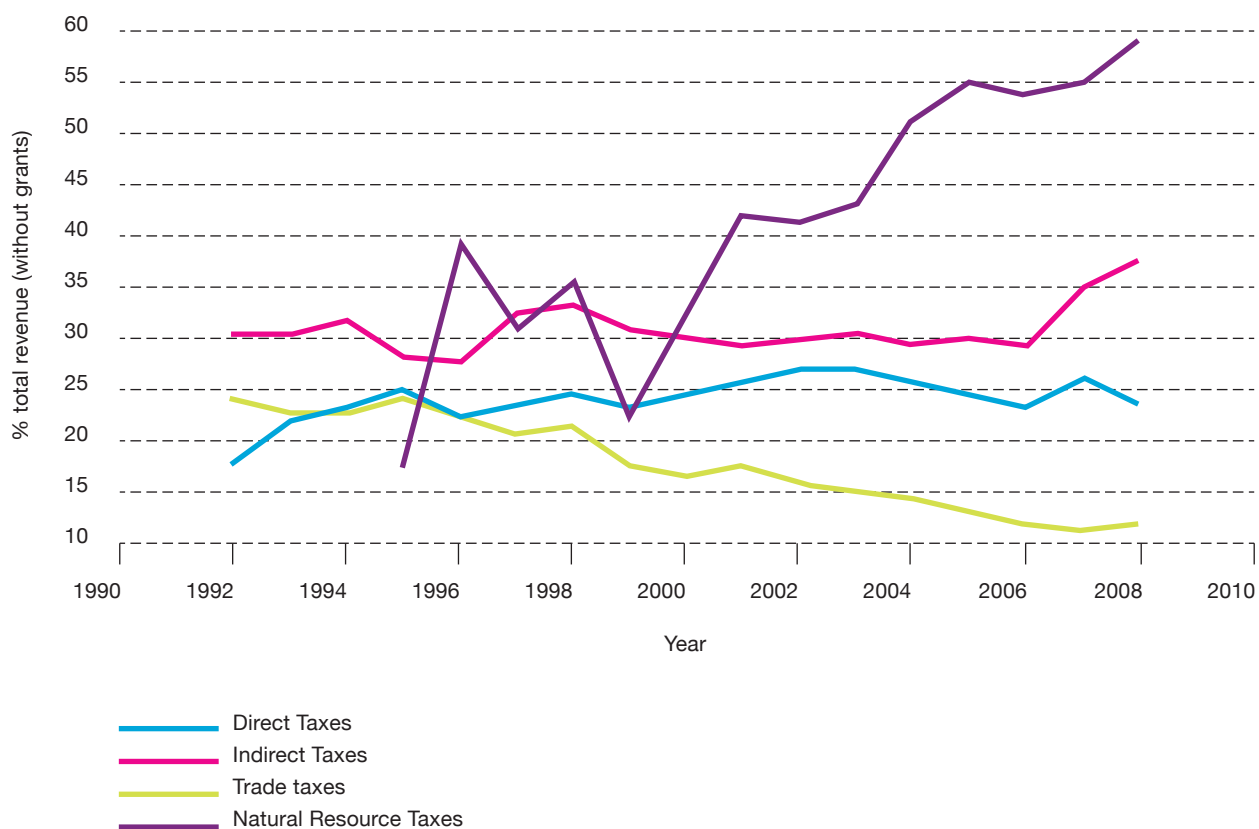
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<p><b>Special zones (EPZs):</b> Geographically limited areas in which qualified firms can locate and thus benefit from exemption of varying scope of taxes and/or administrative requirements.</p>	<p><i>“Special zones can differ so much in their characteristics that it is not possible to make an assessment in general terms”</i></p>
<p><b>Triggering mechanisms</b></p>	<p><i>“Tax incentives should be automatic rather than discretionary(...)There are strong reasons for automatic incentives, based on clearly defined criteria, reflecting both the risk of corruption and the difficulty governments have in picking winners”</i></p>

Source: John Marshall, “One size fits all? IMF tax policy in Sub Saharan Africa”, Christian Aid, 2009.

**Figure 1: Tax types, as a proportion of total non-grant revenues, 1992-2008**



Notes: Contains only years where there are at least five observations. All 2008 values are projections.  
Source: IMF country reports