

THE MISSING MILLIONS

THE COST OF TAX DODGING
TO DEVELOPING COUNTRIES
SUPPORTED BY THE SCOTTISH
GOVERNMENT

POVERTY

A Christian Aid report
September 2009



There is an unprecedented opportunity to tackle the global systems that caused the economic crisis and to put an end to international tax dodging.

The impact of the economic crisis globally

In Scotland, the economic crisis has sparked fears about the security of people's jobs, homes and pensions. While these fears are well-founded, the impact of the crisis is being felt most sharply across the developing world. An extraordinary combination of factors – tumbling exports, rising unemployment, foreign investors withdrawing and declining remittances – have left economies battered in the world's poorest countries. Within those countries, the loss of a job or a fall-off in remittances can be devastating for families with no social safety net.¹

As rich countries struggle to find the money to shore up their own economies, many governments are reducing aid budgets, compounding the financial problems currently facing poor countries. Fears that existing aid commitments may not be honoured are further fuelling concerns that the United Nation's (UN) millennium development goals (MDGs) will not be achieved.

Yet, the money to meet the MDGs – US\$40-60bn a year, according to the World Bank – could be raised by developing countries themselves. At least this much money is owed to them by multinational companies that successfully dodge billions of dollars of tax liabilities every year.

The same factors that caused the economic crisis – inadequate global financial regulations and the lack of transparency offered by 'secrecy jurisdictions' (tax havens) – allow multinational companies to avoid paying tax in the countries where they operate. Yet, in the wake of the economic crisis, there is an unprecedented opportunity to tackle the global systems that caused the crisis and to put an end to international tax dodging. Given the sums of money involved and the consequences for people in

developing countries, tax evasion has been likened to the scandal of slavery by Raymond W Baker, senior fellow at the US Center for International Policy.

The cost of tax dodging

Christian Aid estimates that tax dodging by multinational companies costs developing countries in excess of US\$160bn a year. To put that figure into context, US\$160bn is more than 1.5 times the combined aid budgets of the world – more than enough to meet the cost of delivering the MDGs by 2015.²

The Scottish government has made a commitment to play its part in helping to achieve the MDGs. In 2008, it committed £13m over three years to support projects in five of the poorest countries in the world: Malawi, Zambia, Tanzania, Rwanda and the Darfur region of Sudan. However, this figure is overshadowed by the millions these countries lose every year in tax revenues. Christian Aid estimates that between 2005 and 2007, the five countries being supported by the Scottish government lost just under £43m on imports from, and exports to, the European Union (EU) and US through abusive mispricing of cross-border intra- and inter-company trades³ (see Table 1). This figure would be much higher if other countries, particularly secrecy jurisdictions, were included in the analysis.

For individuals in Malawi, Tanzania and Zambia, where rates of HIV infection are high, this lost revenue could be invested in life-saving healthcare. The estimated US\$160bn a year lost to developing countries, if invested according to current spending patterns in healthcare, could save the lives of 350,000 children under the age of 5 each year.⁴

Christian Aid is not suggesting that the Scottish government or other countries cut their aid budgets. On the contrary,

Table 1: estimated lost tax revenue from countries supported by the Scottish government to the EU and US (million £) as a result of bilateral trade mispricing⁵

	2005	2006	2007	Three-year total
Malawi	1.26	0.84	1.01	3.11
Rwanda	0.19	0.25	0.20	0.65
Sudan	5.55	6.26	3.88	15.70
Tanzania	3.58	6.19	9.92	19.69
Zambia	0.73	1.58	1.49	3.80
Totals	11.32	15.12	16.51	42.94

Inadequate financial regulations and a lack of transparency have enabled these practices to flourish.

within the context of the current financial crisis, it is commendable that Scotland and other countries have honoured their aid commitments. In the shorter term, aid still has a crucial role to play. However, aid budgets should be used to build the capacity of countries to raise their own revenue as in the long term aid dependency is likely to undermine effective governance.

Tax is the most sustainable source of revenue for developing countries. Moreover, evidence suggests that tax supports greater accountability between the state and its citizens.⁶ States that rely on tax revenues are more likely to see the development of responsive governments, and thus improved development prospects, as well as fewer conflicts.⁷

Tax dodging undermines local economic growth

Opportunities to dodge tax are primarily open to companies operating internationally. As a result, tax dodging also introduces a systematic bias in national economies that militates against broad-based and pro-poor economic growth. Tax evasion undermines measures to favour certain sectors. For example, the UK gives favourable treatment to small- and medium-sized enterprises (SMEs) in recognition of their dominant role in providing employment.⁸

The frustration of such measures in developing countries leads to a phenomenon known as the 'missing middle', where the private sector is most likely to exist as large, international companies and smaller businesses in the informal sector.⁹ Typically, the important category of formal sector SMEs is disproportionately small – the middle of business distribution is missing, in no small part because this is where the tax burden actually falls.¹⁰

In effect, international tax dodging gives an unfair advantage to multinational companies, which means that domestic businesses are unable to compete on a level playing-field. While there is widespread agreement that a vibrant domestic private sector is necessary for countries to obtain the level and the type of economic growth that can make a major contribution to the eradication of poverty, less attention is given to the distortion of the domestic private sector by tax dodging.

Thriving businesses in Malawi or Rwanda could directly challenge poverty and marginalisation but this is undermined if they are not competing on a level playing-field. Christian Aid has long worked on the injustices in international trade agreements that hinder developing countries; the way that the international tax system is open to abuse is a fundamental obstacle to progress against poverty.



Rachel Simure (left) is a peer educator in her community in Tanzania and learns about HIV from the Anglican Church internet resource centre

The cost of the missing millions in Tanzania

Although enjoying peace and stability, more than a million people in Tanzania have HIV and more than half the population lives on less than US\$1 a day.

Tanzania lost more than £19.69m in tax revenues between 2005 and 2007 as a result of bilateral trade mispricing with the EU and US – no small sum in a country where poverty is exacerbating the spread of HIV. 'If the man can't provide for the family, the wife might have to sell her body,' says Emmanuel Masasi, a peer educator with Christian Aid partner the Anglican Church of Tanzania.

Grace Tibezi and Rachel Simure sing and act in the church choir with Emmanuel to raise awareness of HIV among young people. Grace echoes Emmanuel's concerns about the spread of HIV because of poverty. 'Usually it's the family situation which can have the biggest effect on girls. If their family have little money then girls can be persuaded to do things for money.'

One of the dramas Grace and Rachel put together with the choir illustrates how easy it is for young girls who need money to fall into the trap of being persuaded by men to engage in unsafe sexual practices.

Key changes required are more transparency and better regulation of corporate activity.

Tax-dodging practices

With multinationals, a system called transfer pricing covers the sale of goods and services between branches of the same company. It also covers intangibles such as intellectual property rights and insurance.

International guidelines suggest that as long as subsidiaries of the same multinational charge a fair market price, known as the 'arm's length' price, these transactions are legitimate, and they are widespread. It is estimated that 60 per cent of all world trade now takes place within rather than between multinational companies.¹¹

The illegitimacy of such transactions arises when the cost of these trades are artificially manipulated. Goods and services can be exported at knockdown prices or imported at inflated prices. This may be to shift money out of a country, dodge tax or for other business purposes, but the effect is almost always that tax is dodged.

A similar scam – false invoicing – involves unrelated multinational companies making secret deals to misprice transactions. By inflating or undervaluing the prices they pay to each other, they can report lower profits, pay less tax and then split the real difference in profit between themselves.

Extracting a fair share in Malawi and Zambia

Before the Malawi government sat down with Paladin Resources to negotiate exploitation of the country's uranium reserves, it took a long hard look at the mining contracts that had been negotiated in surrounding countries.

It was estimated that extracting Malawi's uranium could secure an annual income of US\$250m, which would eclipse tobacco as the country's main foreign exchange earner at US\$19m.

Acting director at the Department of Mines, Ellason Kaseko, explains: 'We knew the uranium deposits were there, but it was better to leave it there than get a raw deal. We saw how our neighbouring countries had blundered and we decided to learn from them.'

The Malawian government subsequently negotiated a deal in which it secured a 15 per cent equity share in the mine and a corporate tax rate of 27.5 per cent.

One of the 'blunders' the Malawian government was keen to avoid was conceding excessive tax concessions

inadequate financial regulations and a lack of transparency have enabled these practices to flourish. For example, at present companies are required only to produce global consolidated accounts rather than reporting where they make their profits. This completely obscures intra-company trade and the scale of multinational companies' profits, thus their tax liability in any one country is concealed.

Reforming the system

The financial crisis offers a unique opportunity to implement a root-and-branch reform of the global financial systems that have enabled multinational companies to escape liabilities in both rich and poor countries. The key changes required are more transparency and better regulation of corporate activity.

Country-by-country reporting

Christian Aid believes an international accounting standard to ensure companies report their profits country by country (rather than as an aggregate figure) would enable revenue authorities to identify genuine wealth-creating activity and tax payments in each jurisdiction in which a company operates.

to the mining company. For years, tax concessions, combined with tax avoidance, have resulted in sub-Saharan African countries with rich mineral deposits forgoing millions in lost tax revenue. In Zambia, secret deals negotiated with mining companies resulted in the exchequer receiving just £12m in tax in 2006 against £2bn of copper production.

Civil society across Africa has started to mobilise to ensure extractives pay their fair share of taxes. 'Copper is a resource that belongs to all of us in Zambia and if it makes money we all have to share in the proceeds,' says Suzanne Matala, general secretary of the Council of Churches Zambia, who has worked with others to expose the deals that were negotiated with mining companies without the involvement of the Zambian parliament. Under pressure from civil society and the churches, president Levy Mwanawasa cancelled all tax concessions to the copper mining industry in Zambia in 2008.

However, the crash in international mineral commodity prices, coupled with the reduction in international finance available for new mining investment, could put pressure on continuing reform in countries such as Zambia and Malawi.

Now is the time to draw a line under the age of irresponsibility and hand back the missing millions.

The obscure, but powerful, International Accounting Standards Board (IASB) has the authority to introduce country-by-country reporting as an international accounting standard. More than 100 governments worldwide, including member states of the EU, tend to rubber-stamp recommendations from the IASB into law. However, the IASB is a private body, which defines its stakeholders as shareholders and providers of capital. It has received funding from accountancy firms, including the so-called Big Four (PricewaterhouseCoopers, Deloitte, Ernst & Young and KPMG – all of which have been found in breach of financial regulations).¹²

External pressure needs to be brought to bear on the IASB to introduce country-by-country reporting as an international accounting standard, through the EU, the UK government, the G20 and the UN.

An end to massive tax evasion will also require the free exchange of tax information between all jurisdictions as well as greater transparency from businesses. Existing bilateral tax information exchange agreements have failed to achieve the transparency needed to shine a light on companies and individuals hiding money in offshore tax havens. The burden of proof that these bilateral agreements impose on those requesting information is so great that even wealthy countries have found them ineffective.

For the UN member states alone to have access to adequate information, 192 countries would need to sign 192 separate bilateral agreements, resulting in 36,864 agreements globally. This scenario seems improbable, particularly given that tax havens have been unwilling to sign agreements with developing countries. Only a global agreement on a multilateral automatic information exchange will deliver the transparency poor countries need to start clawing back the billions they are owed in tax.

A new transparent order?

The world is already waking up to the need for greater transparency in global financial transactions and a clampdown on secrecy. Huge public bail-outs in rich countries, particularly of banks, have forced governments to confront corporate tax evasion.

In the US, where it is estimated that US\$100bn is lost every year through offshore tax evasion,¹³ president Barack Obama has sponsored the Stop Tax Haven Abuse Act. The G20 has agreed to consider how all countries could best benefit from a global agreement on the sharing of tax information, and the UK treasury has committed to exploring the benefits of a country-by-country reporting standard.



Laurence Hurry uses a bicycle ambulance to transport those who fall seriously ill to Phalombe District Hospital in Malawi for care

Missing millions in Malawi

Tax dodging as a result of trade mispricing with the EU and US cost Malawi an estimated £3.11m between 2005 and 2007.¹⁴ In a country with more than half a million children who have been orphaned by HIV-related illnesses and a low life expectancy rate (47 years), that amount of money would go a long way to funding much needed healthcare.

When Laurence Hurry fell ill, Rhoda Iddie, a volunteer with Christian Aid partner Likulezi, advised him and his wife to get an HIV test. They both tested positive. Laurence's wife died soon afterwards but Laurence began to recover after taking antiretroviral drugs (ARVs). 'When I started taking ARVs I had the energy to walk,' he says. But for many sick patients, walking is not an option. Laurence is himself now a volunteer with Likulezi and helps to transport HIV patients to the hospital.

Growing interest in reforming the world's financial systems is to be welcomed, but it is vital that the upshot is not a partial crackdown on tax dodging that delivers benefits for the rich but not for the developing world.

The countries supported by the Scottish government are among the poorest in the world; as other sources of finance dry up, it is becoming increasingly urgent that they and other poor countries recover the taxes they are owed. The current climate offers an exceptional opportunity to put in place systems to ensure developing countries can levy fair taxes to fund their education, healthcare and infrastructure, and grow their domestic businesses.

International tax dodging gives an unfair advantage to multinational companies, which means that domestic businesses are unable to compete on a level playing-field.

Putting local businesses in Rwanda on a level playing-field

It has been a long slow recovery from the Rwandan genocide in 1994. Despite significant economic progress, there is still a long way to go. Rwanda, like other poor countries, needs to support sustainable domestic businesses to develop economic growth levels that can contribute to the eradication of poverty.

For these home-grown businesses to have any hope of competing on a level playing-field with multinational companies, tax dodging must be tackled. Building capacity to mobilise resources from citizens and economic activity within the country could enable the country to stand on its own feet and would increase the accountability of the government to its citizens. This must not be undermined by companies and wealthy individuals dodging their financial responsibilities.

Christian Aid supported the vocational training centre CEFORMI in Rwanda to provide vulnerable primary school dropouts, orphans and other vulnerable youth with training in practical skills. Jean Claude Bimenyimana is one of the young people who trained at CEFORMI in metalwork, welding and electronics. Jean Claude lost his father in the Rwandan genocide and lived in a refugee camp. He was not able to study beyond primary level as his family could not afford the fees. CEFORMI aims to give vulnerable young people such as Jean Claude the skills to gain employment or establish their own businesses.



Christian Aid / Charlotte Brudenell

Jean-Claude Bimenyimana, who lost his father during the genocide in Rwanda, learns metalwork, welding and electronics at CEFORMI vocational training centre

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Conclusions and recommendations

Tax is the most sustainable source of development finance, and an effective way of ensuring that governments act in the interest of their citizens. The electorate can hold their government to account both for the taxes they levy and for how they spend that revenue. This must not be undermined by companies and wealthy individuals opting out of their responsibilities.

British prime minister Gordon Brown has heralded the 'beginning of the end of tax havens'¹⁵ and the G20 has committed to 'to developing proposals, by end 2009, to make it easier for developing countries to secure the benefits of a new cooperative tax environment'.¹⁶

The UK treasury has already made statements in support of country-by-country reporting and is working towards a multilateral agreement for information exchange. However, significant political pressure is required.

In order to clamp down on international tax dodging, which costs developing countries billions in lost revenue, MSPs and Scottish MPs should push the UK government to:

- persuade G20 leaders to support country-by-country reporting and formally request the IASB to adopt this new standard
- work to deliver a fully multilateral agreement for the automatic exchange of tax information
- include in any tax agreement a review mechanism to ensure it benefits developing countries.

Endnotes

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- 3** David McNair and Andrew Hogg. *False Profits: Robbing the Poor to Keep the Rich Tax Free*, Christian Aid, 2009
- 4** See endnote 2.
- 5** More details on losses by all non-EU countries and the methodology used for this research are available in the Christian Aid report *False Profits: Robbing the Poor to Keep the Rich Tax Free*, see Endnote 3.
- 6** Max Everest-Phillips, 'Business tax as state-building in developing countries: applying governance principles in private sector development', *International Journal of Regulation and Governance* 8(2), pp123-154. D. Brautigam, 'Introduction: taxation and state-building in developing countries' in *Taxation and State-Building in Developing Countries Capacity and Consent*, edited by D. Brautigam, O. Fjeldstad and M. Moore, Cambridge University Press, 2008.
- 7** Research by Hendrix shows that as taxation increases as a share of national economic output, conflict becomes less likely. The tax/GDP ratio is strongly and negatively associated with the incidence of conflict. C. Hendrix, *Leviathan in the Tropics? Environment, State Capacity, and Civil Conflict in the Developing World*, (University of California, San Diego, 2007).
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- 12** See endnote 2.
- 13** www.publicintegrity.org/investigations/broken_government/articles/entry/979/
- 14** See endnote 3.
- 15** www.bloomberg.com/apps/news?pid=20601102&sid=arsBi1HyFK0&refer=uk
- 16** www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_020409_-_1615_final.pdf

Acknowledgements

This report was written by Una Bartley with input from David McNair and Alex Cobham.

It was edited, designed and produced by Christian Aid's Publishing team.

Christian Aid is a Christian organisation that insists the world can and must be swiftly changed to one where everyone can live a full life, free from poverty.

We work globally for profound change that eradicates the causes of poverty, striving to achieve equality, dignity and freedom for all, regardless of faith or nationality. We are part of a wider movement for social justice.

We provide urgent, practical and effective assistance where need is great, tackling the effects of poverty as well as its root causes.

Cover image: Abeda, 17, and some classmates take advice from their teacher. When Abeda's father died of an HIV-related illness and her mother could not afford the children's school fees, the whole family's future looked bleak. But thanks to home-based carers provided by Christian Aid partner the Archdiocese of Lusaka and funding from an orphan care project, Abeda is now about to complete her final year of secondary school.

Christian Aid/Sarah Filbey

Poverty is an outrage against humanity. It robs people of dignity, freedom and hope, of power over their own lives. Christian Aid has a vision – an end to poverty – and we believe that vision can become a reality. We urge you to join us.

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UK registered charity number 1105851 Company number 5171525
Scotland charity number SC039150

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