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# IOB Study

## Evaluation issues in financing for development

Analysing effects of Dutch corporate  
tax policy on developing countries

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*Analysing effects of Dutch corporate  
tax policy on developing countries*

*Study conducted by dr. Francis Weyzig, Utrecht University.*

*Commissioned by the Policy and Operations Evaluation Department (IOB)  
of the Ministry of Foreign Affairs of the Netherlands.*

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## Preface

Before the turn of the Millennium the realm of evaluation of the Policy and Operations Evaluation Department (IOB) has already been broadened to all policy areas of the Ministry of Foreign Affairs. Beyond regular evaluations in the area of development cooperation this resulted in IOB evaluations of specific topics in various other foreign policy areas, such as European cooperation, NATO and energy security. Recently, more systematic emphasis is given to evaluations of various interrelated foreign policy areas. This is called for due to important international developments and trends in the implementation of an integrated foreign policy, including domestic policies with international implications. Increasingly, this integrated foreign policy will also require a more integral evaluation of interrelated policies. IOB is therefore involved in the development of new evaluation approaches in order to be able to better assess the result-oriented performance in areas of integrated foreign policy and interdepartmental policy development and implementation. This is also done with a view to enhance the ex post evaluability of policies in future evaluations as well as to develop suitable methodologies for ex ante impact assessments to inform current policy-making, especially for policy themes where policy domains are interrelated. Finance for development is such an important area and an obvious candidate for this approach.

Policy initiatives to enhance finance for development in developing countries have been key issues in the international debate about development for several decades. This attention culminated in the international Conference on Finance for Development in Monterrey in 2002 which produced commitments and regular monitoring efforts by the international donor community. While the focus of this debate was initially on the required volume of official development assistance (ODA) flows and whereas the results of the commitments have been disappointing over time, we have seen a shift in attention over time from ODA towards domestic revenue mobilization by developing countries themselves. This trend was in addition to a growing share in the external financial flows of developing countries of private capital, foreign direct investment (FDI) and remittances from migrants.

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Leaving the decreasing share and importance of ODA for most developing countries aside, this shift in policy attention towards domestic revenues was long overdue and most welcome. Amongst the flows to finance development in developing countries, their own domestic revenues were actually always the largest and more important for other reasons. In particular taxes can enhance self-reliance, foster inclusion of citizens into political and nation building processes and strengthen (in principle) the accountability of governments towards their own tax payers and other constituents. Tax regimes and institutional capacity in most developing countries are, however, often underdeveloped and not immune to outside influences. Corporate taxes, including those paid by multinationals on profits and capital gains (directly) and/or as a withholding tax on dividend, interest or royalty payments transferred abroad, play an important role in domestic revenue mobilization in most developing countries. Those corporate tax revenues may also be affected by both the fiscal planning methods of multinationals and the tax policies of developed countries.

There is fierce competition among developing countries to attract FDI with financial incentives and among developed countries to host multinationals to get their share of the corporate global activity. Moreover, in particular jurisdictions with no or low corporate taxes compete to function as a conduit, yielding them taxable personal income and consumption. The pressure from international competition raises prisoners' dilemmas and obstacles for collective action solutions. The interaction of domestic tax systems and bilateral tax treaties intended to avoid double taxation of corporate income of the multinational in host and home country may also have facilitated perfectly legal tax avoidance. The exploitation of differences in tax rules between countries may have led to the unintended consequence of no – or hardly any – taxation of corporate income in certain cases, especially in the absence of limitations on abuse in tax treaties. It raises issues of distortion of competition between multinationals and domestic companies, of inefficient allocation of resources geared towards tax savings rather than economic returns and of fairness in unequal tax burdens between individual tax payers and multinationals. Especially in a North/South context this sort of tax avoidance can be perceived as contrary to development.

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In recent years, the relationship between tax and development has therefore come to the fore in the international debate on policy coherence for development (PCD), and thereby asking what are the effects of non-aid policies of developed countries on development opportunities in developing countries. For an EU member state like the Netherlands, most relevant non-aid policies with an impact on development are formulated and implemented at the EU-level, such as trade and agriculture. An exception where competence still rests at national level (within a general EU-framework) is tax policy, but the effects of national tax regimes do not stop at the national border. National tax regimes interact with each other in several ways. A transparent, equitable and fair global tax architecture should be the clear objective of this international debate. Though primarily a collective challenge for the international community, it does not absolve individual countries from their own responsibility to take full account of the external effects of their tax systems, especially on weaker countries.

The impact of the Netherlands' corporate tax regime on developing countries has been receiving increasing interest. The reason is that the Netherlands has been mentioned as an important conduit country in multinational fiscal planning strategies. It is widely recognized that the Netherlands has an attractive fiscal climate due to its tax rulings offering upfront certainty about future tax obligations, its extensive network of bilateral tax treaties and its highly skilled advisory infrastructure. Given the current emphasis on PCD, due attention should therefore be given to the implications of the Netherlands' corporate tax regime and its bilateral tax treaties on the potential tax base erosion in and profit shifting (BEPS) from developing countries.

Internationally, a wide array of fiscal practices and mechanisms exists that can enable profit shifting and disentangle corporate income from the location where the actual value is created. A thorough understanding of underlying pathways and approximate amounts of lost tax revenues by developing countries is important for a balanced and fact-based discussion, both internationally and at home. The BEPS debate has now reached the highest level of decision makers in the G-20 who have mandated the OECD to devise and implement a BEPS Action Plan. Ultimately, it is the governments' collective responsibility to revise the rules or negotiate new ones if aggressive fiscal planning by companies within the old systems leads to these undesirable outcomes. The Action Plan might result in fundamental changes in international tax standards that take full account of their impact on developing countries which deserve special attention in this regard and a place at the negotiating table.

Several reports have been published on the subject of the impact of the Netherlands' corporate tax regime, recently by SEO Economic Research, the Netherlands Bureau for Economic Policy Analysis (CPB) and the International Bureau of Fiscal Documentation (IBFD). Other studies may be forthcoming in the near future, for example by the Netherlands Court of Audit (Algemene Rekenkamer) at the request of the Netherlands' Parliament. Considering these reports in more detail, there seems to be some confusion, especially about the size of lost tax revenues in developing countries, but research methodologies also varied. Against this background, IOB invited dr. Francis Weyzig (Utrecht University) to produce an overview paper. This study is based on his doctoral research on the effects of Dutch tax policy on taxation of multinationals in developing countries. The study was also commissioned to gain more insight in methodologies for assessing ex ante the effects of corporate tax regimes and bilateral tax treaties on developing countries, starting at home in the Netherlands. This report is part of the series of independent overview studies on development and foreign policy issues that IOB produces regularly.

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The report offers a detailed review of tax systems in developing countries including the role of corporate taxation of multinationals, the various international pathways for tax avoidance by multinationals, the facilitating role of tax treaties and treaty shopping in this regard and the likely negative consequences for developing countries' tax revenues and their economies. It is based on a detailed analysis of anonymised micro (company) data of the Dutch Central Bank (DNB) and other public sources. Francis Weyzig provides us with a balanced appreciation of the implications of profit shifting via tax treaties. He shows that the negative effects on tax revenues can be substantial but also can vary considerably between individual developing countries, depending on their international profiles, the presence and content of their bilateral tax treaties and their own tax systems and institutional capacities.

Of course this overview report cannot deliver the final word on the topic. Uncertainty remains in this relatively unexplored field about the precise pathways in practice, the magnitude of bilateral financial flows and associated tax avoidance, the net-impact on government revenues of individual developing countries, the effects of the competition between developed countries, the role of tax havens and the most appropriate (inter) national strategies to address these problems. Obviously more research and debate are needed. IOB sincerely hopes that this publication will prove to be helpful in triggering that research and in further deepening the debate in order to enhance insights in the structure of financial flows for development and prospects towards policy coherence for development, both in the Netherlands and by the international community.

The production of this study has been coordinated by Otto Genee (IOB evaluator).

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## Acronyms and abbreviations

AfDB	African Development Bank
AFM	Dutch Authority for the Financial Markets
CBS	Statistics Netherlands
CPB	Netherlands Bureau for Economic Policy Analysis
DNB	De Nederlandsche Bank (Dutch Central Bank)
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GFA	Group Financing Activities (a special Dutch tax regime)
GNP	Gross National Product
HIPC	Heavily Indebted Poor Countries
IMF	International Monetary Fund
LDC	Least Developed Country
LOB	Limitation on Benefits
ODA	Official Development Assistance
OECD	Organisation for Economic Cooperation and Development
PCD	Policy Coherence for Development
PRSP	Poverty Reduction Strategy paper
SADC	Southern African Development Community
SOMO	Centre for Research on Multinational Corporations
SPE	Special Purpose Entity
UNCTAD	United Nations Conference on Trade and Development
USD	United States Dollar
VAT	Value Added Tax
WDI	World Development Indicators
WHT	Withholding Tax

# Summary and conclusions

This study analyses domestic revenue mobilisation in developing countries, which is an essential component of financing for development. It discusses the role of corporate tax revenues and challenges for the taxation of multinational firms in developing countries, with a focus on effects of Dutch corporate tax policy and Dutch tax treaties. The study concludes that for some developing countries these effects are negative and material.

Sources of financing for development can be distinguished into public sector financing and private commercial flows. The former can be used directly to finance public services, such as education, health care, sanitation, and basic infrastructure, which are essential for social development. Foreign Direct Investment (FDI), migrant remittances, trade, and other private commercial sources can stimulate investment and economic growth but they support public services only in an indirect way. Upper-middle income countries largely raise their own public financing while lower-middle income countries have been gradually replacing external development assistance with domestic resources. In low income countries tax revenues have increased as well but Official Development Assistance (ODA) continues to be highly important for public sector financing.

There exist various reasons why developing countries should reduce dependence on foreign aid and increase their domestic tax revenues. Historical patterns show that aid flows can be volatile and unpredictable. Furthermore, aid may result in rent-seeking behaviour by political elites. It also fosters accountability to external donors but limits the pressure on governments to legitimize their actions towards their populations. Aid conditionality may hinder sound development policies, for example limiting the scope for anti-cyclical fiscal policy. In addition, foreign aid may induce capital flight. Thus, tax revenues are to be considered to be a more sustainable source of financing for development and generally have a more positive impact on developing country governance than aid.

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From a developmental perspective, taxes are not only a source of revenue. Taxes have four main purposes: revenue, redistribution, representation and re-pricing. Redistribution through progressive taxes and limiting tax incidence on people with lower ability-to-pay, is important because development has increasingly become an issue of dealing with inequality, also at national level. Representation means that taxation can be a catalyst for governments becoming more responsive and accountable towards their own citizens. Re-pricing refers to minimising market distortions and providing tax incentives to address externalities. Different types of taxes have different properties. Taxes on personal and corporate income tend to have the strongest positive effect on governance but provide a relatively strong disincentive to economic activity.

In developing countries without large government income from oil or diamonds, tax revenues have increased over the past decade, but remain much lower than in high income countries. Revenues are on average around 20% of GDP in middle income countries and 15% in low income countries. In both country groups, consumption taxes (e.g. Value Added Tax and excises) are the largest revenue component and have increased strongly. In middle income countries, direct taxes (on corporate and personal income) constitute the second largest tax component and have also increased. In low income countries, by contrast, trade

taxes (import tariffs and export levies) are the second largest component and account for approximately a quarter of total tax revenues, more than direct taxes. Thus, further trade liberalisation may be problematic for these countries unless they are able to develop alternative revenue sources.

Corporate taxes are an important revenue component for low and middle income countries, typically generating 10-30% of total tax revenues. The importance of corporate tax revenues for developing countries implies that potential threats to these revenues, such as tax avoidance by multinationals, are highly relevant in the context of financing for development.

Apart from taxes on corporate profits, most countries also levy withholding taxes on dividend, interest and/or royalty payments to foreign entities. In some countries, these withholding taxes alone account for 5% of total tax revenues. Withholding taxes are especially relevant for developing countries because most of these countries are net FDI recipients and withholding taxes are relatively easy to collect. Withholding taxes can also form a barrier to international tax avoidance structures and tax evasion.

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There exist several domestic factors that can undermine corporate tax revenues in developing countries, notably weak administrative capacity and negative attitudes towards taxation due to poor government performance. Regional tax competition among developing countries to attract FDI, via tax holidays and other tax incentives, can also threaten corporate tax revenues. Various empirical studies show that lower taxes are largely ineffective to attract FDI; determinants like good governance and infrastructure are more important. Moreover, tax incentives are often not well targeted. When tax incentives do not increase total investment or investors restructure their investments to obtain incentives that were not intended for them, tax incentives can even reduce total government revenues.

Another factor that can undermine corporate tax revenues in developing countries is international tax avoidance by multinational firms. International tax avoidance strategies can be distinguished into base erosion, profit shifting, and other strategies. Different strategies are often used in combination.

Base erosion strategies use qualification mismatches between different tax systems to reduce the overall tax base. These may involve international payments that are tax deductible in one country but that are not taxed in another country.

Profit shifting does not reduce the overall tax base but shifts profits from affiliates in countries with normal or high tax rates to affiliates that are subject to lower or even zero taxes. Such arrangements can become abusive by artificially segregating taxable income from the activity or affiliate that generates it, even if they are fully compliant with the tax laws in all countries involved. Large differences in effective tax rates often deliberately facilitate profit shifting and are usually intended to attract Special Purpose Entities (SPEs). Multinationals can shift profits through reallocation of functions that generate large margins, for example allocating the ownership of patents to SPEs in tax havens. Various

empirical studies show that multinationals also use internal loans to shift profits in the form of interest payments. Furthermore, multinationals can manipulate the transfer prices for internal trades between affiliates in different countries. Transfer mispricing is often illegal but can be hard to prove.

Other tax avoidance strategies include treaty shopping to avoid withholding taxes. Tax treaties limit withholding taxes on a bilateral basis. To illustrate treaty shopping, consider a host country that has different tax treaties, specifying a dividend withholding tax of 10% to one country and 5% to a second country. A few empirical studies show that some foreign investors would then route FDI through an SPE in the second country to benefit from the lower withholding tax rate. Host countries generally disapprove of treaty shopping. Certain clauses in tax treaties, notably a main purpose test or limitation on benefits, can inhibit treaty shopping.

Multinationals use Dutch SPEs on a very large scale and this means that Dutch tax policy can have negative effects on domestic revenue mobilisation in developing countries. Relevant aspects of Dutch tax policy include the network of bilateral tax treaties, the absence of Dutch withholding tax on interest and royalties, and the special tax treatment of SPEs under certain advance pricing agreements (also known as tax rulings) with the tax authority. Other aspects of Dutch tax policy, such as the exemption of profits from the sale of foreign participations, can have material effects on developing countries as well but these effects have not yet been investigated.

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Potential positive and negative effects of Dutch tax policy on domestic revenues in developing countries materialize through different pathways. For instance, a tax treaty may generate additional FDI in a developing country, thus changing the total volume of inward FDI. If a Dutch tax treaty reduces a developing country's withholding tax rates, it also has a rate effect, including for investments that already exist or would take place anyway. Furthermore, structures involving Dutch SPEs can have a composition effect by changing the income and expenses of companies located in a developing country. Some of the volume, rate and composition effects are negative and largely unintended.

Regarding volume effects, econometric studies on the effect of tax treaties on bilateral FDI have produced mixed results. Various studies find positive effects but these effects sometimes appear to be temporary or limited to middle income countries. Other studies find no significant effect of tax treaties. An important limitation of these econometric studies is that they analyse the effects of tax treaties in general. Treaty benefits for investors are, however, not homogenous because the benefits follow from treaty provisions in combination with tax system characteristics of the home and host country. A different type of study found that the tax treaties between the Netherlands and the Philippines, Bangladesh, Ghana, Uganda, and Zambia may not have had a significant effect on the volume of regular FDI from the Netherlands in these countries. Although it is possible that Dutch tax treaties with other developing countries have had a positive volume effect, evidence of such effects is currently not available.

Regarding rate effects, a few academic analyses provide evidence of tax treaty shopping via the Netherlands. Treaty shopping is possible for many FDI routes where Dutch tax treaties specify relatively low withholding tax rates, notably for dividends, without effective anti-abuse provisions. Furthermore, the Dutch tax system facilitates avoidance of withholding tax, primarily on interest paid to external creditors via Dutch SPEs. Various studies estimate that these effects lead to foregone dividend and interest withholding tax revenues in developing countries in the range €150-550 million per year.

Regarding composition effects, avoidance of interest withholding tax stimulates substantially higher debt financing relative to equity because it reduces borrowing costs. This limits a firm's tax base and therefore results in an additional revenue loss. Furthermore, special tax treatment of SPEs under certain advance pricing agreements with the Dutch tax authority facilitates profit shifting to the Netherlands and reduces corporate income tax revenues in some developing countries. While significant, the revenue effect is probably smaller than that of withholding tax avoidance.

Considering the other purposes of taxation beyond revenue generation, it can be concluded that tax avoidance strategies facilitated by Dutch corporate tax policy have further negative effects on developing countries. The effect on redistribution mainly takes place at the international level; income is redistributed from developing countries to the Netherlands and other high-income countries. The effect on representation is somewhat ambiguous. On the one hand, tax avoidance by foreign and domestic multinationals can weaken broader taxpayer morale. On the other hand, citizens in developing countries may find other revenue problems more pressing. Finally, the re-pricing effect of tax avoidance reduces market efficiency, because it redirects resources to unproductive rent-seeking uses and distorts competition between large firms that can engage in international tax arbitrage while medium-sized or smaller firms cannot. These negative effects on broader economic development are difficult to quantify but may be as important as the direct negative effect on public revenue mobilisation.





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# Introduction

Research on financing for development often focuses on international sources of finance or on domestic policies in developing countries to promote private investments and raise tax revenues. The same applies to policy initiatives to enhance financing for development. These mainly concern official development assistance (ODA), policy coherence for development with regard to trade, foreign investment, and other external financing sources, and technical assistance to improve the business climate and tax administration of developing countries. However, domestic revenue mobilisation in developing countries is also affected by external factors, including by tax policies of donor countries.

This study discusses effects of the Dutch corporate tax system, including Dutch tax treaties, on taxation of multinational firms in developing countries. The Dutch tax system affects corporate tax revenues in many countries, not just in developing countries. In absolute terms, by far the largest impact is on tax revenues in the United States and some European countries. However, for some developing countries, especially those that have a tax treaty with the Netherlands, the impacts are also material. The impacts on tax revenues in some least developed countries may be more limited as Dutch tax policy will be less relevant to countries with insignificant foreign direct investment (FDI).

Development scholars, policy makers and practitioners may be unfamiliar with the effect of tax systems in high income countries on corporate tax revenues in developing countries. Furthermore, taxation of multinational enterprises is a rather specific aspect of the overall design and functioning of a developing country's tax system. The relevance of foreign tax systems and of the Dutch tax system in particular, for development policy and government revenues may therefore not be immediately apparent. Nonetheless, the revenue impacts for developing countries can be substantial. This study provides further insights into those impacts and the underlying mechanisms.

The outline of this study is as follows. Chapter 2 describes the role of tax revenues in financing for development and provides a framework to analyse taxation in developing countries. Chapter 3 reviews the relevance of corporate taxes and briefly discusses some general challenges to raise corporate tax revenues in developing countries. Chapter 4 provides an overview of corporate strategies for international tax avoidance and evasion and reviews empirical studies on different tax strategies. Chapter 5 analyses different effects of Dutch corporate tax policy on developing countries. It discusses existing research, including on the effect of tax treaties on FDI, presents examples of tax avoidance structures, and provides relevant figures and estimates of tax avoidance. Finally, Chapter 6 summarizes the various effects and identifies the most important strategies for tax avoidance in developing countries facilitated by Dutch tax corporate policy and bilateral tax treaties.

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# Taxation and development

## 2.1 Public and private sources of international development financing

Initiatives that contribute to poverty reduction in developing countries and other development goals can be financed with various sources of finance. This section focuses on external financial flows and on domestic tax revenues. These include public as well as private sources, and there exist important differences between public sector financing and private commercial flows. The former can be used directly to finance public services, such as education, health care, sanitation, and basic infrastructure, which are essential for social development. Private commercial sources can stimulate investment and economic growth, but they support public services only in an indirect way. Some forms of official development assistance (ODA) and private aid flows, such as project support and grants for public-private partnerships, are somewhere in between. These sources may contribute directly to the financing of public projects, but cannot be fully directed by developing country governments themselves unlike direct budget support. The African Economic Outlook 2010 explicitly distinguishes the private and public component of development financing and emphasises the importance of equitable and efficient tax systems to finance public expenditures (OECD & AfDB, 2010). This study focuses on the structure of tax systems and hence on the public component of domestic resource mobilisation.

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Historically, official development assistance (ODA) has been mainly focussed on foreign grants and public sector loans as sources of finance. However, the importance of these sources in external financial flows has declined over time. In 1960, ODA to developing countries, consisting of grants and loans on concessional terms, was approximately 0.50% of donor countries' Gross National Product (GNP). Although in 1970 member countries of the Organisation for Economic Cooperation and Development (OECD) committed to increase ODA to 0.7% of their GNP, by 1996 on average ODA had decreased to 0.25% of their GNP (Todaro, 2000). In 2002, the Financing for Development conference in Monterrey resulted in renewed donor commitments and ODA to Least Developed Countries (LDC) increased substantially for one year. Similarly, the 2005 G8 summit in Gleneagles renewed the promise and produced a temporary increase, especially in the field of debt relief. However, aid flows have remained volatile and are currently declining, as donors failed to fulfill their commitments (United Nations, 2010; Weeks, 2010). Thus, even without considering issues around aid dependency and governance, these patterns show that ODA is not a reliable and sustainable source of development financing for most developing countries.

The decrease of new concessional loans in the period 1974-1979 went together with a strong increase in lending to developing country governments by commercial banks, on non-concessional terms and with shorter maturities. The boom in external borrowing during the late 1970s supported broader government spending, as developing countries sought to sustain fast growth in the face of declining exports. During this financial boom, sustainability of external borrowing was not regarded as a source of concern. However, the second oil shock in 1979 caused a strong increase in interest rates and import prices for

developing countries, triggering the debt crisis of the 1980s. Many developing countries were unable to meet their rising debt service obligations and the International Monetary Fund (IMF) stepped in to provide stabilisation loans, subject to strict policy conditions. The IMF's policy prescriptions were intended to generate macroeconomic stabilisation and did not have a development focus (Stewart, 1991). Thus, neither the commercial bank loans nor the IMF stability loans were specifically intended as a source of finance for development.

The stabilisation programmes that were linked to IMF support often included a tax component, which formed part of the Washington consensus. This tax component consisted of three main pillars. First, governments should aim to maximise the neutrality of the tax system with regard to economic activity. This was translated into a standard prescription for a broad-based indirect taxes such as a Value Added Tax (VAT), much lower rates of corporate and personal income tax, and reducing tax incentives and exemptions (Bird, 2012). Second, governments had to limit the use of taxes for redistributive goals. Third, developing countries should realise tax revenues of approximately 15-20% of Gross Domestic Product (GDP) (Cobham, 2007). As a consequence, countries in Latin America and sub-Saharan Africa hit by the debt crisis on average increased their tax revenues from the 1970s to the 1980s, but the progress was limited (Cobham, 2005b).

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The Heavily Indebted Poor Countries (HIPC) initiative, launched in 1996 to address the still unsustainable debt burden of developing countries with high levels of poverty, was slightly different. The national Poverty Reduction Strategy Papers (PRSPs), describing the policy commitments of HIPC countries, showed some diversity in tax policy reforms. Some tax-related policy goals continued to reflect the Washington consensus, such as limiting the tax burden to a certain share of GDP (Kenya). However, several PRSPs emphasised more progressive taxation (Uganda, Benin) or contained explicit goals to increase total tax revenues (Mozambique, Zambia). Such policies emphasised the role of tax in raising revenues and enhancing redistribution, departing from the more one-sided focus on minimising the distortionary effects of taxes on economic activity.

Since the 1990s, sources of development finance other than external grants, loans and domestic tax revenues have received increasing attention. A new phase of economic globalisation took off in this period. FDI in low and middle income countries strongly increased, even while it was initially highly concentrated in the largest emerging economies and resource rich countries (Botchwey, 2003). In 1997, approximately 60% of FDI inflows to developing countries went to China, Brazil, Mexico, Indonesia and Poland (Todaro, 2000). International trade also increased, in part due to trade liberalisation and economic reform. FDI and international trade were major themes in the 2002 Financing for Development conference in Monterrey and the 2008 conference in Doha. Migrant remittances could be added to this list of alternative sources of finance for development other than ODA. The volume of registered remittances to developing countries has grown from USD 81 billion in 2000 to approximately USD 325 billion in 2010. Taking into account unrecorded flows, total remittances are still significantly larger. They have become the third largest source of external finance for developing countries, after export earnings and FDI, and represent more than twice the amount of official development aid received (World Bank, 2011b).

Remittances are also strongly concentrated, though. In 2010, over 50% of recorded migrant remittances to low and middle income countries were sent to India, China, Mexico, Nigeria and the Philippines (World Bank, 2011a).

Figure 1 (see next page) shows various domestic and external sources of financing as a proportion of Gross domestic Product (GDP) around 1997 and 2007. It shows public as well as private flows and of these, such as migrant remittances, are not necessarily employed to finance development initiatives or domestic investment. The figure distinguishes three groups of countries on the basis of World Bank income categories.<sup>1</sup> The first two sources of financing, tax revenues and Official Development Assistance (ODA), are the main funding sources for public expenditures and public investments.<sup>2</sup> In upper-middle income countries, ODA is insignificant. In the group of lower-middle income countries, on average the contribution of ODA to public financing dropped from 7% to 5% of GDP, but this was compensated by increasing domestic tax revenues. As a consequence, the sum of tax revenues and ODA increased slightly from 24% to 25% of GDP in this country group. For low-income countries, net ODA receipts reached a low point in 2000, then peaked in 2003, and by 2007 ODA receipts had fallen again to approximately 14% of GDP, the same level as in 1997. Tax revenues, by contrast, rose steadily from 12% to 15% of GDP. Thus, while lower-middle income countries have been gradually replacing external development assistance with domestic resources, in low income countries tax revenues increased as well but ODA continues to be a highly important source of public financing.

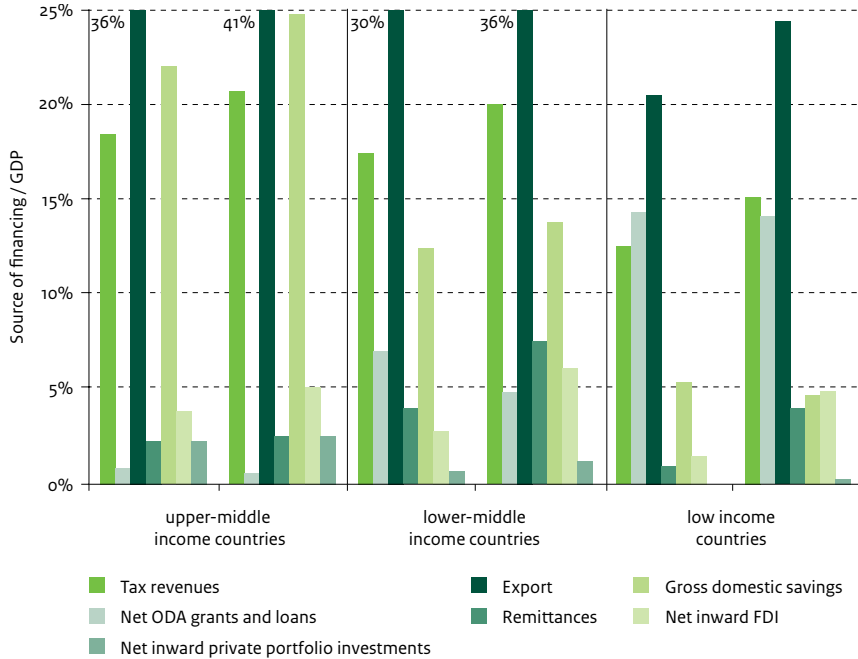
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The next two sources shown in the figure, export earnings and remittances, are private sources of foreign income, resulting from trade and migration. Exports are by far the largest source of external revenue in all country groups and periods and increased considerably since 1997. Note that relatively high export earnings do not necessarily imply a positive trade balance; a country will still have a trade deficit if imports are even higher. Furthermore, although exports are a source of private income, international trade can also generate government revenues via export levies and import duties. Remittances are especially important for lower-middle income countries,<sup>3</sup> but remittances to low-income countries have also increased strongly.

<sup>1</sup> The figure excludes countries with government revenues from natural resources higher than 10% of GDP in 2006-2008. In addition, Swaziland and Lesotho are excluded because of their unusually high government revenues from Southern African Development Community (SADC) tariff revenue allocations. The analysis uses fixed country groups based on World Bank income classifications from 2012. Thus, developments over time in the various graphs are not influenced by reclassifications of countries.

<sup>2</sup> Other external financing for public goods and services, such as official flows other than ODA and grants from private development organizations, are relatively small compared to ODA and tax revenues. See OECD (2012a).

<sup>3</sup> Out of the 22 lower middle income countries in the figure, seven countries received remittances over 10% of GDP in the period 2006-2008. These were Cape Verde, El Salvador, Guatemala, Moldova, Nicaragua, the Philippines and Senegal.

**Figure 1** Domestic and external sources of financing by country group

Notes: unweighted averages per country group for the periods 1996-1998 and 2006-2008; exports exclude 7 countries due to missing data; private portfolio investment includes bank loans. Sources: tax revenues for African countries from OECD and AfDB (2010); tax revenues for Latin American countries except Nicaragua from OECD (2012b); remittances from World Bank (2011a) if available; all other data from World Bank (2012).

Finally, domestic savings and external FDI and portfolio investments are three sources of financing for private investment. Although domestic savings can also be invested abroad or in non-productive assets, they provide important potential financing for domestic investment. Gross domestic savings differ markedly between the country groups. In upper middle-income countries, domestic savings are relatively high and much larger than FDI and portfolio investment. Private investment in these countries is unlikely to be constrained by savings (Rodrik & Subramanian, 2009).<sup>4</sup> In lower-middle income countries, domestic savings are on average much lower and FDI has become an important complementary source of investment. In low-income countries, domestic savings are still lower, on average a mere 5% of GDP. In some of these countries, notably Burundi and the Kyrgyz Republic, gross domestic savings have been substantially negative since at least 2004. FDI to low-income countries has strongly increased and on average FDI inflows around 2007

<sup>4</sup> FDI and domestic savings are no perfect substitutes, though. FDI can be qualitatively different, for example if it involves transfer of skills and technology.

were also 5% of GDP, as large as domestic savings. Portfolio investments to all three country groups are on average much smaller than FDI.<sup>5</sup>

Note that net external portfolio investment in developing countries reached an all-time high in 2007 and net inward FDI peaked in 2008. After that, both types of foreign investment sharply declined as a result of the global financial crisis. Figure 1 therefore shows foreign investment at its peak. Portfolio investment to developing countries reached a peak in 1997 as well, just before the Asian crisis hit. However, the three-year average data shown in the figure also include flows in 1998, when portfolio investments to Thailand and Indonesia had turned substantially negative due to withdrawals of previous investments. ODA has also been volatile, as noted above, but less so than foreign direct investment. Domestic tax revenues and migrant remittances from abroad, by contrast, have been relatively stable over time.

To summarise, there exist important differences between public and private sources of financing for development, because only the former can directly finance public services and investments. Private sources such as trade, FDI and remittances do not have a primary development objective but may yield important development benefits. Regarding public sources, most developing countries have been able to increase domestic tax revenues, but in low-income countries tax revenues are still relatively low and ODA continues to be highly important.

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## 2.2 Tax, aid and governance

Developing countries need to replace foreign aid flows with domestic tax revenues because the former are not a very reliable long-term source of development financing, as argued above. Moreover, many developing countries have made considerable progress in reducing absolute poverty over the past decades and have experienced strong economic growth. As countries become less poor, they become less eligible for aid. By 2012, 49 countries are classified as LDCs. By definition, poverty in these countries is widespread and severe; they have a low level of economic development and are vulnerable to external shocks. In the 1990s, most poor people lived in low-income countries. However, this has changed and currently most poor people live in lower-middle income countries. The main reason for this development is that India, China, Nigeria, Indonesia, and Pakistan have achieved lower-middle income status between 1999 and 2008. Over 900 million poor people live in these five countries (Sumner, 2010). Countries like India and Indonesia have quickly growing economies, high inward FDI, and large national firms and home-based multinationals. This means that development has increasingly become an issue of inequality, not just at the international level, but also and mainly at the national level. Accordingly, development

<sup>5</sup> Data on portfolio investments are not complete, though, and may underestimate the total volume of net inward investments. Furthermore, some multinationals based in developing countries issue debt securities via foreign subsidiaries located in, for example, the Netherlands or Singapore. The foreign subsidiaries often lend the issuance proceeds onwards to their own parent companies. These reverse loans are recorded as negative outward FDI instead of positive inward portfolio investment.



financing is shifting from external aid, which may be necessary for poverty reduction in LDCs, to domestic resource mobilisation and redistribution, which may help to reduce inequality in middle-income countries.

However, there exist other and more pervasive reasons why developing countries should reduce dependence on foreign aid and increase domestic tax revenues. Tax and aid have very different qualities and therefore different impacts on economic growth and institutions. First, aid flows are often more volatile and unpredictable. The erratic behaviour of aid flows limits their potential positive impact (Bulif & Hamann, 2006; Lensink & Morrissey, 2000; Weeks, 2010).

Second, aid may result in rent-seeking behaviour by political elites. Empirical research finds that foreign aid has a negative impact on institutions, similar to the resource curse of natural resource revenues (Djankov et al., 2008). As development assistance has shifted from project aid to budget support, some suggest that opportunities for rent seeking may have increased (Kolstad et al., 2008).

Third, development aid fosters accountability to external donors but limits the pressure on governments to legitimate their actions to the population (Moss et al., 2006). By contrast, taxation is a catalyst for the establishment of governments that are more responsive and accountable towards their own citizens (OECD, 2010a). It also stimulates the development of civil society organisations that advocate responsible use of public funds. This is a very important difference. If a government depends on public support, taxation is likely to drive revenue bargaining. Revenue bargaining means that tax payers interact with the government to keep taxes at a socially acceptable level and try to hold the government to account for the use of public resources and delivery of public goods and services. This process is a main element for building a functional state (Moore, 2008; Prichard, 2010). In most countries, the focus of revenue bargaining is on the expenditure side rather than the revenue side, with citizens demanding more efficient and responsible use of government funds.

Fourth, and linked to the previous point, bilateral and multilateral aid usually involves aid conditionality. To some extent, conditionality has shifted from policy conditions to institutional reforms that have a broader and more permanent positive effect on development (Adam & O'Connell, 1999). However, in many cases aid conditionality still limits macroeconomic policy options for developing countries and this may hinder sound development policies, for example limiting the scope for anti-cyclical fiscal policy (Weeks, 2010).

Fifth, some aid is diverted directly or indirectly to finance capital flight (Serieux, 2011). Although this may also apply to government revenues from oil and other natural resources, transparent tax revenues do not produce this adverse effect. In other words, domestic tax revenues are less associated with capital flight than foreign aid. These five reasons make tax revenues a key component of finance for development.

Research shows that aid also has an effect on taxation. In theory, the effect can be either positive or negative depending on the circumstances. Regarding positive effects, aid can stimulate economic growth and thereby raise tax revenues. Aid may also support domestic resource mobilisation if it aims to enhance domestic institutions and strengthen fiscal administration (Serieux, 2011). A positive relationship between aid and taxation may also result from other factors, such as good governance, that increase both tax revenues and external aid. Aid will not have a positive effect if it is captured by political elites and used for unproductive purposes, so it does not generate economic activities that yield reliable and enduring tax revenues. Moreover, a negative effect can occur if aid reduces incentives for domestic revenue mobilisation and accountability towards domestic constituents (Andreoni, 1993; Heijdra et al., 1998).

Some empirical studies find a positive relationship between aid and taxation (Gambaro et al., 2007; Khan & Hishino, 1992); others find that grants reduce the revenue effort (Gupta et al., 2003). A newer study, using extended panel data and distinguishing between different types of aid and taxes, finds a robust positive effect. Bilateral aid and grants have a stronger effect than multilateral aid and loans. The positive relationship is also stronger for middle income than for low-income countries. Moreover, the results suggest that the introduction of budget support in the late 1990s stimulated domestic revenue mobilisation (Ruben & Pop, 2009). However, another recent study using similar panel data finds a negative effect. This overall effect is small and decreasing over time, but in countries with weak institutions, the study finds that an increase in donor grants is associated with a decrease in tax revenues of a similar magnitude (Benedek et al., 2012).

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Thus, tax revenues are to be considered as a more sustainable source of financing for development and generally have a more positive impact on developing country governance than aid. Well-designed development aid can help to strengthen taxation, but the general effect of aid on tax revenues remains contested.

## 2.3 A developmental perspective for analysing revenue mobilisation

Taxation performs several other roles in addition to generating public revenues. Traditionally, and especially from a neoclassical economic perspective, academic analysis has emphasised the trade-off between revenues on the one hand and economic disincentives and market distortions on the other hand. Development studies increasingly pay attention the relationship between tax and governance. In environmental economics, the focus is on environmental taxes and tax exemptions as policy instruments to influence behaviour and environmental impact. Combining such different elements yields a broader framework for analysis of tax policy.

Cobham (2005b) summarizes the different roles or purposes of taxation as Revenue, Representation, Redistribution and Re-pricing. Revenues from taxation obviously serve to fund government expenditures, but the total level of tax revenues can also be an instrument for countercyclical macroeconomic policy. The current financial crisis emphasises the importance of stable economic development, which requires sufficient policy space for developing countries to adjust their fiscal balance (Weeks, 2010). Representation refers to governance; tax can foster representation because citizens will demand greater influence on government spending when it is funded by taxes. Redistribution can be implemented on purpose through progressive income and wealth taxes and the allocation of government expenditures or subsidies. Especially in low and middle-income countries, a progressive tax system can help to fund poverty-directed expenditures and mitigate income inequality. However, it should be recognised that all types of taxes can have distributional impacts.

Table 1	Four main purposes of taxation
Purpose	Description
Revenue	Generating sufficient revenues for the government to fund public goods and services, investment, administration, and debt service; dampening economic cycles through countercyclical movements in the tax burden
Redistribution	Enhancing equality through progressive taxation, reducing tax incidence on people with lower ability-to-pay
Representation	Fostering inclusion of citizens in political processes and good governance, supporting the implicit social contract and legitimacy of the state
Re-pricing	Providing targeted tax incentives to stimulate certain activities (or disincentives to discourage certain activities); minimising market distortions and general disincentives to economic activity

Source: Based on Cobham (2005b).

Re-pricing refers primarily to incentives resulting from taxes on specific goods or activities with negative externalities, such as excises or fiscal incentives for activities with positive spill-over effects. Obviously, in practice tax exemptions are not always linked to positive externalities and may also serve special interests. For a more complete framework of analysis, it makes sense to include general disincentives to economic activity and market distortions due to unintended differences in tax treatment under re-pricing as well.

The resulting framework is summarised in table 1 above. Parts of this framework can also be found in other studies. For example, Tanzi and Zee (2000) assess tax systems in developing countries on three of the above elements: sufficient revenues, equity (redistribution), and minimal disincentives that distort economic activity (re-pricing). This analytical framework may be helpful to understand the different properties of various types of taxes. Tax revenues from natural resources mainly generate public funds. The impact on governance is a by-effect and usually negative, although there also exist countries with large resource rents and good governance like Botswana. Direct taxes, on personal income and corporate profit, tend to have the strongest positive effect on governance because taxpayers are well aware of

how much tax they contribute and make use of public goods and services, such as infrastructure and education (OECD, 2010a). The main disadvantage of these taxes is that they provide a relatively strong disincentive to economic activity. To some extent, income taxes can easily be made progressive and this also mitigates disincentives to work or start a business (in the formal sector).

Taxes on personal wealth and property, such as real estate and land, have an even stronger redistributive impact because the distribution of wealth is generally more unequal than the distribution of income. Moreover, these taxes have a limited impact on direct economic activity. Property and wealth taxes are less established in low and middle-income countries due to the existing political economy, so there is considerable potential for increasing their use and reducing evasion of existing taxes. Taxes on certain types of property are relatively easy to collect if a domestic registration system is in place and taxes are actually collected. This is not the case for taxes on financial wealth, which can be held offshore.

Indirect taxes, which include consumption and trade taxes, have a weaker impact on governance, largely because of their indirect nature; consumers are not very much aware of how much indirect taxes they pay. However, indirect taxes often have strong re-pricing and inflationary effects. Excises raise the price of goods on which they are levied compared to other goods while import tariffs raise the prices of imports compared to domestic production. The properties of Value Added Tax (VAT) and sales taxes depend very much on their design. A uniform rate on all goods and services is regressive and disproportionately hits poor households that buy goods produced in the formal economy, because the poorest households spend the largest part of their income on immediate consumption. For this reason, human rights groups have been campaigning heavily against a uniform 15% VAT in Bangladesh that was proposed in 2010 to meet policy conditions for IMF support. Such a VAT would substantially increase government revenues, but at the expense of higher inequality and increased poverty. This illustrates that IMF conditionality for tax policy is still questionable from a development perspective. A VAT or sales tax that exempts basic food items and other goods that account for a large share of consumption of poor households has a very different impact. Although it still affects the poor, the loss in purchasing power is smaller and the distributional effect of the tax can be slightly progressive (Newhouse & Zakharova, 2007; Refaqt, 2003).

Until recently, environmental taxes had been virtually absent from the development agenda. One reason is that these taxes are not the easiest ones to administer and require a relatively developed tax authority, just like a VAT. However, these taxes have two important advantages. First, their re-pricing effect is to discourage economic activities that produce relatively large negative environmental externalities. Thus, they do not generate undesirable disincentives to economic activity. Second, they may have a neutral or progressive distributional impact. Currently many developing countries heavily subsidise fuel, which works the opposite way as an environmental tax and is usually regressive, because it disproportionately benefits car owners. The German development agency GIZ, which is a key provider of technical assistance for tax policy and administration, has started to advise some developing countries on the introduction of environmental taxes. In some

member countries of the European Union (EU), environmental tax revenues are 3-4% of GDP, which illustrates that they can be a substantial source of revenues (European Commission, 2012).

This study focuses on corporate taxes for large multinational firms. Corporate taxes are an important source of revenues for many developing countries. In general, corporate taxes are important for government accountability because they are one of the most visible types of tax. For large firms, though, the main institutional effect may result from public perceptions about the firms' tax behaviour. If it is perceived that large taxpayers are not paying their fair share, this may lower tax compliance by others (Torgler et al., 2007) and undermine constructive involvement of citizens in revenue bargaining. The next chapter will describe the revenue-generating role of corporate taxation in more detail.



3

# Revenue composition and corporate taxation

### 3.1 Level and composition of tax revenues

Developing countries differ greatly from high-income countries with regard to the level and composition of domestic government revenues. Total tax revenues in developing countries are generally lower, in the range of 10-25% of GDP, compared to 25-40% for high-income countries. Consumption taxes, which include VAT, sales taxes and excises, have become a major component of tax revenues in most countries. In most developing countries, the share of import tariffs and export levies in total revenues is still substantial. Personal income taxes and social security contributions are typically low, in part because of large informal sectors, weak tax administrations and small social security systems funded by premiums. As a consequence, corporate taxes account for a relatively large share of total tax revenues as well. For middle-income countries, this share is usually between 10% and 30%. By contrast, in high-income countries, personal income tax and social security contributions are key components and corporate taxes form a smaller part of total tax revenues (Cobham, 2005b; IMF, 2011; Keen & Simone, 2004; Tanzi & Zee, 2000).

However, there exists considerable heterogeneity among developing countries as well. Tax systems are typically influenced by the structure of the domestic economy, the degree of urbanisation, and the political regime. This section briefly describes general developments in tax revenues for broad groups of developing countries. More detailed descriptions and analyses of tax systems in Latin America can be found in the Latin American Outlook 2009 (OECD, 2008) and a report about underlying statistics (OECD et al., 2011). Bernardi et al. (2007) provide detailed case studies of various Latin American countries. Tax systems in Africa are described in the African Economic Outlook 2010 (OECD & AfDB, 2010) and Keen and Mansour (2009). More detailed country studies include Fjeldstad and Heggstad (2011) and Volkerink (2009). Sources for Asia are more limited; Bernardi et al. (2005) provide an analysis of tax systems in several Asian countries.

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General trends show declining total tax revenues in developing countries during the 1980s and the 1990s, followed by increasing revenues during the past decade (IMF, 2011). During the 1980s and 1990s, the importance of trade revenues generally fell due to trade liberalisation while direct tax revenues increased only marginally. Reliance on consumption taxes increased, reflecting the tax component of the Washington consensus (Cobham, 2005b). Developments in tax composition since the 1990s have been remarkably similar (McKinley & Kyrili, 2009), with increasing pressures on corporate tax revenues because of tax competition between developing countries to attract foreign investment (Christians, 2010).

When describing the level and composition of revenues, it is useful to analyse countries with high revenues from natural resources separately. Countries with very large government revenues from oil or other natural resources tend to have different tax structures. In the analysis below, countries whose governments had revenues of more than 10% of GDP from natural resources in the years 2006-2008 are therefore assigned to a separate country



group.<sup>6</sup> Resource-rich countries with government revenues from natural resources below this threshold, such as Cameroon and Mauritania, have tax structures that are more similar to other countries.

Furthermore, it is useful to broadly distinguish between low income, lower-middle income, and upper-middle income countries. Despite the heterogeneity within these three groups, developments over the past decades differ markedly between the groups. The differences between income groups are more pronounced than differences between geographical regions.

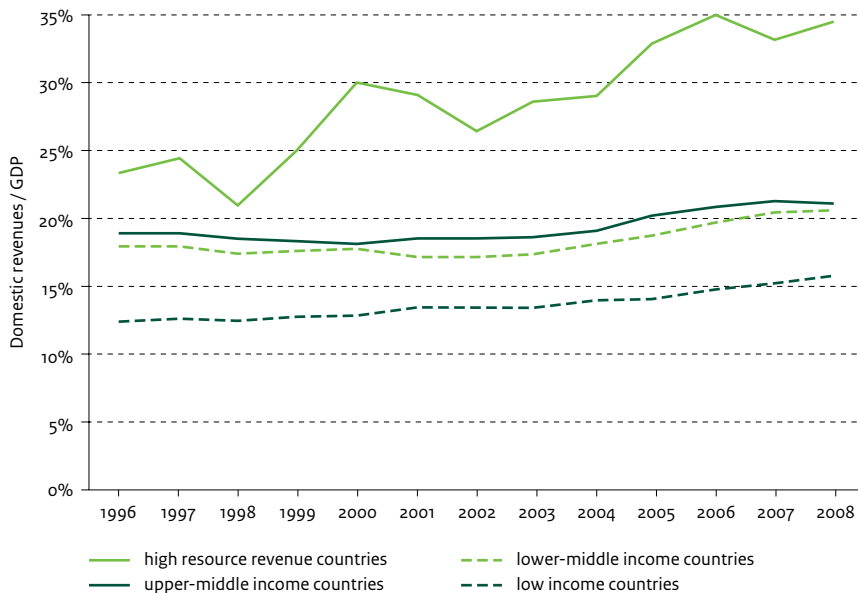
Data on tax revenues are available from different sources, but data consistency is a major problem. For example, the World Development Indicators (WDI) database of the World Bank includes revenues at the central government level only. This does not properly reflect the overall tax systems of countries with substantial revenues at lower government levels, such as Nigeria (IMF, 2011). Data are also inconsistent between databases, partly because of different definitions but often the reasons for inconsistency are unclear. The graphs below combine data from different sources to achieve a better coverage of developing countries. However, for total revenues or individual revenue components of each country, it uses the same source for different years in order to present developments over time more accurately.

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Figure 2 below shows total domestic revenues by country group over the period 1996-2008, excluding ODA but including social security contributions and revenues from natural resources. Revenues have increased strongly in countries with large resource revenues, in part because of rising commodity prices. Domestic revenues in other countries have increased slowly, with much lower levels of revenues in low-income countries than in middle-income countries. Tax revenues in low income countries as a percentage of GDP are now approximately back at the level of the 1980s (IMF, 2011). Thus, raising tax revenues requires continued attention.

<sup>6</sup> These countries are Algeria, Chad, Gabon, Angola, Sudan, Nigeria, Republic of Congo, Botswana, Iran, and Mongolia.

**Figure 2** Total domestic revenues by country group



Sources: data for African countries from OECD and AfDB (2010); data for Latin American countries except Nicaragua from OECD (2012b); data for other countries from World Bank (2012).

Figure 3 shows the composition of domestic revenues for each country group at the beginning and end of the period. Direct taxes consist of taxes on personal and corporate income, wealth, and capital gains. Consumption taxes include VAT and sales taxes as well as excises. Trade revenues mainly reflect import tariffs and export taxes. Other revenues consist of social security contributions, natural resource revenues, and other domestic sources.

For upper- and lower-middle income countries, the increase in total revenues is driven by a rise in both direct and consumption taxes. The main difference between upper-middle income and lower-middle income countries is that the latter continue to depend more strongly on trade taxes. In the low-income country group, consumption taxes also increased substantially, but direct tax revenues increased only marginally and remained below 4% of GDP. Trade taxes were approximately a quarter of total domestic revenues in this country group. Thus, further trade liberalisation may be problematic for government revenues unless low income and lower-middle income countries are able to develop alternative revenue sources (Braunsgaard & Keen, 2005; Khattry & Mohan Rao, 2002). In countries with very high resource revenues, other revenue sources are much less important.

**Figure 3** Revenue composition in developing countries



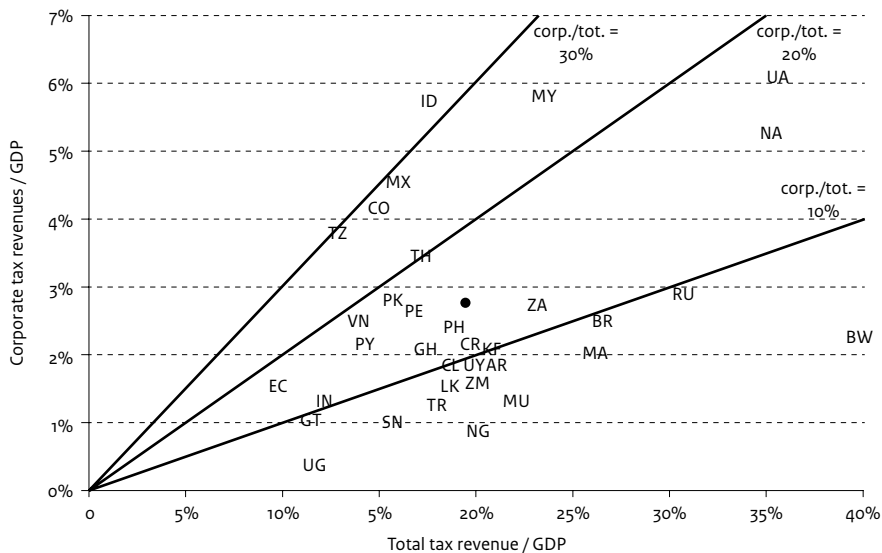
Sources: data for African countries from OECD and AfDB (2010); data for Latin American countries except Nicaragua from OECD (2012b); data for other countries from World Bank (2012). Note: the table shows three-year averages for the periods 1996-1998 and 2006-2008.

### 3.2 Corporate tax revenues

This study focuses on corporate taxes. There is no global database that provides a breakdown of direct taxes into corporate and other types (mainly personal income tax) before 2007.<sup>7</sup> For various Latin American countries, data are available from the OECD. For some countries in Africa, Asia and Eastern Europe, data are available from a comparative IMF study (Abbas & Klemm, 2012), IMF country reports or national sources. The graphs below combine data from the OECD and IMF. They show corporate taxes and total domestic revenues as a share of GDP for 32 middle-income countries and 3 low-income countries (Kenya, Tanzania and Uganda).

<sup>7</sup> From 2007 onwards, corporate tax revenue data are available for many countries worldwide from the USAID Collecting Taxes database, which combines data from various sources.

**Figure 4** Corporate and total tax revenues, 1997



Sources: corporate tax data for Guatemala and Venezuela from OECD (2012b), for other countries from Abbas and Klemm (2012); total tax revenue data for African countries from OECD and AfDB (2010), for Latin American countries from OECD (2012b), for Indonesia, Malaysia, the Philippines, Sri Lanka, Pakistan and India from World Bank (2012), and for Thailand, Vietnam, Turkey, Ukraine, and Russian Federation from Abbas and Klemm (2012); data for Ecuador and Russian Federation are for 1998.

Figure 4 shows data for 1997, at the beginning of the period that was also analysed above. Each country is indicated with its ISO-code.<sup>8</sup> A black dot shows the unweighted average of the 35 countries. Countries at the right hand side of the graph have relatively large total domestic revenues. For example, government revenues in Namibia (NA) and Botswana (BW) are 35-40% of GDP, in part due to high revenues form diamond mining. Countries on the left have low domestic revenues. In Ecuador (EC), Guatemala (GT), India (IN) and Uganda (UG), domestic revenues were near 10% of GDP in 1997, which is low by any standard. Many countries in the graph have total domestic revenues in the range of 15-20% of GDP. Countries at the top have relatively high corporate tax revenues. In Indonesia (ID), Malaysia (MY) and Ukraine (UA), corporate tax revenues were approximately 6% of GDP. This is large, also compared to high-income countries. Countries at the bottom have low corporate tax revenues. In Uganda, Guatemala, Senegal (SN) and Nigeria (NG), corporate tax revenues were only 1% of GDP or less. Most countries are in the lower part of the graph, with corporate tax revenues of 1-3% of GDP.

<sup>8</sup> See annex 2 for a list of all relevant country codes. This code is also the extension for webpages.

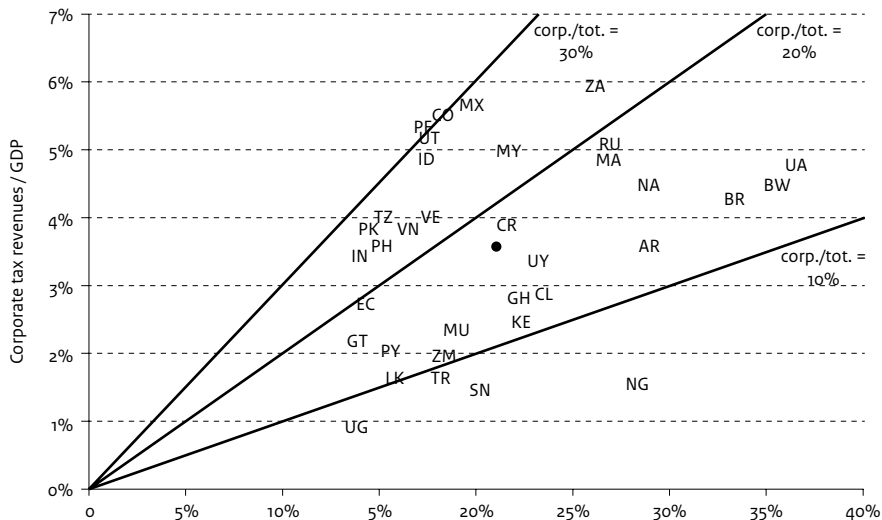
Combining the two axes, countries closer to the upper left corner have a higher proportion of corporate taxes to total domestic revenues.<sup>9</sup> Tanzania (TZ), Colombia (CO), Mexico (MX) and Indonesia stand out as countries with corporate tax revenues around 30% of total domestic revenues. This means that corporate taxes are a very important source of revenue for these countries. Countries closer to the bottom right corner or near the bottom of the graph have a low proportion of corporate taxes. Examples are Uganda, Nigeria and Botswana. In these countries, corporate taxes were a relatively minor source of revenue in 1997. As a reference, three lines indicate corporate tax shares of 10%, 20% and 30%. Many countries have a proportion of corporate tax revenues to total revenues near 10%. This is above the proportion in many high-income countries. Thus, for many developing countries, corporate tax revenues were a material source of revenues in 1997.

Figure 5 (see next page) shows data for 2007, the latest year for which comprehensive data were available from the same sources. Three general trends can be observed. First, most countries have moved to the right, meaning their total revenues increased. This is not a uniform development, though. The increase has been particularly large in the upper-middle income countries Argentina (AR) and Brazil (BR). Some lower-middle income countries, notably Ghana and Senegal, showed considerable progress as well. On the left hand side, domestic revenues in Ecuador, Guatemala, Uganda and India rose to approximately 15% of GDP, but the revenue performance of these countries remained weak compared to other developing countries and even to the target range of the tax consensus of the 1980s. In some countries, such as Indonesia and Zambia (ZM), domestic revenues stagnated, and in other countries, notably the Philippines (PH) and Sri Lanka (LK), revenues substantially decreased between 1997 and 2007. This means that raising tax revenues remains a challenge for many developing countries.

Second, most countries have move upward, meaning corporate taxes have also increased relative to GDP. Corporate tax revenues rose strongly in Morocco (MA), Peru (PE) and South Africa (ZA). However, in some countries, such as Indonesia and Malaysia, corporate tax revenues declined by approximately 1% of GDP. Overall, there exists only a weak correlation (0.24) between the change in corporate tax and total revenues over the period 1997-2007.

<sup>9</sup> Note that this graph shows lower proportions of corporate tax than Abbas and Klemm (2012). The reason is that it uses other data sources that indicate higher total domestic revenues, probably because these other sources include social security contributions and other domestic revenues that are not included in Abbas and Klemm (2012).

**Figure 5** Corporate and total tax revenues, 2007



Sources: corporate tax data for Guatemala and Venezuela from OECD (2012b), for other countries from Abbas and Klemm (2012); total tax revenue data for African countries from OECD and AfDB (2010), for Latin American countries from OECD (2012b), for Indonesia, Malaysia, the Philippines, Sri Lanka, Pakistan and India from World Bank (2012), and for Thailand, Vietnam, Turkey, Ukraine, and Russian Federation from Abbas and Klemm (2012).

Third, the average proportion of corporate taxes to total revenues increased from 15% to 18%. This development has also been uneven. The relative importance on corporate taxes increased strongly in Peru, India, South Africa, the Philippines and Morocco. Countries with a declining share of corporate taxes include Indonesia and Tanzania. Nonetheless, the graph clearly shows that in 2007, many countries had a proportion in the range of 10-20% (between the first and second line) or 20-30% (between the second and the third line). This strongly contrasts with the situation in 1997, when many countries had a share of corporate tax revenues near 10%. Only in a few countries, corporate taxes remained below 10% of domestic revenues.

It can be concluded that corporate taxes are an important source of domestic revenues for most developing countries. The relative importance of corporate taxes has further increased since 1997. This contrasts with high-income countries, where corporate taxes are generally not a major source of revenue and declining. The importance of corporate tax revenues for developing countries implies that potential threats to these revenues, such as tax avoidance and evasion by multinational firms, are relevant in the context of financing for development.

### 3.3 Policy challenges for taxation of multinationals

This section briefly discusses some general challenges to raise corporate tax revenues in developing countries. Some of these challenges involve domestic constraints, others have a regional character. International tax avoidance strategies, such as profit shifting by multinationals firms, are discussed in the next chapter.

A major domestic constraint is weak administrative capacity (IMF, 2011). Understaffed and poorly funded tax authorities limit both the amount of corporate taxpayers that can be assessed and the quality of the assessments. As a consequence, many small taxpayers are not subjected to direct income taxes at all and large taxpayers may relatively easily reduce their tax burden using international tax planning strategies without being challenged by the tax authorities. Most developing countries also have a large shadow economy where consumption taxes can be evaded. Cobham (2005a) estimates that tax revenues in developing countries could increase by USD 110 billion per year if shadow economies were brought into the formal system to the extent feasible.

The large size of the shadow economy does not only result from administrative constraints. Torgler and Schneider (2007) show that it also depends directly on the tax culture and institutions of a country. If people believe more strongly that paying taxes contributes to society and to better governance, this is generally associated with a smaller shadow economy. However, government performance influences the tax culture as well. Strong and progressive tax regimes and equitable access to efficient public goods and services strengthen the social contract and contribute to a more positive attitude towards taxation (OECD, 2008).

Another problem, related to globalisation, is the loss of revenues due to international tax competition and tax incentives granted to foreign investors discriminating domestic entrepreneurs (CABRI et al., 2010). These tax incentives can take many forms, including tax holidays, exemptions from various types of taxes, accelerated depreciation of investments, and tax credits.<sup>10</sup> It is often thought that foreign investment is highly responsive to corporate tax rates and tax incentives. Various econometric studies confirm this and suggest that export-oriented investments are especially sensitive (Grubert & Mutti, 2000; Hines, 2005; Mutti & Grubert, 2004). High indirect taxes, such as VAT and trade tariffs, are also associated with lower foreign investment (Desai et al., 2004a). The apparent effect of taxes on location decisions of multinational firms has been a reason for lowering tax rates and granting exemptions.

This has resulted in tax competition among developing countries to attract FDI (Klemm & Van Parys, 2012; Nassar, 2009). In the end, this is detrimental to all countries involved, because lowering taxes across a group of countries hardly changes their relative attractiveness for foreign investors. In some cases, tax exemptions have also been granted to individual firms in secret deals vulnerable to corruption. Taking into account the

<sup>10</sup> For a detailed discussion of different types of tax incentives, see Tanzi and Zee (2000).

reductions in corporate tax rates and widespread use of incentives, the increase in corporate tax revenues in many developing countries since 1997 is a bit puzzling (Keen & Mansour, 2009). It seems that tax exemptions and declining tax rates have been offset by an increasing share of corporate profits in GDP (CABRI et al., 2010).

Recent studies show that countries with lower taxes are much less effective in attracting FDI than is often thought. High corruption has a negative impact on FDI (Habib & Zurawicki, 2002) and may be a larger burden for foreign investors than taxes, because it usually goes hand in hand with bad economic governance. When controlling for the quality of governance and infrastructure, Goodspeed et al. (2011) and James (2009) find that FDI in developing countries is not very sensitive to host country taxation. This is consistent with surveys among investors that show that the investment climate depends on many factors other than taxation. Klemm and Van Parys (2012) find that lower tax rates and tax incentives attract FDI in Latin America, but not in Africa. Moreover, tax incentives are often not well targeted and therefore provide benefits to investors that would have invested anyway. Bols et al. (2001) and Muller et al. (2004) conclude that tax incentives are usually not a decisive factor and therefore ineffective. Developing countries are therefore generally advised to limit the use of tax incentives to specific cases of market failures and focus on improving the overall business climate (CABRI et al., 2010; James, 2009; Zee et al., 2002).

Tax incentives for FDI show that a large trade-off can exist between policies to increase foreign private investment flows and public revenue generation.<sup>11</sup> When such tax incentives do not increase total investment or investors restructure their investments to obtain incentives that were not intended for them, tax incentives can actually reduce total government revenues.

Thus, several important constraints to domestic revenue mobilisation result from domestic and regional factors. These constraints are unrelated to the fiscal systems of donor countries and can to some extent be addressed by technical assistance. Some forms of tax incentives, such as secretive tax deals, may also be discouraged by extending requirements for multinationals based in donor countries to report relevant financial data and payments to the government on a country-by-country basis.<sup>12</sup>

<sup>11</sup> In this case, the trade-off is between corporate tax revenues and expenditures to facilitate foreign investments (for example to enhance infrastructure) on the one hand and FDI inflows on the other hand. The trade-off depends on the importance of tax incentives to foreign investors. If taxes are not one of the main factors for location decisions, which is usually the case (Bols et al., 2001; Goodspeed et al., 2011; James, 2009; Muller et al., 2004), then a government may need to offer relatively large tax incentives to a broad group of foreign investors in order to attract additional investments. More generally, at the margin, any tax that generates economic disincentives usually involves a trade-off between additional public revenue and additional private economic activity.

<sup>12</sup> Such requirements have been adopted by the US and EU for extractive industry firms, but are not yet being introduced across all industries.



### 3.4 The role of withholding taxes

The previous sections referred to corporate tax revenues in general. A corporate income tax is usually the most important source of these revenues. Like any tax component, two key characteristics of a corporate income tax system are the tax base (the level of profit that can be taxed) and the tax rate(s). Most countries also tax capital gains from the sale of land, real estate, and natural resource properties; this is in fact a special type of corporate income. Some countries also use a turnover tax as an alternative minimum tax, to secure a certain level of revenue in case a company reports artificially low profits.

Withholding taxes are a different type of corporate taxes. They are not levied on corporate profit or turnover, but on certain corporate payments to foreign entities. These payments can be distributions of profit that have already been subject to corporate income tax (that is, dividends) as well as payments that are deductible from corporate income tax (interest, royalties, or management fees). In practice, most countries impose withholding taxes on dividends, on interest payments, or on both. In addition, many countries levy withholding taxes on royalty payments for the use of intellectual property, such as trademarks or patents, and some countries levy withholding taxes on management fees and technical services. Withholding taxes are hardly mentioned in development research. However, they do play an important role in corporate taxation of multinationals and are highly relevant for the impact of the Dutch tax system on developing countries. Therefore this section discusses withholding taxes in more detail, with a focus on the withholding tax on dividend and interest payments.

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Withholding taxes can be a substantial source of revenue. Unfortunately, comprehensive data on withholding tax revenues are not available from an existing dataset and many developing countries do not distinguish withholding tax revenues in national revenue statistics publications. However, some examples show that withholding tax revenues can be substantial. In 2007, withholding tax revenues were 3.0% of GDP in Brazil, 1.1% in Kenya, and 0.7% in Zambia. By comparison, corporate tax revenues excluding withholding taxes were 3.7% of GDP in Brazil, 3.3% in Kenya, and 2.7% in Zambia (Fjeldstad & Heggstad, 2011; OECD et al., 2011; Waris et al., 2011).<sup>13</sup> Out of the 34 countries in the graphs, only Mauritius, South Africa<sup>14</sup> and Egypt<sup>15</sup> do not have withholding taxes on interest or dividends. 8 countries impose withholding taxes on interest but not on dividends. The other 23 countries tax both interest and dividend payments to foreign entities. In 2010, the standard rates of all 34 countries were on average 17% for interest (to foreign affiliates) and 10% on

<sup>13</sup> For Brazil, figures 4 and 5 show corporate tax revenues excluding withholding taxes. For Kenya and Zambia, the figures show corporate revenue data from Abbas and Klemm (2012), because these are available for both 1997 and 2007. For 2007, Abbas and Klemm report corporate tax revenues of 2.5% of GDP for Kenya and 2.0% for Zambia; Waris et al. (2011) and Fjeldstad and Heggstad (2011) report higher figures.

<sup>14</sup> For South Africa, this applies to the period until 1 April 2012; when it introduced a dividend withholding tax.

<sup>15</sup> Egypt has a withholding tax of 20% on interest payments, but this does not apply on loans with a maturity of more than three years.

dividends (to foreign controlling parents). This shows that withholding taxes are extremely relevant for many developing countries.

There are several reasons for levying withholding taxes. First, they are relatively easy to collect by the host country (Faria, 1995) because they involve international transfers, similar to trade taxes, and the basis for calculating the tax is straightforward. From a theoretical perspective, if a developing country has specific qualities such as natural resources or a large domestic market that attract FDI, the government has some market power. This generates an incentive to tax profits of foreign investors more strongly (Sørensen, 2006).

Second, historically withholding taxes on payments to both foreign and domestic recipients have served to prevent tax evasion (Li, 1995). An investor that receives dividend or interest payments could try to hide this income from the tax authority. If a tax on this income was already levied at the source and paid by the entity distributing the dividend or paying the interest, the tax was more difficult to evade. The recipient of the dividends or interest can usually deduct the source tax so the overall tax charge may remain unaffected, depending on the levels of withholding tax and corporate income tax. To some extent, this reason still applies at the international level for payments to foreign security holders. In case an external shareholder or debt security holder is based in a tax haven, for example, withholding taxes can prevent that the dividend or interest income remains untaxed in both countries. For developing countries, the use of withholding taxes also simplifies tax collection at the domestic level (Bird & Zolt, 2011).

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Third, withholding taxes allow FDI host countries, referred to as source countries (of income) in fiscal terms, to take a larger share of the total tax revenue that can be levied on income earned by foreign investors. In the case of foreign investment, withholding taxes are about the allocation of taxing rights between host and home country. Developing countries are usually net FDI recipients. Therefore withholding taxes can have a redistributive effect at the international level by increasing the share of taxes paid by multinational firms in developing countries. This generally applies to interest and royalty payments, because most countries tax interest and royalty income but grant a tax credit for withholding taxes paid abroad. Similarly, it allows developing countries to capture part of the profits distributed to foreign external shareholders (Faria, 1995). In many such situations, withholding taxes do not affect the total taxes paid by a firm and its shareholders, but they shift some of the tax revenues from the home to the host country by allocating more taxing rights to the latter. In principle, the total tax charge can increase if the dividend withholding tax rate in the source country is higher than the income tax rate in the recipient's country, or if the recipient is a tax-exempt entity, for example a pension fund. For intra-firm interest and royalty payments, though, this is unlikely unless the affiliate receiving the income is based in a tax haven or operates under a low-tax regime.

Historically, the distributional aspect tended to be largely similar for dividends paid to foreign parents, because many countries used to tax foreign dividend income, allowing for a tax credit to offset corporate income taxes and/or dividend withholding taxes paid in host countries. However, at present most countries exempt foreign dividend income from

subsidiaries; the main exception is the United States. If a home country does not tax foreign dividend income, it usually does not grant a credit for foreign withholding tax paid on this income either. This may result in double taxation of dividends distributed by a foreign subsidiary that are paid out of current or retained income that have already been taxed. Double taxation of distributed profits increases the total tax charge in the host country instead of reallocating taxation rights from the home to the host country. There is still a distributional effect because inward FDI is much larger than outward FDI in most developing countries. However, double taxation also creates a disincentive for foreign investment, thus generating a trade-off between revenues and international redistribution on the one hand and re-pricing on the other. To mitigate double taxation, withholding tax rates for dividend payments within a firm are usually lower than rates for dividends distributed to external portfolio shareholders that hold only a small, non-controlling part of a firm's shares.

Fourth, withholding taxes serve as a backstop measure against profit shifting (Conklin & Robertson, 1999; IMF, 2008, 2012). In particular, withholding taxes on interest, royalties, and management fees form a barrier against profit shifting to low-tax affiliates by multinational firms. The operation of one of Chile's largest copper mines by Exxon Mobil is a notorious example of such tax avoidance strategies. The mine reported losses for 23 years, but it was in fact highly profitable. The losses resulted from high interest payments to a financing subsidiary of Exxon Mobil in Bermuda, where the interest income was not taxed (Riesco et al., 2005). At the time, Chile imposed a mere 4% withholding tax on interest. After the profit shifting came to light, Chile raised withholding taxes on intra-firm interest payments to 35%; the 4% now applies for interest paid to foreign banks and financial companies only. Similar to Chile, many countries prefer to impose low or zero withholding taxes on interest payments to banks and other external creditors to facilitate access to external financing for domestic companies. The anti-avoidance reason explains why many countries differentiate between interest payments to foreign affiliates and non-affiliated creditors and apply higher rates for the former category. The case for dividend withholding taxes is somewhat different, because dividends are usually paid out of profits that have already been taxed. However, dividend withholding tax may still serve to secure minimum government revenues in case a company does not report profits, for example due to corporate income tax exemptions or high depreciation of new investments, or enjoys tax holidays exempting it from paying corporate income tax for several years.

Fifth, in theory withholding taxes on dividend and interest payments have a re-pricing effect. Dividend withholding taxes make it less attractive for foreign investors to repatriate profits. This incentive can be important to stimulate foreign direct investment through re-investing profits in the host country (UNCTAD, 2008). Interest withholding taxes, however, increase the cost of international debt financing for all companies. Both types of withholding taxes may therefore increase equity financing of investments relative to debt financing.

Indeed, some borrowing countries tend to regard taxation of interest payments as a mechanism to discourage excessive debt financing (Faria, 1995). Interest and royalty

withholding taxes also form a key element of a dual income tax system, a normative framework for taxation that might be well suited for developing countries. A dual income tax system combines a uniform and relatively low<sup>16</sup> tax on all capital income (at source, thus in the host country) with a progressive tax on labour. To ensure a uniform rate on capital income, withholding taxes should be levied on interest, royalties, and similar payments that are deductible from the corporate income tax base on which corporate tax is levied. Interest withholding tax gets particular emphasis in this framework because its re-pricing effect prevents distortion of corporate financing decisions (Bird & Zolt, 2011; Fjeldstad & Heggstad, 2011; Volkerink, 2009).

Regarding dividend withholding taxes, a study on German multinationals confirms that these significantly decrease dividend repatriations by foreign subsidiaries (Bellak & Leibrecht, 2010). However, empirical research on US-based firms finds that taxes on dividend repatriations do not increase retained earnings. The reason is that firms have some flexibility with regard to the structuring of internal payments. Different withholding tax rates alter the composition of payments from a foreign subsidiary to the parent and other affiliates, but do not necessarily affect the total amount of payments (Grubert, 1998). This result provides support for the idea of a uniform withholding tax rate on all types of payments.

In summary, many developing countries levy withholding taxes, especially on interest payments. These taxes are important as a source of revenue by themselves and also as a protection against international tax avoidance structures and tax evasion. Withholding taxes are especially relevant for developing countries because most of these countries are net FDI recipients and withholding taxes are relatively easy to collect. Bilateral tax treaties that reduce withholding taxes can therefore have substantial effects on tax revenues in developing countries.

<sup>16</sup> Relatively low might be interpreted as 20-25%.

4

# Tax avoidance by multinationals

## 4.1 Domestic and international tax avoidance

Companies can use a broad range of strategies to avoid taxes. Some of these strategies are domestic and involve arbitrage between different tax regimes in the same country. For example, small businesses can choose whether or not to incorporate legally in a country as a limited liability company and tax considerations often influence this decision (De Mooij & Nicodème, 2008). Moreover, firms can choose how much external debt financing they want to use. In most countries interest payments are tax deductible (and interest income is taxed) whereas dividend payments are not deductible (and dividend income is exempt). Therefore tax considerations influence capital structure choices, including for domestic firms (Overesch & Voeller, 2010). Next, some developing countries have special export processing zones or other special tax regimes that provide tax exemptions for a certain time period, for example 10 years. Sometimes firms set up a production site in an area with a special tax regime, close down at the end of the tax exemption period, and then start up a new production site in another area. In addition, firms can try to negotiate special tax deals with the government. Sometimes these deals, especially in the extractive sector, are highly secretive (Africa Progress Panel, 2013) and may involve illegal payments to corrupt officials.

These various tax avoidance strategies may spur international tax competition, but do not involve arbitrage between the tax systems of different countries. Some domestic tax avoidance strategies are mainly used by multinational firms. Large multinationals that are planning to undertake major investment projects have more bargaining power to negotiate special tax treatment. Moreover, multinationals may find it easier to relocate certain activities, or threaten to do so, for tax reasons. International initiatives can therefore help to level the playing field and address domestic tax avoidance issues in developing countries. For example, secretive tax deals may be discouraged by extending financial reporting requirements for multinationals based in donor countries, as noted above.

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The remainder of this chapter focuses on international tax avoidance strategies that involve some form of arbitrage between the tax systems of different countries. Tax avoidance strategies can be distinguished into base erosion, profit shifting, and other strategies that include withholding tax avoidance. The title of the OECD report “Addressing base erosion and profit shifting” (OECD, 2013b) highlights the first two types, but does not make a very clear distinction and describes withholding tax avoidance as well. The three groups of international tax avoidance are briefly clarified below.

Base erosion strategies use mismatches between different tax systems to reduce the overall tax base. These typically involve payments between affiliates that are deductible in the first country, by the affiliate making the payment, but not recognised as taxable income of the affiliate in the second country, where the affiliate receiving the payment is located. Mismatches can exist between any two countries and are often unintended.

Profit shifting does not reduce the overall tax base, but shifts profits from affiliates in countries with normal or high tax rates to affiliates that are subject to lower or even zero taxes. Profit shifting may occur between any two countries with a different tax rate. Several

empirical studies analyse profit shifting in general and find that higher profits are reported in jurisdictions with lower tax rates (Bartelsman & Beetsma, 2003; Weichenrieder, 2009). Large multinationals can also shift profits to special affiliates in tax havens or subject to special tax regimes. Governments are aware of this and compete for mobile profits by lowering general statutory tax rates and offering special regimes (Rixen, 2011). In contrast to qualification mismatches, large differences in effective tax rates often deliberately facilitate profit shifting and are usually intended to attract Special Purpose Entities (SPEs).

Other strategies exploit differences in tax rates or tax treatment of certain income without reducing the corresponding tax base or shifting it to another country. Such opportunities exist because of differences between tax treaties concluded by the same country with different treaty partners. For example, treaties may specify a dividend withholding tax of 10% to one country and 5% to a second country. A foreign investor can then try to benefit from the lower rate by routing the investment through the second country.

The following sections describe different types of international corporate tax avoidance strategies in more detail. The various sections do not provide a complete overview of tax avoidance structures, but they provide a broad classification and identify key tax avoidance strategies affecting taxation of multinationals in developing countries.

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## 4.2 Profit shifting through reallocation of functions

When different affiliates of the same multinational trade with each other, the allocation of profits between the different affiliates is often determined using the arm's length principle developed by the OECD (OECD, 2010b). This principle essentially means that the trade between the affiliated companies should take place under the same conditions, and at the same prices, as a so-called 'arm's length' transaction between unrelated entities. Assuming the price is indeed at arm's length, a multinational can still shift profits by allocation functions that generate large margins to lowly taxed affiliates. For example, it can transfer the business risks of a manufacturing affiliate to another affiliate by turning the former into a contract manufacturer that supplies to the latter (De Graaf, 2013). Due to the low business risks, the margins of the manufacturing affiliate will be low. By assuming the risks of selling the output, the other affiliate can charge a much higher margin. Similarly, a multinational can transform affiliates that sell to customers into agents or low-risk distribution affiliates.

Many multinationals centralize the ownership of the patents, registered in the countries where they operate, in low-tax environments (De Graaf, 2013; Karkinsky & Riedel, 2012). Empirical evidence shows that the general profit shifting effect, which reduces profits in high-tax countries, is stronger for research & development intensive firms (Grubert, 2003a, pp. 227-229; Stöwhase, 2002). This provides evidence of income shifting through the location of the ownership of the intangibles and subsequent royalty payments for their use. Trademarks, brand names and retail chain formats are often located in low-tax jurisdictions as well, just like patents. The affiliate located there can charge high license fees for the use of these valuable intangible assets, resulting in substantial profit shifting. Application of

the arm's length principle for the price setting is very difficult if not impossible due to a lack of comparable transactions. Moreover, the management of these assets does not require large active business operations and are therefore relatively easy to manage with a small office or outsource to an external service provider in a distant jurisdiction or tax haven. Other functions that can be centralised in low-tax affiliates do involve substantial real business operations, such as marketing, sales and distribution. Firms can also shift profits through management fees for corporate functions charged to subsidiaries.

To summarise, multinationals have various options to shift profits from one country to another by merely changing the allocation of different functions between the parent and other affiliates. In theory, this is similar to choosing one investment location over another because of tax considerations. In practice, though, these arrangements can become abusive by artificially segregating taxable income from the activity or affiliate that generates it (OECD, 2013a), even if they are fully compliant with the tax laws in all countries.

### 4.3 Profit shifting through financial structures

A special way of reallocating functions and risks within a multinational is through financial structures, such as equity participations, internal loans, insurance arrangements, or derivatives contracts. In principle, any multinational can use financial structures to shift profits, regardless of the type of business activities and operational structure. Therefore this section discusses profit shifting through financial structures separately.

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Captive insurance means that a multinational uses a special affiliate to internally insure risks of various group companies. This can make sense from a risk management perspective because it allows a large multinational to pool risks from many subsidiaries worldwide, from insurance against property damage to directors' liability, and centrally reinsure part of the remaining risks with an external insurance company if desired. Moreover, it allows subsidiaries to insure themselves against risks for which they cannot easily insure themselves in the market (Cross et al., 1988). However, multinationals can also shift profits to captive insurance companies in the form of tax deductible insurance premiums (Winslow, 1989). Nearly all captive insurance companies are located in tax havens where their profits are tax free or subject to a very low effective rate of corporate income tax. Bermuda is the leading location of captive insurance companies (Palan et al., 2010). Although tax avoidance through captive insurance has been extensively analysed from a legal perspective since the 1980s, a comprehensive economic analysis is not available, probably because of insufficient data on internal insurance arrangements.

Multinationals can use internal loans to shift profits from high-tax countries to lowly taxed affiliates in the form of interest payments on internal loans. This practice is commonly referred to as debt shifting. The case of Exxon Mobil's copper mine in Chile (Conklin & Robertson, 1999), mentioned in the previous chapter, provides an example of debt shifting to a financing entity in Bermuda. In contrast to captive insurance arrangements, various



economic studies on debt shifting are available and micro data on the financing structure of individual affiliates are available from several databases.

Empirical evidence shows that multinationals finance their subsidiaries in countries with higher corporate income tax rates with a larger proportion of debt than their subsidiaries in low-tax countries (Altshuler & Grubert, 2002; Büttner & Wamser, 2007; Desai et al., 2004b; Egger et al., 2010; Grubert, 2003b; Huizinga et al., 2008; Jog & Tang, 2001; Mintz & Weichenrieder, 2005; Møen et al., 2011). Part of this effect is due to deliberate debt shifting among affiliates within a multinational, but taxes also influence the leverage of domestically owned companies that do not form part of a multinational (Egger et al., 2010; Overesch & Voeller, 2010). Some have proposed alternative explanations as well, for example that higher taxes increase the leverage of subsidiaries by lowering the net profits that can be retained (Ruf, 2008). Several studies have tried to distinguish debt shifting from the domestic tax effect by analysing how leverage depends on tax rate differences within a firm rather than on absolute tax rates. These studies find that debt shifting is statistically significant but small in magnitude (Büttner & Wamser, 2007; Huizinga et al., 2008; Møen et al., 2011). A study that directly compares domestically owned and foreign-owned firms finds a larger debt shifting effect for multinationals (Egger et al., 2010).

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Most empirical studies do not pay special attention to developing countries. Again, data availability is a key constraint. Comprehensive micro data are available for corporate entities in Europe and for the worldwide subsidiaries of multinationals from a few high-income countries, notably from the US and Germany. Remarkably, even studies that use a dataset with worldwide subsidiaries sometimes struggle to include developing countries in the analysis due to unavailability of macroeconomic control variables (Mintz & Weichenrieder, 2005).

Most empirical studies build on a theoretical model developed by Hartman (1985) and Sinn (1993). This model describes the capital structure choice of a single foreign subsidiary and its parent company. As a consequence, most studies on debt shifting implicitly assume that firms respond to tax rate differences among countries where they have active operations and do not model the use of special financing entities in low-tax jurisdictions. Moreover, in line with the Hartman-Sinn model, most studies assume that the external leverage of a multinational follows directly from the financing structure of the parent company and its operating subsidiaries. However, large multinationals often have a more complex internal holding and financing structure and use central treasury entities to raise external debt financing and to manage intra-group loans and deposits (Mintz & Weichenrieder, 2005; Ruf, 2008). Thus, the model assumptions mainly reflect tax planning in small and medium sized firms.

Regarding the first assumption, about active operations, Büttner and Wamser (2007) and Møen et al. (2011) do account for the possibility of lowly taxed financing affiliates, which helps to understand more complex tax planning structures. However, their alternative assumption that the lowest-tax affiliate provides internal loans to other affiliates may still be problematic for large firms, because some large firms establish tax haven affiliates for other purposes.

Regarding the second assumption, about external leverage, Barion et al. (2010) use an alternative theoretical framework in which a multinational independently chooses the desired level of total external leverage and the amount of intra-group debt shifting. This alternative framework seems more appropriate for large multinationals.

An analysis of publicly listed European firms that uses a methodology adapted to large multinationals finds that the sensitivity of subsidiary leverage to host country tax rate is relatively low, because large firms are more likely to shift debt from special lowly taxed affiliates towards subsidiaries in most or all EU countries (Weyzig, 2013).

## 4.4 Profit shifting through transfer mispricing

Revenue losses due to trade mispricing form a major constraint to taxation of international business. When affiliates that belong to the same multinational trade with each other, they set internal transfer prices. The current international standard for transfer pricing, developed by the OECD, specifies that the trade should be at arm's length, that is, prices should not differ from those charged to unrelated parties. However, transfer prices are relatively easy to manipulate, because for many trades there are no comparable transactions with unrelated parties. Therefore, the OECD approach has become increasingly problematic (Avi-Yonah, 1995). Transfer mispricing is often illegal and thus a form of tax evasion rather than legally allowed tax avoidance, at least in theory. In practice, transfer mispricing is hard to prove because it is difficult to determine arm's length prices. The line between tax avoidance and tax evasion is therefore not always clear.

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The problem of transfer mispricing has been known for a long time and is more severe for developing countries because they have weaker tax administrations and face more difficulties collecting data on transfer pricing (Lall, 1979; McLure Jr., 2006). Furthermore, trade taxes are still an important source of revenue for low income and lower middle-income countries, and transfer mispricing can also be used to evade import tariffs or export levies. A survey among tax authorities shows that developing countries are themselves aware of the issue and regard it as a serious cause of concern (Borkowski, 1997).

Empirical research on transfer pricing has been limited due to data constraints. Nearly all studies use US customs data to analyse trade between the US and other countries and find substantial trade mispricing (De Boyrie et al., 2005; Pak et al., 2003; Zdanowicz et al., 1999). The methods of some of these studies are somewhat problematic because they involve strong definitions about when trades are abnormally priced. Studies using a more sophisticated approach confirm that multinationals manipulate import and export prices to shift profits to low-tax countries (Bernard et al., 2006; Clausing, 2003), but do not allow to estimate the precise amount of transfer mispricing. Moreover, when multinationals shift profits out of developing countries through transfer pricing, they probably shift them to low-tax jurisdictions and not to the US. Detailed data on these trades are not available. One

study using data from Ireland, a low-tax jurisdiction, shows that multinationals indeed shift profits into Ireland through transfer pricing (Stewart, 1989).

In a recent case, two independent audits of the large Mopani copper mine in Zambia, commissioned by the revenue authority, found that the Swiss firm Glencore operating the mine had engaged in substantial transfer mispricing. In the last five years, transfer pricing problems and their impact on domestic revenue mobilisation in developing countries have been receiving increasing attention from policy makers.

Transfer mispricing reinforces the problem of reallocation of functions, notably through high licence fees and royalties for the use of brand names and patents and through management fees for alleged services rendered. Market prices for these services are often not available, so the transfer prices are relatively easy to manipulate. Internal insurance premiums may also be susceptible to mispricing.

## 4.5 Avoidance of withholding tax

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Withholding taxes can be a material source of revenue by themselves and also serve as a backstop measure against profit shifting, as noted above. Standard withholding tax rates are often reduced on a bilateral basis in tax treaties. In theory, the main purpose of tax treaties is to remove tax barriers to international economic activity. Tax treaties prevent double taxation by allocating taxing rights between the host country, where the income is generated, and the home country, where the capital provider or shareholder and beneficiary of the income resides. This provides legal certainty to foreign investors and this is assumed to enhance the investment climate. Withholding tax reductions limit the taxing rights of the host country and are therefore a core element of tax treaties.<sup>17</sup>

Some multinationals avoid withholding taxes by diverting FDI through a conduit country with favourable tax treaties. To this effect, a tax treaty must exist between the host and intermediate country (Kandev, 2009; OECD, 1986). The diversion of FDI to achieve reduction of withholding taxes is called treaty shopping (Kingson, 1981).

Tax treaty shopping has received substantial attention in legal analyses since the early 1980s. Many of these focus on the use of Dutch conduit entities and on attempts of the US to limit tax avoidance via conduit structures. They generally regard the Netherlands as a key intermediate country, mainly due to its extensive and favourable tax treaty network (Avi-Yonah, 2009; Dolan & Walsh Weil, 1995; Kingson, 1981; Wacker, 1993).

<sup>17</sup> Many high income countries also offer unilateral relief for withholding taxes levied by developing countries, such as a tax credit or exemption for income that has been taxed abroad. Where such unilateral measures exist, tax treaties merely confirm these. Nonetheless, tax treaties do offer benefits to foreign investors. An example is a reduced withholding tax on dividends paid to a parent in the home country that exempts these dividends from tax. In this case, the withholding tax cannot be recovered by the company and the reduced rate is a real benefit.

Certain clauses in tax treaties can inhibit treaty shopping. One type, limitation on benefits (LOB), specifies detailed objective substance criteria that an investor must meet to qualify for treaty benefits. These criteria exclude conduit entities or special purpose entities (SPEs). A second type, a main purpose test, is subjective and denies treaty benefits if an investment relation is established or maintained mainly for the purpose of securing these benefits. This clause is more common, but may be difficult to apply, because the host country tax authority would need to assess the operations of foreign entities to determine their purpose and the qualitative approach partly changes the burden of proof.

Host countries generally disapprove of treaty shopping, because it breaches the principle of reciprocity and treaty benefits are not intended for investors from third countries (Kandev, 2009; Lee, 2009; OECD, 1986). Indeed, some developing countries regard treaty shopping as a major challenge for the taxation of multinational firms (Heggstad, 2011). This raises the question why many countries, including most Dutch treaty partners, conclude treaties without anti-treaty shopping provisions. Legal cases illustrate that these countries, too, find treaty shopping abusive when it hits them. Examples are the *Prévost* case in Canada, involving a Dutch conduit (Kandev, 2009), and the *Andolan* case in India, involving a Mauritian conduit (Baistrocchi, 2008).<sup>18</sup> However, these cases do confirm that a tax treaty allows treaty shopping unless it contains explicit countermeasures.

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To date, there exist only a few empirical economic studies on treaty shopping. Collins and Shackelford (1998) examine the effect of withholding and home country taxes on cross border payments between foreign affiliates of US firms. They find that internal dividend and interest flows are structured in such a way as to mitigate taxes and conclude that the results are consistent with treaty shopping. Weichenrieder and Mintz (2008) and Dreßler (2012) show that higher bilateral withholding taxes to and from Germany substantially increase the probability that outward and inward FDI is diverted via a third country. This provides direct evidence of treaty shopping. However, the existence of an intermediate holding does not always lower the overall tax burden on repatriated profits, which suggests that non-tax factors play a role as well (Dreßler, 2012). Weyzig (2013) finds that Dutch bilateral tax treaties are a key determinant of foreign investments held via Dutch conduit entities (SPEs). The effect of tax treaties on FDI diversion partly arises from the reduction of dividend –withholding tax rates, which confirms that tax treaty shopping significantly influences bilateral FDI flows and stocks.

Avoidance of withholding taxes is not just a problem for developing countries because of potentially lower withholding tax revenues. Several case studies on tax law show that conduit entities can also play a key role in profit shifting schemes, especially for intangibles, and thus lower corporate income tax revenues as well (Bender, 2007; Kandev, 2009; Kleinbard, 2011; Michielse, 2011). A well-known example is the use of a Dutch conduit by Google to shift huge profits from Ireland to Bermuda without triggering Irish royalty withholding tax (Kandev, 2009). Most broader economic studies that analyse profit shifting

<sup>18</sup> The *Andolan* case concerns avoidance of capital gains tax, which is further discussed in the next section.

through interest and royalty payments have not paid special attention to the important link between profit shifting and avoidance of withholding taxes.

## 4.6 Avoidance of capital gains tax

Many host countries levy a tax on capital gains that arise from the sale of certain property or shares. In some countries this tax is limited to the sale of interests in real estate, mining assets, land, and other immovable property; in other countries it also applies to the sale of participations in domestic companies. Tax treaties often allow host countries to levy capital gains tax on immovable property, but allocate the right to tax capital gains on the sale of shares<sup>19</sup> to the home country of foreign investment. This is also the case for Dutch tax treaties.

Multinational firms use strategies to avoid capital gains tax on the sale of foreign assets that closely resemble strategies to avoid withholding taxes. These strategies usually involve an intermediate holding in a third country. This can be a third country with a tax treaty that eliminates capital gains tax on a bilateral basis. An example is the Lamesa Holding case, concerning a US private equity firm that acquired an Australian mining company via a Dutch conduit.<sup>20</sup> When the conduit sold the mining company's shares, the capital gains on the mining property were exempt from Australian tax under the Netherlands-Australia tax treaty and from Dutch tax under domestic tax rules (Bender, 2007).

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Alternatively, a firm can sell the intermediate holding itself instead of the shares held by the intermediate holding. In that case, the conduit country where the intermediate holding is located may also be a tax haven that does not have a tax treaty with the host country. A well-known example is the sale of Essar India, a large telecommunications company, from Hong Kong-based Hutchinson to UK-based Vodafone for an amount of USD 11 billion. In this case, a Hutchinson subsidiary incorporated in the Cayman Islands sold its shares in another Cayman Islands entity, which indirectly held a majority stake in the Indian company via a conduit in Mauritius. Thus, Vodafone obtained the shares of the Indian company indirectly by acquiring an intermediate holding based in the Cayman Islands (Loomer, 2009). The Indian revenue authority challenged this structure, but was in the end unable to impose a capital gains tax on this transaction.

<sup>19</sup> In many recent tax treaties, the treatment of immovable property extends to shares in businesses that derive most of their income from immovable property.

<sup>20</sup> *Lamesa Holding BV v. Commissioner of Taxation*, Federal Court of Australia, case no. 1999 FCA 612.

## 4.7 Base erosion through mismatches and hybrid structures

Base erosion can occur in many different ways, but usually involves structures that deliberately make use of mismatches between the tax systems of different countries. Mismatches can result in international payments that are tax deductible in one country but not taxed in another country, or in payments that generate two deductions in different countries (OECD, 2013a). Mismatches may arise from differences in the treatment of financial transactions and derivatives contracts that produce the same economic result, for example. They may also arise if one country allows a deduction for certain transactions at a standard rate or at arm's length prices, even though no payment is made or the actual pricing is different, and another country taxes only the actual payment (De Graaf, 2013). Partial mismatches are also possible. For example, the Belgian notional interest deduction regime scheme allows for certain deductions against dividend payments to foreign parents, whereas the dividend income of the foreign parent may be fully exempt from tax.

For base erosion structures involving Dutch entities, two types of mismatches are particularly relevant. The first type concerns hybrid entities that are treated according to different tax regimes by the relevant countries. Consider for example a corporation that is incorporated in one country, but has its effective place of management in another country. In some cases, neither country may consider the corporation as a resident for tax purposes. Other structures involve a hybrid entity that from the perspective of one country classifies as a corporation subject to tax, but from the perspective of another country classifies as a partnership, of which the income should be attributed to the partners for tax purposes (De Graaf, 2013). Such hybrid entities are often used by firms from the US, because US tax laws allow firms to designate foreign partnerships as incorporated subsidiaries for US tax purposes.

The second type concerns hybrid-financing arrangements that one country treats as debt, but another country as equity. For example, under certain conditions, interest payments on so-called profit participating loans from Dutch entities are regarded as dividends for Dutch tax purposes.<sup>21</sup> Since 2007, these payments are tax exempt in the Netherlands, even if they are tax deductible in the source country (Heithuis, 2006). Examples of countries that allow such deductions are France, Belgium, Spain, and Finland.

<sup>21</sup> X B.V. v. State Secretary for Finance, Dutch Supreme Court, case no. AT5958.

## 4.8 Avoidance of home country tax on foreign income

A few important home countries of foreign investment, notably the US, tax the income of foreign subsidiaries.<sup>22</sup> The tax on this income is usually offset by a tax credit equal to the tax already paid abroad and thus arises only if the foreign tax rate is lower. Furthermore, the tax is normally deferred until the income is repatriated in the form of dividends. Multinationals use different strategies to avoid this home country tax. Indirectly, this can also affect developing host countries. Avoidance of home country tax on dividends from entities in low-tax jurisdictions, such as Bermuda, may facilitate profit shifting from developing countries to such entities, for example through transfer mispricing.

If a multinational invests abroad via a so-called base company, which is a holding company in an intermediate country, it can reinvest the income of subsidiaries via the base company without distributing dividends to the home country of the ultimate parent (Desai et al., 2003). A multinational can also use an intermediate holding to mix dividends from low-tax and high-tax countries. This allows to offset taxes paid in different countries against each other when the dividends are paid onwards to the ultimate parent, which may not be possible if the ultimate parent holds the subsidiaries directly (Dolan & Walsh Weil, 1995). Base and mixing companies are established in countries that exempt foreign dividend income and have a favourable treaty network, such as the Netherlands. They can be difficult to distinguish from conduits (SPEs), because they involve similar holding structures. Various studies show that multinationals from countries that tax foreign dividend income use intermediate holdings on a large scale and are effectively able to avoid the home country tax (Altshuler & Grubert, 2002; Desai et al., 2003; Grubert, 1998; Weichenrieder & Mintz, 2008).

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## 4.9 Combinations of tax avoidance strategies

Different strategies for international tax avoidance are often used in combination (IMF, 2013). For example, a multinational may shift profits from a developing country to a tax haven entity in the form of interest payments, but if the interest were paid directly to the tax haven entity, a withholding tax would apply. The multinational may then provide the loan from the tax haven entity via a conduit in a country with a tax treaty that reduces or even eliminates the interest withholding tax. Furthermore, the multinational may increase profit shifting by charging a high interest rate on the loan, which may amount to transfer mispricing. In such combinations, a multinational often uses SPEs in different countries. The tax avoided in the host country can then not be attributed to one individual SPE or the tax system of one country. However, each of the SPEs may play an essential role in the overall company structure and tax avoidance strategy. In practice, tax avoidance structures of large multinationals are often complex because of the many different jurisdictions where the multinationals operate, all of which have different tax laws and tax treaty networks. This

<sup>22</sup> The UK and Japan recently switched from credit to exemption systems for foreign dividend income. Many structures set up in response to past tax rules are still in place.

implies that tax avoidance structures often have extra layers and case-specific elements in addition to the basic strategies described in this chapter.

For the same reason, it is difficult to say which tax avoidance strategies cause the largest revenue losses in developing countries. Regarding taxation of multinationals, transfer mispricing is often regarded as one of the key problems (Bartelsman & Beetsma, 2003; McLure Jr., 2006; OECD, 2013b). Indeed, the huge volume of intra-firm trade and the lack of reliable market prices for many ‘arm’s-length’ trades suggest that transfer mispricing is a major challenge. However, transfer mispricing may occur in combination with reallocation of functions and profit shifting via financial structures that are facilitated by tax treaties. Moreover, for specific countries other forms of tax avoidance may be at least as important, for example because large foreign investors trade relatively often directly with third parties or because of strong reliance on withholding taxes for revenues from foreign investment.



5

## Tax avoidance via Dutch Special Purpose Entities

## 5.1 Pathway effects of Dutch corporate tax policy

The previous chapters described that taxation in developing countries serves different purposes and is a key source of financing for development. For many developing countries, corporate taxes are an important source of revenues, but taxation of multinational firms is challenging due to widespread tax avoidance and evasion. Some forms of international tax avoidance involve SPEs in developed countries. As a consequence, the tax policy of developed countries can affect domestic revenue mobilisation in developing countries negatively by creating tax avoidance opportunities, or positively by restricting such opportunities. Dutch tax policy is particularly relevant, because multinationals use Dutch SPEs on a very large scale, also for FDI in developing countries.

This chapter reviews effects of Dutch corporate tax policy on corporate tax revenues in developing countries. Figure 6 (next page) shows potential positive and negative, which materialize through different pathways. A tax treaty between the Netherlands and a developing country may generate additional FDI in the developing country (boxes 1 and 2), thus changing the total volume of inward FDI (box A).<sup>23</sup> Effect 1A is intended; effect 2A is usually unintended, but positive. In addition, if withholding tax reductions lower the cost of external borrowing, a tax treaty can increase investment by domestic multinationals in the developing country (box 3). This contributes to the change in total volume of investments. Effect 3A is intended with regard to borrowing from the Netherlands; borrowing via the Netherlands may not be intended, but stimulates investments as well. The volume effect is likely to be positive and increases total tax revenues from multinationals in the developing country.<sup>24</sup>

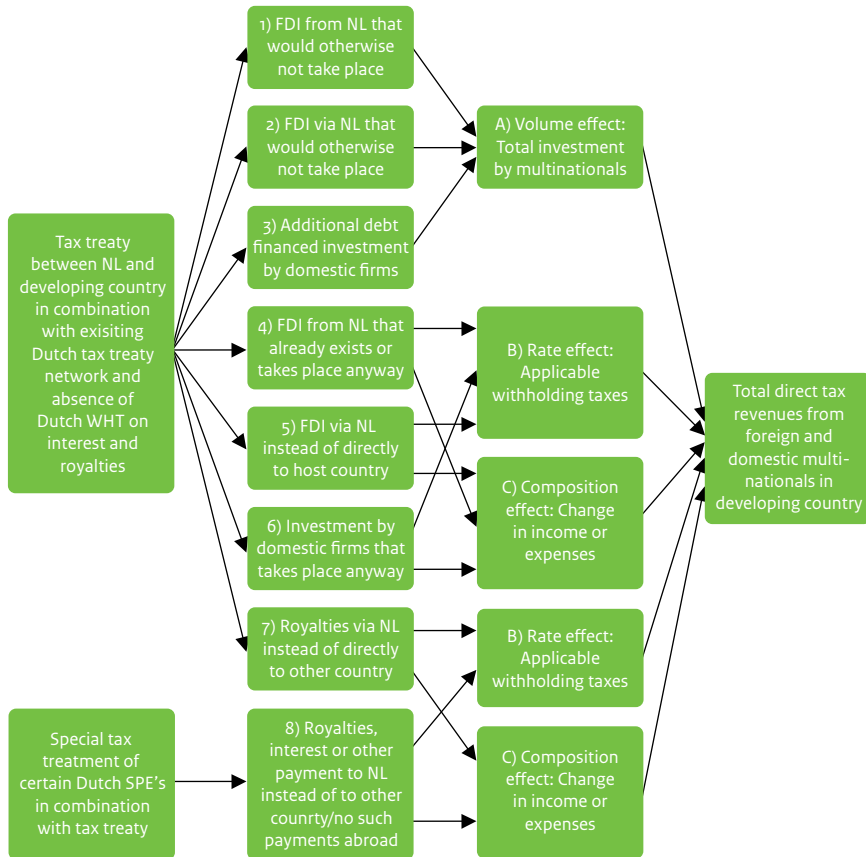
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For investments that already exist or would take place anyway (boxes 4 and 5), there is a tax rate effect (box B) if the tax treaty limits the host country's withholding tax rates on interest or dividend payments. The treaty can then also affect the financing structure of investments (box C) because withholding taxes influence the relative costs of debt and equity. Note that investments via the Netherlands (box 5) include FDI that is diverted for other reasons, for example to enhance investment protection. They also include intra-group loans from subsidiaries in other countries. The rate and composition effects exist for domestic multinationals that raise funding in international capital markets as well (box 6) and mainly reflect debt funding via the Netherlands. The pathway effects 4B and 4C are taken into account as known by-effects. The effects 5A, 5B, 6A, and 6B are unintended by-effects that may not be fully taken into account when a treaty is concluded. The tax rate effect is always negative and can substantially reduce withholding tax revenues; the composition effect is likely to be negative or neutral.

<sup>23</sup> A tax treaty can have negative effects on incremental investments by foreign multinationals as well if withholding tax reductions lower the costs of repatriating income, as discussed above. Thus, the effects 1A and 2A may also include repatriations to the Netherlands and via the Netherlands that would otherwise not occur.

<sup>24</sup> It does not necessarily raise total corporate tax revenues from multinationals and smaller domestic enterprises combined, for example if foreign investment crowds out domestic investment.

Figure 6: Potential pathway effects of Dutch corporate tax policy



At the bottom, Figure 6 shows potential negative effects resulting from other aspects of the Dutch corporate tax system, related to royalty payments for the use of intellectual property such as trademarks, copy rights and patents. The Netherlands does not have a withholding tax on outgoing royalty payments. Thus, a Dutch SPE can pay royalties to its parent or another affiliated company in any country free of withholding tax. In combination with a tax treaty that limits withholding tax on royalty payments to the Netherlands, this can result in royalty conduits (box 7). In this case, a Dutch SPE passes nearly all of the royalties onwards, possibly to an affiliate in a tax haven where the royalty income is not taxed.

Furthermore, some SPEs have apparently concluded so-called advance pricing agreements with the Dutch tax authority that provide for a low effective tax rate on royalty income. In popular media, these agreements are often referred to as tax rulings.<sup>25</sup> Between 1997 and

<sup>25</sup> Technically, advance pricing agreements and advance tax rulings are two types of agreements that cover different aspects of tax planning.

2010, certain Dutch SPEs also benefitted from a low effective tax rate on royalty income under the Dutch Group Financing Activities (GFA) regime.<sup>26</sup> Multinationals may move the ownership of intellectual property such as trademarks to the Netherlands to take advantage of such special tax treatment (box 8). These intangible assets transferred to a Dutch SPE (often called a royalty BV) can originate from the home country of the multinational, but also from developing countries, as in the case of local trademarks. In this case, a Dutch SPE does not pass on the royalties, and the royalty income is effectively taxed at a low rate in the Netherlands.

The treatment of royalty payments is unlikely to have a significant effect on the total volume of investments. Therefore the bottom part of the figure shows rate and composition effects only. Pathway effects 7A, 7B, 8A and 8B are unintended. The rate effect may be negative or neutral; the composition effect is always negative and probably larger, because firms have considerable flexibility in determining the level of the license fees or royalties.

Note that Figure 6 does not show all possible effects of the Dutch corporate tax system. It does not consider effects of FDI on the broader economy and externalities of foreign investments in the host country that have an indirect impact on tax revenues. Effects on the broader economy include crowding in or crowding out of domestic investment, for example due to changes in market structure, exchange rate effects, or acquisitions of domestic firms by foreign investors. Positive and negative externalities range from the creation of forward and backward linkages and transfer of skills and technology to negative impacts on the environment and on local communities. This study focuses mainly on direct effects on corporate tax revenues in developing countries and on market functioning. It does not analyse indirect impacts of investments by multinational firms on domestic revenue mobilisation.

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Furthermore, Figure 6 shows potential pathway effects for an individual developing country. The volume effects for individual countries do not add up to the total volume effect for all developing countries combined. A tax treaty between the Netherlands and a developing country may cause some firms to invest in this country instead of in another developing country, thus creating a substitution effect. Such investment decisions generate a positive volume effect for this specific country only, but not for developing countries as a group. By contrast, rate and composition effects for individual countries do usually add up to the total effect on all developing countries combined, because these effects do not involve substitutions between direct investments in different countries.

Regarding the effects shown in the figure, this chapter first reviews existing research on the effect of tax treaties on FDI volume in general. These effects may also apply to FDI originating from the Netherlands (1A). Next, it discusses avoidance of withholding taxes. This includes negative tax rate effects for FDI via the Netherlands (5B), external debt of

<sup>26</sup> Chapters 2 and 4 briefly describe the GFA regime; chapter 5 provides examples of advance pricing agreements that result in low effective tax rates. Special tax treatment of Dutch SPEs may also result in a low effective tax rate for other types of foreign income, notably interest income. This study focusses on special tax treatment of royalties.

domestic multinationals based in the developing country (6B), and royalty payments via the Netherlands (7B). The discussion also covers potential negative composition effects resulting from lower interest withholding taxes (5C and 6C) and royalty withholding taxes (7C). After that, this chapter reviews effects of profit shifting to Dutch SPEs in the form of royalties, interest, and trading income (8B and 8C). Finally, it discusses other types of tax avoidance via the Netherlands, such as hybrid structures.

This study does not analyse potentially positive volume effects of FDI via the Netherlands (2A). It would have been useful to analyse this effect separately and determine what part of FDI diverted via the Netherlands is additional (box 2) and what part merely follows a different route (box 5). However, data limitations form a major obstacle. Time series data on bilateral FDI originating from the Netherlands are available, for example from the OECD. However, time series data on total bilateral FDI from the Netherlands, including FDI via the Netherlands, are available for a few developing countries only. The reason is that data on FDI via the Netherlands for years before 2009 must be obtained from statistics reported by the host countries themselves, and for many developing countries such statistics are not available or inconsistent.

Furthermore, this study does not review potentially positive effects of tax treaties on the volume of investments by domestic multinationals (3A) or rate effects of FDI originating from the Netherlands (4B and 4C). The reason is that these issues have hardly been covered in empirical research.

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## 5.2 The effect of tax treaties on Foreign Direct Investment

From a development perspective, a key question about tax treaties is whether the benefits from higher inward FDI due to concluding tax treaties more than compensate for the tax revenue losses due to the lowering of withholding tax rates granted to foreign investors in tax treaties. This section reviews existing studies addressing the first part of that question, on the effect of tax treaties on inward FDI (pathway effect 1A in Figure 6). Somewhat surprisingly, there are no academic studies that address the second part of the question above and estimate the value of tax benefits granted to foreign investors and thus tax losses for the host government.

Econometric studies on the effect on FDI volume generally employ gravity models with dummy variables for the existence of tax treaties. A few studies use micro data. One study using US firm data finds that tax treaties do not make foreign direct investment in a country more attractive (Louie & Rousslang, 2008). By contrast, a study using Swedish firm data finds that the probability of establishing a foreign subsidiary is higher in countries that have a tax treaty with Sweden. However, it finds no effect on the total sales of all Swedish firms in a country, suggesting that tax treaties do not increase overall direct investment (Davies et al., 2009).

Several other studies use macro data from the US, which cover a wide range of partner countries. Early studies found that US outbound FDI does not increase because of tax treaties (Blonigen & Davies, 2004) or renegotiations of existing treaties (Davies, 2003). However, newer studies find some heterogeneous effects. Neumayer (2007) finds that tax treaties increase FDI to middle income countries, but not to low income countries.<sup>27</sup> Millimet and Kumas (2008) find positive effects for country pairs that initially have relatively low bilateral investment and negative effects for country pairs that already have relatively high investment.

Some other studies use bilateral FDI data from the OECD or UNCTAD. These data sets cover a range of home as well as host countries, but data quality is generally poor (Zhan, 2006), which may affect results. Broader data sets facilitate methods that control for the endogeneity of concluding a tax treaty. This is an important issue to the gravity models: two countries may decide to conclude a tax treaty because they have close economic relations, rather than that bilateral FDI is following after the conclusion of a treaty. It is also possible that large existing investors lobby for a treaty that would reduce their overall tax burden. However, even if bilateral FDI grows faster after a tax treaty has been signed, this does not necessarily imply a causal relationship. Broad economic reforms of low and middle income countries that opened up to foreign investors may explain both the increasing number of tax treaties and the rise in FDI (Barthel, Busse, Krever, et al., 2010). Even the more advanced studies, using broad data sets and controlling for endogeneity, may therefore not provide conclusive evidence that certain FDI patterns are the result of tax treaties.

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Blonigen and Davies (2008) distinguish between old and new treaties. Old treaties were mainly concluded between economies with strong historical ties and therefore largely endogenous. The authors find that old treaties are associated with higher and new treaties with lower FDI. This result seems consistent with the heterogeneous results mentioned above, because old treaties were probably concluded between countries with relatively high existing bilateral direct investments and with middle rather than low-income countries. Newer studies with broad data sets use more advanced methods to control for endogeneity, producing mixed results. Egger et al. (2006) find negative effects of tax treaties on FDI, whereas Coupé et al. (2008) find no significant effects. Barthel et al. (2010), who use a dataset with extended coverage of developing countries, find positive effects, including for FDI into low income countries when controlling for endogeneity. Siegman (2007) also finds positive effects (Lejour, 2013; Lejour & Van 't Riet, 2013). Thus, results regarding the effect of tax treaties on bilateral FDI have been mixed.

<sup>27</sup> Note that the letter to parliament of 19 June 2013 from the Dutch State Secretary for Finance (IFZ/2013/414 M), answering questions about the recently concluded tax treaty with Ethiopia, represents the results of Neumayer (2007) incorrectly. In footnote 1, the letter suggests that the study provides evidence of positive effects for all developing countries, including low income countries like Ethiopia, but that is not the case.

A new draft study<sup>28</sup> of the Netherlands Bureau for Economic Policy Analysis (CPB) produces mixed results as well. The study suggests that tax treaties have a temporary positive effect and shows that higher FDI follows the conclusion of tax treaties, not the other way around (Lejour, 2013; Lejour & Van 't Riet, 2013). The average effect of a new treaty reaches a peak at almost 35% higher bilateral FDI stocks after six years, but becomes insignificant after eleven years. Moreover, the effect of a specific treaty becomes insignificant when controlling for the number of tax treaties concluded by the home country and by the host country. The coefficients for the number-of-treaty variables are highly significant (Lejour, 2013; Lejour & Van 't Riet, 2013). This could reflect treaty shopping via countries with many tax treaties. However, it could also reflect that countries with FDI-friendly policies have more tax treaties, while these treaties themselves have little influence on bilateral FDI.

Note that broader studies using OECD or UNCTAD data analyse the effect of tax treaties in general, not the effect of treaties concluded by a particular home country. However, the impact on bilateral FDI probably depends on the benefits that a treaty offers over existing tax rules. These benefits are not homogenous, because they follow from treaty provisions in combination with tax system characteristics of the home and host country. Furthermore, some studies (including the CPB study) do not differentiate between developing host countries and other host countries.<sup>29</sup> The effects identified in such broader studies may therefore differ considerably from the average effect of Dutch tax treaties on FDI from the Netherlands (a specific home country) in developing countries (a specific subset of host countries).

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Researchers that found insignificant or negative effects have attributed these to FDI-reducing aspects of tax treaties, such as enhanced transfer pricing regulation, exchange of information between tax authorities, and anti-treaty shopping provisions (Blonigen & Davies, 2008; Davies et al., 2009). However, this explanation seems inconsistent with the diversion of FDI through conduit countries to take advantage of their tax treaties. Leaving aside data flaws, an alternative explanation would be that tax treaties facilitate repatriation of income from foreign subsidiaries. The host country records these transactions as negative FDI inflows,<sup>30</sup> because they reduce inward investment positions, offsetting positive FDI inflows related to new investments. Thus, tax treaties may increase FDI flows between parents and subsidiaries in both directions, and it is not self-evident whether the balance will be positive, neutral, or negative.

If tax treaties increase bilateral FDI significantly, this may to some extent result from treaty shopping (Thuronyi, 2010). The diversion of inward FDI from non-treaty countries through treaty countries affects the apparent origin of investments. The UK Office for National Statistics calls this the '*Netherlands effect*', although it occurs for other countries as well

<sup>28</sup> The final version the CPB discussion paper may include adjustments to the gravity model and to the variables capturing additional effects of EU directives.

<sup>29</sup> Such a differentiation may be included in further analyses of the CPB.

<sup>30</sup> Repatriation of income reduces inward FDI in the host country (capital invested by foreign investors in domestic subsidiaries), it does not affect outward FDI from the country (capital invested by domestic investors in foreign subsidiaries).

(Wilkie, 2010). Weyzig (in press) analyses structural determinants of FDI diversion via the Netherlands, using a combination of OECD macro data and micro data from the Dutch central bank. The analysis shows that FDI diversion is higher if the Netherlands has treaties with both the home and host country, and lower if there is a direct treaty in place between the home and host country. Furthermore, it shows that diversion of investments is partly driven by specific conduit structures that benefit from reduced withholding taxes under Dutch tax treaties. This provides direct empirical evidence on tax treaty shopping.

Due to treaty shopping, the effect of tax treaties on total inward FDI in developing countries may be smaller than most existing studies suggest. FDI diversion via a treaty country leads to overestimation of the effect of the treaty on bilateral FDI originating from that country itself.<sup>31</sup> Furthermore, after a host country concludes additional treaties with similar provisions regarding withholding taxes, new direct investments might no longer be diverted. This increases the apparent short-term effect of new treaties. However, changes in the investment routes do not affect the total level of inward FDI in developing countries from all countries combined. Only Neumayer (2007) has analysed the effect of tax and investment treaties on total FDI. He finds that tax treaties increase FDI to middle income countries, but not to low income countries. Most studies are not robust to treaty shopping, though.

Another limitation of most empirical studies is that they do not consider qualitative differences between tax treaties. Except for a few studies on tax sparing clauses (Azémar et al., 2006; Hines, 2001), all existing economic studies investigating the effect of tax treaties on FDI regard tax treaties as homogenous and use dummy variables only to test their impact on FDI. However, Weyzig (in press) shows that differences in the reduction of dividend withholding tax rates have a significant effect on FDI patterns, even after controlling for the general effect of tax treaties. Thus, the effects of tax treaties are heterogeneous and depend on the combination of domestic tax law and specific provisions in the treaty. Analysing effects of tax treaties without taking into account relevant treaty characteristics can therefore produce misleading results. To summarise, existing econometric studies have important limitations and evidence about positive effects of tax treaties on the volume of FDI is, at best, inconclusive.

A different type of study that specifically analysed Dutch FDI in ten developing countries found that the investment position of normal Dutch companies in treaty countries had hardly increased. During the period 2003-2011, regular Dutch FDI stock in the Philippines, Bangladesh, Ghana, Uganda, and Zambia combined varied from €0.44 billion to €0.97 billion but did not show a clear trend. The relative share of Dutch foreign investments in total inward FDI in these countries strongly decreased (Kosters et al., 2013). This suggests that tax treaties may not have a significant effect on the volume of regular FDI from the

<sup>31</sup> Assuming diverted FDI is included in the bilateral FDI data. This is not the case for FDI data reported to the OECD by the Netherlands and Luxembourg, two key conduit countries. However, the use of OECD outward FDI data still leads to an underestimation of FDI originating from non-treaty countries if part of this FDI is diverted via treaty countries.



Netherlands (while the same study suggests that they do cause a strong increase in the volume of FDI diverted via the Netherlands).

Thus, although it is possible that Dutch tax treaties with other developing countries have had a positive volume effect on regular FDI originating from the Netherlands, for example because of special treaty characteristics, evidence of such effects is currently not available. At the level of developing countries as a group, a significant positive volume effect is even more uncertain than at the level of individual countries.

### 5.3 Avoidance of withholding tax

Many multinationals pass dividend, interest and royalty flows through Dutch SPEs and this can reduce taxable income in developing countries and withholding tax revenues (pathway effects 5B and 6B in Figure 6). This section describes such conduit structures, aggregate figures on income flows passing through Dutch SPEs, and rough estimates of lower withholding tax effects for developing countries as a result of tax treaties.

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Investing in foreign countries via a Dutch SPE generally allows companies to benefit Dutch tax treaty rates for host country withholding taxes on intra-group dividend and interest payments. Since 2006, many firms have extended holding chains for foreign participations by inserting a Dutch members' cooperative between the Dutch holding and its foreign parent. Until 2012, this allowed to avoid any Dutch withholding tax on profits distributed onwards to the home country as well, because profit distributions by cooperatives were not treated as dividends<sup>32</sup>. Firms may also avoid Dutch dividend withholding tax by distributing income in the form of capital repayments (Merks, 2011). Interest payments distributed onwards are never subject to Dutch withholding tax. Note that Dutch SPE structures are also partly driven by investment treaty shopping and Dutch SPEs hold material investments in developing countries that do not have a tax treaty with the Netherlands (Weyzig, in press). Thus, not all investments via Dutch SPEs reduce applicable withholding tax rates in developing countries.

The investment of Canadian firm Turquoise Hills Resources in Mongolia provides a relevant example of FDI via a Dutch SPE. In 2009, the firm transferred most of its stake in the Mongolian copper mine project Oyu Tolgoi LLC to a newly established Dutch company, which it holds via a Dutch cooperative. As a consequence, the dividends from the Mongolian subsidiary are not subject to the standard 10% withholding tax rate specified in the investment agreement or the 5% rate of the Mongolia-Canada tax treaty, but exempt under the Mongolia-Netherlands tax treaty. Before 2012, profits distributed onwards via the Dutch cooperative to the Canadian parent would have been exempt from Dutch withholding tax as well (Michiels, 2011; Sunley et al., 2010).

<sup>32</sup> A cooperative must have at least two members, so most firms divide the direct ownership of the Dutch cooperative between two legal entities in the home country. In 2012, the Dutch government introduced anti-abuse legislation, treating distributions to foreign members of the cooperative as dividends if a structure mainly aims to avoid dividend withholding tax.

The investment of Vodafone in Ghana provides another example. In 2008, five months after the Ghana-Netherlands tax treaty had been signed, Vodafone acquired a 70% stake in a Ghanaian telecommunications company. Vodafone owns this and other subsidiaries through a Dutch SPE that holds €19 billion of equity investments and is financed with a mix of equity and intra-group loans. The SPE structure allows Vodafone to benefit from the 5% withholding tax on dividends under the Ghana-Netherlands tax treaty, compared to 7.5% under the Ghana-UK treaty. In 2010, the investment in Ghana was valued at €300 million but at that time the Ghanaian company had not distributed dividends to Vodafone and so had not realised the advantage of a lower withholding tax on dividends yet.

Weyzig (2013) provides empirical evidence of tax treaty shopping via the Netherlands related to dividend withholding tax reductions under Dutch tax treaties. Kusters et al. (2013) show that FDI stock held via Dutch SPEs in the Philippines, Bangladesh, Ghana, Uganda, and Zambia strongly increased from a combined total of €1.2 billion at the end of 2003 to €7.6 billion at the end of 2011, whereas FDI from normal Dutch companies hardly changed during this period. Moreover, in five other countries that did not have a tax treaty with the Netherlands (Cambodia, Cameroon, Nepal, Kenya, and Tanzania), FDI via Dutch SPEs increased more slowly. These results provide further evidence of tax treaty shopping.

Other tax avoidance strategies involve the diversion of external debt rather than FDI. Some non-financial firms from EU countries use Dutch conduits to issue debt securities on the international capital market. This eliminates any withholding taxes on interest payments to foreign creditors, because payments to a Dutch conduit are exempt under the EU Interest and Royalties Directive and the Netherlands has no withholding tax on interest. The Dutch conduits usually on-lend the funds to the foreign parent company or other affiliates (DNB, 2009). This tax strategy is similar to the issuance of bonds by US multinationals via the Netherlands Antilles in the past (Papke, 2000). Firms from non-EU countries can use this strategy if the withholding tax rate on interest payments to Dutch affiliates is lower than the average rate on payments to foreign non-affiliated creditors. The diversion of debt financing can involve bank loans as well.

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The Indonesian energy firms Parser and Ciaran Listrindo provide examples of international debt issues via Dutch SPEs. Both firms pass on the debt finance in two steps. First, the Dutch issuing entity invests the issuance proceeds as equity into a Dutch subsidiary. Second, this Dutch subsidiary on-lends the funds to the ultimate parent in Indonesia. These structures may provide a legal defence against anti-avoidance measures in the bilateral tax treaty or at the national level in Indonesia. For Indonesian firms, withholding taxes on interest paid directly to foreign creditors typically range from 10% to 20%, depending on the country. Interest paid via a Dutch SPE, however, is free of withholding tax, provided the loan has a maturity of more than two years.

Regarding royalty structures, there are several examples of large US firms, such as Forest Laboratories and Google that collected royalties for the use of their intellectual property via

Ireland and then passed the payments onwards to Bermuda via a Dutch conduit.<sup>33</sup> In this strategy, the Dutch royalty conduit holds a sub-license and serves to avoid the standard Irish 20% withholding tax on outgoing royalties (Kleinbard, 2011). The rate to the Netherlands is 0% because of the EU Interest and Royalties Directive and the Netherlands does not impose a withholding tax on outgoing royalties. Velcro Canada provides an example of a non-US firm.<sup>34</sup> Velcro migrated the ownership of its intellectual property to Curaçao and also channelled the royalties it received through a Dutch entity with a sub-license. The royalty payments qualified for 0% withholding tax under the Canada-Netherlands tax treaty instead of the standard 25% rate. Specific examples of royalty payments from developing countries passed on by Dutch SPEs are not available.

Various studies have attempted to estimate the missed tax revenues in developing countries due to withholding tax avoidance via Dutch SPEs that make use of the bilateral tax treaties of the Netherlands. The estimates differ because the studies use different data and assumptions. Table 2 compares estimates by Weyzig (2013), Oxfam Novib (Berkhout, 2013), SOMO (McGuaran, 2013), and SEO Economic Research (Kerste et al., 2013). These studies use similar calculation methods but different data and assumptions. All estimates have been split into dividend and interest withholding tax; none of the studies other than Weyzig (2013) provides an estimate of missed royalty withholding tax. The figures from the SOMO report have been adjusted to exclude countries for which a split between FDI from Dutch SPEs and normal Dutch multinational companies was unavailable. All estimates of missed tax revenues have been rounded to multiples of €50 million in order not to provide a false sense of accuracy.

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SEO reports much lower dividend flows than the other studies, because it disregards upper-middle income developing countries. Weyzig (2013) describes that €2.9 billion of the SPEs' dividend income was passed onwards.<sup>35</sup> Oxfam Novib, SOMO and SEO all assume that the average rate of missed tax revenues is approximately 5%. This seems on the high side, considering that the withholding tax on dividends to the Netherlands should be compared with the withholding tax on dividends to the ultimate home country of the multinational, which may also be reduced by a treaty, instead of the non-treaty rate. For example, in the above-mentioned case of a Vodafone investment in Ghana, one has to compare the 5% withholding tax on dividends under the Ghana-Netherlands tax treaty to the 7.5% due under the Ghana-UK treaty.

<sup>33</sup> J. Drucker, "Forest Laboratories' Globe-Trotting Profits", *Bloomberg Businessweek*, 13 May 2010; J. Drucker, "The Tax Haven That's Saving Google Billions", *Bloomberg Businessweek*, 21 Oct 2010.

<sup>34</sup> *Velcro Canada Inc. v. Her Majesty the Queen*, Tax court of Canada, case no. 2012 TCC 57.

<sup>35</sup> This study reports figures for all low and middle income countries combined because of confidentiality constraints that would arise if smaller country groups were reported separately.

Table 2				
Estimates of withholding tax (WHT) avoidance via Dutch SPEs				
Study	Weyzig	Oxfam Novib	SOMO	SEO
Dividend flows	€5.5 bln of which €2.9 bln passed on	€6.7 bln	€4.8 bln	€2.9 bln
WHT avoided	at least 3% of €2.9 bln = €100 mln <sup>36</sup>	5% = €350 mln	4.4% = €200 mln	5.1% = €150 mln
Interest flows	€1.1 bln, of which €1.0 bln passed on	€2.5 bln	€3.6 bln	Not disclosed
WHT avoided	at least 5% of €1.0 bln = €50 mln <sup>37</sup>	5% = €100 mln	9.6% = €350 mln	€250 mln
Royalty flows	€0.4 bln, of which €0.1 bln passed on;	Not included	Not included	Not disclosed
WHT avoided	5% of €0.1 bln ≈ €0 mln <sup>38</sup>			
<b>Total WHT avoided</b>	€150-500 mln <sup>39</sup>	€450 mln	€550 mln	€400 mln
Data sources for income flows	DNB micro data and debt security data from AFM, S&P and individual companies	Estimate based on DNB and CBS macro figures	Estimate based on DNB and CBS macro figures	DNB micro data
Year of income flows	Dividend: 2007 Interest: 2007/2010	2011	2011	2011
Countries	Dividend: low and middle income countries  Interest on debt securities: Indonesia and Kazakhstan	Low and middle income countries	Low and middle income countries	Low and lower-middle income countries

<sup>36</sup> The €2.6 billion of dividend income that is not passed onwards by Dutch SPEs may be related to structures facilitating avoidance home country tax on foreign income. Although these structures may reduce withholding tax revenues in host countries as well, this is less clear than for SPEs passing on dividends.

<sup>37</sup> The estimate does not include withholding tax avoided on interest payments passed onwards within the group. It reflects withholding tax avoided on interest payments passed on to debt security holders only and is based on data for 2010 from annual reports and other individual company records of Dutch entities that had issued debt securities. Note that the €1.0 billion of interest passed on to debt security holders calculated from these data do not match with the total interest income of €1.1 billion calculated from anonymized central bank micro data for 2007 mentioned in the table. Out of this €1.1 billion, only €0.4 billion was passed on to debt security holders (€0.6 billion was passed on to other recipients).

<sup>38</sup> The withholding tax avoided is closer to €0 million than to €50 million. The other €0.3 billion of royalty income is not passed onwards by Dutch SPEs and probably involves avoidance of host country corporate income tax rather than withholding tax.

<sup>39</sup> The upper end of this range is not mentioned in Weyzig (2013), but its order of magnitude may be inferred from the conservative assumptions for avoided dividend withholding tax and the partial estimate for avoided interest withholding tax.

The three studies also provide a figure for interest flows from developing countries. SOMO arrives at a high estimate, because it attributes total income from FDI received by SPEs and miscellaneous financial institutions (other than banks, pension funds, insurers, and SPEs) to SPEs and normal Dutch companies. This may underestimate the SPEs' dividend income and overestimate their interest income, because SPEs earn relatively more dividend income and less interest income from FDI than miscellaneous financial institutions.<sup>40</sup> SEO only reports a total estimate of missed withholding tax and cannot provide a figure for interest flows, because of confidentiality requirements that apply to the micro data. To estimate the rate of missed interest withholding tax, Weyzig (2013) takes into account the main sources of interest, which are Indonesia and Kazakhstan, and the overall tax treaty networks of these countries. This provides a relatively refined calculation. SOMO's assumption of 10% missed interest withholding taxes seems rather high.

Weyzig (2013) also reports royalty income from low and middle-income countries. Only €0.1 billion of the received royalty income of €0.4 billion was passed onwards to foreign affiliates which suggest that withholding tax avoidance is not a main aim of royalty flows to Dutch SPEs.

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Despite the differences in data sources and assumptions, the outcomes of the four studies are all in the same order of magnitude. It can be concluded that missed withholding tax revenues amount to several hundred million euro. These figures are not very precise, mainly because of the rough assumptions about missed withholding tax revenues in most studies.<sup>41</sup> More accurate estimates are currently not available. In principle, it is possible to produce more detailed estimates that take into account all bilateral withholding tax rates in the other tax treaties of developing countries using DNB micro data. This would require a substantial data processing effort. Moreover, it should be realised that dividend flows to Dutch SPEs are highly volatile and differ strongly per country (Kosters et al., 2013). More detailed aggregate estimates are therefore of limited value for policy purposes but could be very relevant for specific partner countries of the Netherlands.

Avoidance of interest withholding tax on debt securities also has a composition effect, because lower borrowing costs may induce higher debt financing (pathway effect 6C in Figure 6). An analysis of European firms shows that multinationals with a Dutch issuing SPE on average have some 15-20% more debt, controlling for relevant firm characteristics (Weyzig, 2013). Not all of this effect may be attributable to the Dutch SPE. Firms that pursue corporate tax deductions more aggressively will use more debt and are also more inclined to avoid interest withholding taxes, for instance. However, the analysis confirms that the

<sup>40</sup> In 2011, Dutch SPEs reported €70.2 billion of dividend and €26.0 billion of interest income, whereas other financial institutions reported €4.0 billion of dividend and €7.5 billion of interest income, according to Statistics Netherlands (CBS). These figures are also used in the SOMO report.

<sup>41</sup> The estimates also include missed withholding tax on investments via SPEs that would otherwise not take place (box 2 in Figure 6). However, it is not possible to distinguish between investments via SPEs that would be made anyway and investments that would not occur without a tax treaty route. Considering the mixed evidence on the effect of tax treaties on FDI, it is likely that most investments would be made anyway, so probably this does not make a substantial difference.

higher debt financing is at least partly facilitated by Dutch issuing SPE. Assuming these results can be extended to developing country firms, the use of Dutch issuing SPEs by Indonesian firms results in an additional revenue loss, which may be equal to a third of the avoided interest withholding tax.<sup>42</sup>

## 5.4 Profit shifting via Dutch Special Purpose Entities

Conduit structures do not only allow to avoid withholding taxes, they can also facilitate profit shifting to entities in low-tax jurisdictions in the form of interest, royalty payments and management fees (pathway effects 5C and 7C in figure 6). This would reduce corporate income tax revenues in host countries. In 2007, Dutch SPEs channeled approximately €0.2 billion of interest income from low and middle-income countries onwards to affiliates in low-tax jurisdictions.<sup>43</sup> This shows that profit shifting via Dutch SPEs is significant, but has a smaller revenue effect than withholding tax avoidance. If all of the interest payments passed on to tax havens would be additional to other interest payments that take place anyway, and if the payments would be deductible against corporate income tax at an average rate of 25%, then this would result in €50 million of corporate tax avoidance in developing host countries. However, an analysis of profit shifting among EU countries suggests that only about 10% of the interest payments are additional (Weyzig, 2013). The remainder of the interest payments would take place anyway, but are diverted towards affiliates in tax havens at the expense of affiliates in other countries that receive less interest income as a result. It is difficult to determine which countries these would have been; probably in part the home countries of multinationals. In 2007, Dutch SPEs did not pass on substantial royalty flows directly from low and middle-income countries to low-tax jurisdictions.

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## 5.5 Profit shifting to Dutch Special Purpose Entities

Some Dutch SPE structures also involve avoidance of host country corporate income tax through profit shifting to the Netherlands (pathway effect 8C in figure 6). This section presents some cases of profit shifting to Dutch SPEs in the form of intragroup trade, royalties, and interest payments. Usually the profits shifted to the Netherlands benefit from special tax treatment under an advanced pricing agreement (sometimes referred to as a tax ruling). The cases presented below are merely examples and include cases of profit shifting out of EU countries as well.

<sup>42</sup> Assuming an increase in deductible interest payments of 15% in the case of Indonesia suggests a reduction in tax revenues of approximately 3% of total interest payments. This reduction is roughly a third of the withholding tax avoidance, which is estimated at 10% of interest payments via Dutch SPEs.

<sup>43</sup> Bermuda, Cayman Islands, British Virgin Islands, Jersey, Guernsey, Aruba, Curacao, Puerto Rico, Switzerland, Luxembourg, Ireland, and Belgium. These jurisdictions either have a low or zero general corporate income tax rate or special regimes for international interest or royalty income resulting in a low or zero effective tax rate.

SABMiller, a large UK-based brewery, provides an example of profit shifting in the form of royalties. The firm transferred its trademarks of originally African beers from the African subsidiaries in Ghana and South Africa to a Dutch SPE (royalty BV). From 1998 to 2005, SABMiller benefitted from a Dutch low-tax regime for royalty income (SOMO, 2008). After that, SABMiller apparently concluded an agreement with the Dutch tax authority<sup>44</sup> that allows a flexible amortisation of the trademark rights for tax purposes beyond their purchase value, almost reducing the taxable royalty income of the Dutch royalty BV to zero. Royalty payments from South African and Ghanaian subsidiaries to the Dutch SPE amount to approximately €15 million and €0.3 million per year, respectively (Hearson & Brooks, 2010).

Energias de Portugal, a large energy company, provides an example of profit shifting in the form of interest. A Dutch conduit of Energias de Portugal on-lends financing from debt issuance and bank loans to affiliates in Portugal and Spain. An agreement with the Dutch tax authority specified its minimum taxable income as an arm's-length return on equity, plus a spread of 0.03% on on-lent funds, minus operational costs. The agreement apparently allowed the conduit to earn some €12 million of net interest income effectively tax free in the years 2008 and 2009 combined (Weyzig, 2013). In 2012, it was decided that the agreement with the tax authority did no longer apply from 2010 onwards, so for these years the full profits of the conduit were subject to corporate income tax in the Netherlands.

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Finnish pulp and paper company Stora Enso provides an example of profit shifting through trade in goods. This example is remarkable because earlier studies did not find evidence of such strategies (IBFD, 2004; Muller et al., 2004). In the case of Stora Enso, a Dutch subsidiary buys pulp from a Brazilian joint venture at cost-plus prices and sells it onwards to a Finnish affiliate at substantially higher market prices.<sup>45</sup> Due to an advance pricing agreement, apparently only a small trading margin is included in the tax base even though the actual margin is much larger (Finér et al., 2012).

These cases show that some multinationals shift profits to Dutch SPEs that are taxed at a low effective rate. Some of these structures affect developing countries. A more comprehensive analysis and detailed figures on total profit shifting are not available, because special tax treatment can only be identified on a case-by-case basis by examining individual company data. However, income flow data provide an indication of potential profit shifting via interest and royalties. In 2007, Dutch SPEs received roughly €0.1 billion of interest income and €0.3 billion of royalty income from low and middle income countries that was not passed onwards in the same form (Weyzig, 2013). This shows that profit shifting to the Netherlands through interest payments is probably small, while profit shifting through royalty payments is potentially more substantial.

<sup>44</sup> The accounts of the relevant Dutch SPE of SABMiller mention an "agreement with the fiscal authority". SABMiller denied that it concluded an advance tax ruling or advance pricing agreement with the Dutch tax authority, but confirmed that the taxable income of the SPE "is reduced by a tax amortisation allowance".

<sup>45</sup> The pulp does not physically pass through the Netherlands but is shipped from Brazil to Belgium and from there onwards to Finland and other destinations.

## 5.6 Hybrid structures and other types of tax avoidance

This section briefly discussed other potential tax avoidance structures involving Dutch SPEs not shown in figure 6. In contrast to the previous sections, concrete examples or aggregate figures are hardly available for these structures.

First, firms may avoid host country corporate income tax through hybrid financing via Dutch SPEs. Under certain conditions, interest payments on so-called profit-participating loans from Dutch entities are regarded as dividends for Dutch tax purposes.<sup>46</sup> Since 2007, these payments are tax exempt in the Netherlands, even if they are tax deductible in the source country (Heithuis, 2006). Examples of countries that allow such deductions are France, Belgium, Spain, and Finland. Tax advisory firms have also promoted tax avoidance via profit-participating loans in several non-EU countries, including Mexico and Azerbaijan.<sup>47</sup> Figures on Dutch profit participating loans or concrete cases of firms using such loans in tax avoidance structures are not available, though.

Second, US firms may use hybrid Dutch SPEs to avoid host country corporate income tax. They can do this by channeling interest payments via a Dutch limited liability company to a Dutch partnership that they designate as an incorporated entity for US tax purposes. It is widely known that US firms use Dutch SPEs in this strategy, but figures are not available.

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Third, firms may avoid home country tax on foreign income via Dutch base companies (intermediate holdings). Weyzig (2013) did not find empirical evidence of such strategies, but this may be explained by Dutch SPEs whose direct and ultimate parents are located in different countries. Anecdotal evidence suggests that US firms do use Dutch base companies. Moreover, Dutch subsidiaries distributed approximately USD 90 billion of dividends qualifying for the US tax holiday on repatriated foreign profits during 2004-2006. This was almost a third of total qualifying dividends from all countries worldwide (Redmiles, 2008). Thus, US firms probably use Dutch holdings on a large scale to avoid home country taxes on foreign dividend income. Dutch intermediate holdings may also facilitate exemption of dividend income from low-tax jurisdictions. In 2010, Dutch SPEs received approximately €4.2 billion of dividends from countries with a corporate tax rate lower than 10% in 2010 (Kerste et al., 2013). In principle, this dividend income is only exempt in the Netherlands if it is derived from active business operations, but part of these dividend flows may still be related to tax avoidance structures.

Fourth, firms may use Dutch SPEs in strategies to avoid a capital gains tax. As capital gains are not a regular income flow and arise in a one-off transaction with the sale of the assets involved, it is difficult to systematically analyse the magnitude of potential capital gains avoidance in developing countries. Again, figures or concrete examples are not available.

<sup>46</sup> *X B.V. v. Deputy Minister of Finance*, Dutch Supreme Court, case no. AT5958.

<sup>47</sup> See for example Deloitte (2011). *The Netherlands: As an intermediary*. [http://www.deloitte.com/assets/Dcom-Azerbaijan/Site%20SMF/EN/Events/The%20Netherlands\\_As%20an%20intermediary.pdf](http://www.deloitte.com/assets/Dcom-Azerbaijan/Site%20SMF/EN/Events/The%20Netherlands_As%20an%20intermediary.pdf) (accessed 24 August 2013).



Although the magnitude of tax avoidance via these and other strategies cannot be estimated, the revenue impact on developing countries can be substantial. This is certainly the case for capital gains avoidance, because the sale of large assets in a developing country could yield once-off capital gains that are much larger than annual dividend or interest payments from the affiliated companies in that country to Dutch SPEs. The potential impact of home country tax avoidance on developing host countries is only indirect, as explained in the previous section.



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## Concluding remarks

Strengthening domestic revenue mobilisation for public investments and expenditures is an essential element of enhancing financing for development. In developing countries, approximately 10-30% of tax revenues consist of taxes on corporate income and the share of withholding taxes alone can be 5% of total tax revenues. There exist several factors that can undermine corporate tax revenues, though. Some of these factors result from domestic constraints or regional tax competition among developing countries, for example in the form of tax holidays. Others result from international arbitrage opportunities due to differences between the tax systems and tax treaties of different countries. Arbitrage opportunities can accidentally arise whenever there are differences between tax systems, yet some arbitrage opportunities are also knowingly facilitated or even intentionally created by offshore tax havens and various developed countries.

This study focussed on effects of Dutch corporate tax policy on taxation of multinationals in developing countries and potential tax revenue losses for these countries. Table 3 (next page) summarizes the findings about these effects. It mentions relevant aspects of Dutch tax policy and tax treaties, their effect on the investment volume, financing structure and intra-group transactions of multinationals, and the main types of revenue effects. The pathway effects in Table 3 refer to Figure 6 in Chapter 5.

In general, it is remarkable that so little is known about the effects of tax treaties on the volume of FDI and on the level of withholding tax revenues. From a development perspective, a main objective of tax treaties is to promote higher foreign investment while a main cost comes in the form of lower withholding tax revenues. However, empirical studies do not provide much insight into the effect of tax treaties on the volume of inward FDI because most studies do not consider differences in key characteristics of tax treaties, notably by how much they reduce withholding tax rates. Moreover, academic studies on the total effect of tax treaties on withholding tax revenues are not available. Thus, existing insights on benefits and costs of tax treaties are rather limited.

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Regarding Dutch tax corporate policy, a few aspects stand out because of significant negative revenue effects on developing countries. Dutch tax treaties that specify relatively low dividend withholding tax rates, without anti-abuse provisions, allow avoidance of dividend withholding tax by foreign multinationals and therefore induce tax treaty shopping. Similarly, Dutch tax treaties that specify relatively low interest withholding taxes, in combination with the absence of Dutch withholding tax on interest, facilitate avoidance of interest withholding tax. Various studies estimate that this leads to missed withholding tax revenues in developing countries in the range €150-550 million per year. The same aspects of the Dutch tax system also facilitate avoidance of withholding tax on interest paid to external creditors. For example, in 2010, the use of Dutch issuing SPEs resulted in estimated missed interest withholding tax revenues of approximately €50 million in

Table 3		Effects of Dutch corporate tax policy	
Aspect of Dutch corporate tax policy	Pathway <sup>a)</sup>	Effect on investment volume, financing structure and transactions	Main effect on tax revenue in developing countries
Tax treaties in general, no interest WHT in NL	1A	Effect on FDI from NL unclear but probably limited, empirical studies have important limitations and produce mixed results	Volume effect: unclear
	2A	Effect on FDI via NL unclear but probably limited, FDI via NL cannot be distinguished into additional and diverted FDI due to data limitations	Volume effect: unclear
Tax treaties reducing interest WHT, no interest WHT in NL	3A	Effect of lower borrowing costs on investment volume unknown, no empirical studies available	Volume effect: unclear
Tax treaties reducing dividend or interest WHT	4B 4C	Financing structure of existing FDI from NL may change due to changes in WHT rates but no estimates available	Rate effect: lower WHT on dividend and interest, composition effect: unclear
Tax treaties reducing dividend WHT	5B	Equity participations diverted via NL	Rate effect: lower dividend WHT
Tax treaties reducing interest WHT, no interest WHT in NL	5B	Intra-group loans from non-haven countries diverted via NL	Rate effect: lower interest WHT
	5C	Intra-group loans from tax havens via NL	Composition effect: larger share of debt financing reduces corporate income tax
	6B 6C	Debt issuance and external borrowing via NL	Rate effect: lower interest WHT, composition effect: larger share of debt financing reduces corporate income tax
Tax treaties reducing royalty WHT, no royalty WHT in NL	7B	Royalty payments to normal countries diverted via NL	Rate effect: lower royalty WHT
	7C	Royalty payments to tax havens diverted via NL	Composition effect: unclear
APAs resulting in low effective tax rate	8B 8C	Royalty payments to NL	Rate effect: unclear, composition effect: larger royalty payments abroad and missed corporate tax
Other aspects of corporate tax policy		Possibly FDI diverted via NL and hybrid structures, but no concrete examples	Effects are unclear

Note: WHT = withholding tax; APA = advance pricing agreement; <sup>a)</sup> pathway effects refer to Figure 6.

Indonesia alone.<sup>48</sup> As avoidance of interest withholding tax reduces borrowing costs, it stimulates substantially higher debt financing relative to equity. This limits the tax base in the firm's home country and therefore results in an additional revenue loss, which may be equal to a third of the avoided withholding tax.

Next, special tax treatment of SPEs under certain advance pricing agreements with the tax authority facilitates profit shifting to the Netherlands and reduces corporate income tax revenues in some developing countries. While significant, the revenue effect is probably smaller than that of withholding tax avoidance. Direct profit shifting from developing countries via Dutch SPEs onwards to other jurisdictions, instead of to Dutch SPEs, is probably unsubstantial. However, the absence of a Dutch withholding tax on royalties can also facilitate profit shifting to low-tax affiliates in other countries by way of royalty payments passing through Dutch SPEs. This affects developing countries indirectly, for example in the case of Google, which collected royalties from African countries in Ireland and then passed on this royalty income via the Netherlands to Bermuda. The effect is indirect because the royalties are not paid directly from developing countries to the Netherlands.

Other aspects of Dutch corporate tax policy can have (intended or unintended) effects on developing countries as well. Probably the most important aspect is the exemption of profits from the sale of foreign participations and the elimination of capital gains tax under bilateral tax treaties, which may facilitate the creation of structures to avoid capital gains tax in developing countries. This is important because the sale of large operations in a developing country could yield large capital gains.

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Considering the other purposes of taxation beyond revenue generation, it can be concluded that tax avoidance strategies facilitated by Dutch corporate tax policy have further negative effects on developing countries. They also have an impact on the redistribution, representation, and re-pricing roles of taxation.

The effect on income redistribution is rather complex because it is difficult to determine who ultimately bears the cost of the withholding and corporate income tax paid by multinational firms and who benefits from tax avoidance. Probably some of the private benefits from tax avoidance accrue to the shareholders of multinational firms. However, part of the tax savings may also be passed on to customers and consumers, through lower sale prices, and to suppliers and creditors, through higher procurement prices and interest

<sup>48</sup> This estimate takes into account that interest payments may have been some 12% lower if they were not passed through a Dutch SPE, because withholding tax avoidance induces larger debt financing. Roughly half of the interest payments concern the state-owned energy company Persero. Thus, the missed tax revenues are partly offset by higher profits of this company. However, Persero incurs some costs for operating the tax avoidance structure and the lower borrowing costs probably induce higher debt financing. As a consequence, the structure still reduces total revenues for the Indonesian government.

rates.<sup>49</sup> The distribution among shareholders, clients, suppliers, creditors, and other stakeholders depends on the characteristics of the markets in which the firm operates. If a firm has some degree of market power or has a highly inelastic demand for its products and debt securities, the shareholders can capture a larger part of the benefits. A substantial part of the benefits accrues to beneficiaries in high-income countries.

In addition to the net private benefits for the firm, two types of actors also benefit from the costs that a firm incurs through its tax avoidance practices. The first type consists of tax advisors, law firms, accountants, administrators, and other service providers that help to set up and manage tax avoidance structures. For Dutch SPE structures, specialised firms in the Netherlands provide the majority of these services. Some structures also involve SPEs in other countries, such as Bermuda or Ireland. The second type consists of foreign governments of conduit countries that obtain revenues from (relatively low) withholding taxes and corporate income taxes on the small profit margins of SPEs. Thus, the tax avoidance facilitated by Dutch SPEs redistributes income from developing countries to the Netherlands and other high-income countries.

Distributional effects at the domestic level in developing countries are less clear and depend on the incidence of corporate tax and other types of taxes. If the government of a developing country raises less tax revenue from multinationals (that pass on part of their tax burden to domestic customers), the government may need to raise more revenue from other sources (or lower public expenditures). The more progressive the domestic tax system, the less likely that tax avoidance by multinational firms has an adverse impact on redistribution within a developing country. For example, if lower tax payments by multinationals would cause the government to increase personal income taxes that are highly progressive, the impact on redistribution within the country could still be positive. However, the incidence of most other types of taxes is less progressive than the incidence of corporate tax, so in practice it is likely that tax avoidance by multinationals has a negative impact on redistribution at the domestic level.

The effect on representation is somewhat ambiguous. On the one hand, tax avoidance by foreign and domestic multinationals can weaken broader taxpayer morale (IMF, 2011) and hinder constructive revenue bargaining between the government and citizens. On the other hand, citizens in developing countries may find other revenue problems more pressing, such as excessive tax incentives for foreign investors offered by the government itself or the diversion of public revenues by domestic elites. In case the tax practices of a specific multinational become the subject of a public scandal, it is also possible that this has a positive by-effect on representation by strengthening civil society groups that promote responsible tax practices and stimulating tax reforms.

<sup>49</sup> This depends on how these parties respond to higher prices. For example, if the demand for a company's product is hardly affected by a price increase, the company can largely pass on the withholding tax to its customers. By contrast, if customers, suppliers, creditors and other parties are all highly price sensitive, then it may not be possible for a company to pass on the withholding tax and the tax will be borne by the shareholders. In practice, the situation is usually somewhere in between.

Finally, the re-pricing effect of tax avoidance by multinationals goes well beyond incentives for higher debt financing and is decidedly negative. Tax avoidance reduces market efficiency, because it redirects resources to unproductive rent-seeking uses and distorts competition between large firms that can engage in international tax arbitrage and medium-sized or smaller firms that cannot. These negative effects on broader economic development are difficult to quantify, but may be as important as the direct negative effect on public revenue mobilisation.



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# Annexes

## Annex 1 About IOB

### Objectives

The remit of the Policy and Operations Evaluation Department (IOB) is to increase insight into the implementation and effects of Dutch foreign policy. IOB meets the need for the independent evaluation of policy and operations in all the policy fields of the Homogenous Budget for International Cooperation (HGIS). IOB also advises on the planning and implementation of evaluations that are the responsibility of policy departments of the Ministry of Foreign Affairs and embassies of the Kingdom of the Netherlands.

Its evaluations enable the Minister of Foreign Affairs and the Minister for Development Cooperation to account to parliament for policy and the allocation of resources. In addition, the evaluations aim to derive lessons for the future. To this end, efforts are made to incorporate the findings of evaluations of the Ministry of Foreign Affairs' policy cycle. Evaluation reports are used to provide targeted feedback, with a view to improving the formulation and implementation of policy. Insight into the outcomes of implemented policies allows policymakers to devise measures that are more effective and focused.

### Organisation and quality assurance

IOB has a staff of experienced evaluators and its own budget. When carrying out evaluations it calls on assistance from external experts with specialised knowledge of the topic under investigation. To monitor the quality of its evaluations IOB sets up a reference group for each evaluation, which includes not only external experts but also interested parties from within the ministry and other stakeholders. In addition, an Advisory Panel of four independent experts provides feedback and advice on the usefulness and use made of evaluations. The panel's reports are made publicly available and also address topics requested by the ministry or selected by the panel.

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### Programming of evaluations

IOB consults with the policy departments to draw up a ministry-wide evaluation programme. This rolling multi-annual programme is adjusted annually and included in the Explanatory Memorandum to the ministry's budget. IOB bears final responsibility for the programming of evaluations in development cooperation and advises on the programming of foreign policy evaluations. The themes for evaluation are arrived at in response to requests from parliament and from the ministry, or are selected because they are issues of societal concern. IOB actively coordinates its evaluation programming with that of other donors and development organisations.

### Approach and methodology

Initially IOB's activities took the form of separate project evaluations for the Minister for Development Cooperation. Since 1985, evaluations have become more comprehensive, covering sectors, themes and countries. Moreover, since then, IOB's reports have been submitted to parliament, thus entering the public domain. The review of foreign policy and a reorganisation of the Ministry of Foreign Affairs in 1996 resulted in IOB's remit being extended to cover the entire foreign policy of the Dutch government. In recent years it has



extended its partnerships with similar departments in other countries, for instance through joint evaluations and evaluative activities undertaken under the auspices of the OECD-DAC Network on Development Evaluation.

IOB has continuously expanded its methodological repertoire. More emphasis is now given to robust impact evaluations implemented through an approach in which both quantitative and qualitative methods are applied. IOB also undertakes policy reviews as a type of evaluation. Finally, it conducts systematic reviews of available evaluative and research material relating to priority policy areas.

## Annex 2 Country codes

Code	Country	CY	Cyprus
AE	United Arab Emirates	CZ	Czech Rep.
AF	Afghanistan	DE	Germany
AL	Albania	DJ	Djibouti
AM	Armenia	DK	Denmark
AO	Angola	DO	Dominican Rep.
AR	Argentina	DZ	Algeria
AT	Austria	EC	Ecuador
AU	Australia	EE	Estonia
AW	Aruba	EG	Egypt
AZ	Azerbaijan	ER	Eritrea
BA	Bosnia and Herzegovina	ES	Spain
BB	Barbados	ET	Ethiopia
BD	Bangladesh	FI	Finland
BE	Belgium	FR	France
BF	Burkina Faso	GA	Gabon
BG	Bulgaria	GE	Georgia
BH	Bahrain	GG	Guernsey
BI	Burundi	GH	Ghana
BJ	Benin	GM	Gambia
BM	Bermuda	GN	Guinea
BN	Brunei Darussalam	GQ	Equatorial Guinea
BO	Bolivia	GR	Greece
BR	Brazil	GT	Guatemala
BS	Bahamas	GW	Guinea-Bissau
BT	Bhutan	GY	Guyana
BW	Botswana	HK	Hong Kong
BY	Belarus	HN	Honduras
BZ	Belize	HR	Croatia
CA	Canada	HT	Haiti
CD	Congo, D.R. of	HU	Hungary
CG	Congo, Rep. of	ID	Indonesia
CH	Switzerland	IE	Ireland
CI	Ivory Coast	IL	Israel
CL	Chile	IM	Isle of Man
CM	Cameroon	IN	India
CN	China	IQ	Iraq
CO	Colombia	IR	Iran
CR	Costa Rica	IS	Iceland
CU	Cuba	IT	Italy
CV	Cape Verde	JE	Jersey
CW	Curacao	JM	Jamaica

JO	Jordan	PA	Panama
JP	Japan	PE	Peru
KE	Kenya	PG	Papua New Guinea
KG	Kyrgyz Republic	PH	Philippines
KH	Cambodia	PK	Pakistan
KP	Korea, D.P.R. of	PL	Poland
KR	Korea, Rep. of	PR	Puerto Rico
KW	Kuwait	PT	Portugal
KY	Cayman Islands	PY	Paraguay
KZ	Kazakhstan	QA	Qatar
LA	Laos	RO	Romania
LB	Lebanon	RS	Serbia
LI	Liechtenstein	RU	Russian Fed.
LK	Sri Lanka	RW	Rwanda
LR	Liberia	SA	Saudi Arabia
LS	Lesotho	SD	Sudan
LT	Lithuania	SE	Sweden
LU	Luxembourg	SG	Singapore
LV	Latvia	SI	Slovenia
LY	Libya	SK	Slovak Rep.
MA	Morocco	SL	Sierra Leone
MD	Moldova	SN	Senegal
ME	Montenegro	SO	Somalia
MG	Madagascar	SR	Surinam
MK	Macedonia	SV	El Salvador
ML	Mali	SY	Syria
MM	Myanmar	SZ	Swaziland
MN	Mongolia	TD	Chad
MO	Macau	TG	Togo
MR	Mauritania	TH	Thailand
MT	Malta	TJ	Tajikistan
MU	Mauritius	TL	Timor Leste
MW	Malawi	TM	Turkmenistan
MX	Mexico	TN	Tunisia
MY	Malaysia	TR	Turkey
MZ	Mozambique	TW	Taiwan
NA	Namibia	TZ	Tanzania
NE	Niger	UA	Ukraine
NG	Nigeria	UG	Uganda
NI	Nicaragua	UK	United Kingdom
NL	Netherlands	US	United States
NO	Norway	UY	Uruguay
NP	Nepal	UZ	Uzbekistan
NZ	New Zealand	VE	Venezuela
OM	Oman	VG	British Virgin Islands

VI	US Virgin Islands
VN	Viet Nam
YE	Yemen
ZA	South Africa
ZM	Zambia
ZW	Zimbabwe

## Evaluation reports of the Policy and Operations Evaluation Department (IOB) published 2008-2013

Evaluation reports published before 2008 can be found on the IOB website:  
[www.government.nl/foreign-policy-evaluations](http://www.government.nl/foreign-policy-evaluations).

IOB no.	Year	Title evaluation report	ISBN
384	2013	Achieving universal access to sexual and reproductive health and rights. Synthesis of multilateral contribution to advancing sexual and reproductive health and rights (2006-2012)	978-90-5328-445-2
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Developing countries need reliable sources to finance their development. What better way to enhance their economic self-reliance than with their own tax revenues. Because corporate taxes are an important part of their tax revenues, tax avoidance by multinationals can be a serious threat. What role do the Dutch corporate tax policy and its unique network of bilateral tax treaties play in facilitating tax avoidance strategies by multinationals? How much tax revenues do developing countries stand to lose and what can be done?

Francis Weyzig (Utrecht University) answers these pertinent questions in this study which was commissioned by the Policy and Operation Evaluation Department (IOB). He offers an

overview of tax systems and the share of corporate taxation in developing countries, the various pathways for tax avoidance by multinationals, the facilitating role of bilateral tax treaties and treaty shopping and possible consequences for developing countries' tax revenues and their economies.

The study provides us with a balanced appreciation of the implications of profit shifting via tax treaties. Weyzig shows that the negative effects on tax revenues can be substantial but also can vary considerably between individual developing countries, depending on their international profiles, the presence and content of their bilateral tax treaties and their own tax systems and institutional capacities.

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