Rebalancing the Global Tax System: Empowering Developing Countries in an Era of Globalization and Digitalization

By:

Augustine Gwata

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Introduction

The global tax system is facing a critical crisis, particularly in its impact on developing countries. Globalization and the rise of multinational enterprises (MNEs) have created an uneven playing field, enabling large corporations to exploit loopholes and minimize their tax liabilities in low-tax jurisdictions (Organization for Economic Co-operation and Development [OECD], 2023). This phenomenon, known as base erosion and profit shifting (BEPS), refers to the practice of multinational corporations shifting profits from high-tax jurisdictions to low-tax or no-tax jurisdictions, thus eroding the tax base of the high-tax countries. This is often achieved through legal but aggressive tax planning strategies that exploit loopholes and mismatches in tax rules. As a result, developing nations have witnessed stagnation and setbacks in tax revenues. This stagnation, as highlighted in the recently released Elements paper for the outcome document of the Fourth International Conference on Financing for Development (FfD4 Elements Paper), stems from a confluence of factors, including low growth, inadequate domestic tax policy reforms, and capacity constraints. Furthermore, many tax systems fail to consider crucial aspects like gender and climate change. On the expenditure side, public spending often suffers from opacity and inefficiency, hindering its alignment with the Sustainable Development Goals (SDGs).

In this globalized and digitized age, tax avoidance and evasion by MNEs are increasingly prevalent, exacerbated by the difficulty in accurately allocating profits across subsidiaries and the rise of intangible assets and digital business models. Africa, for instance, loses almost US$ 89 Billion annually due to these loopholes, hindering its development and exacerbating existing inequalities. This loss of revenue significantly cripples Africa's ability to bridge the vast financing gap estimated at $200 billion per year to achieve the Sustainable Development Goals (SDGs). Essential public services like healthcare, education, and infrastructure all suffer from a lack of funding, further hindering progress towards a more sustainable future. Therefore, a fundamental reform of the global tax system is urgently needed to address this revenue loss faced by developing nations.

According to United Nations Conference on Trade and Development (UNCTAD), illicit financial flows in Africa, which include tax evasion and avoidance, is 3.7% of GDP, draining resources from developing countries and hindering their economic growth. This loss in revenue is further exacerbated by the operations of multinational enterprises. The lack of robust domestic transfer pricing rules in many African countries significantly hampers the ability of local judicial authorities to effectively challenge and counter tax evasion by multinational enterprises (MNEs). Nigeria is a major oil producer, but faces significant revenue losses due to illicit financial flows, including illicit capital flight and tax evasion by multinational oil companies. These companies often use complex structures and transfer pricing mechanisms to shift profits to low-tax jurisdictions, depriving Nigeria of much-needed revenue for development.

Furthermore, Democratic Republic of Congo (DRC), which is rich in natural resources, also suffers from widespread corruption and tax evasion by multinational mining companies. These companies often exploit loopholes in the tax system and engage in illicit activities, such as smuggling and under-reporting of profits, depriving the government of substantial revenue that could be used for poverty reduction and infrastructure development. Kenya has been implementing tax reforms to broaden its tax base and improve revenue collection. However, the country continues to face challenges in taxing the digital economy, as many multinational technology companies generate significant revenue in Kenya without having a physical presence. This limits Kenya's ability to capture its fair share of the taxes generated within its borders. While South Africa has a relatively developed tax system, it still faces challenges in addressing tax evasion by wealthy individuals and multinational companies. The country has been implementing measures to improve tax compliance and combat illicit financial flows, but more needs to be done to ensure that all taxpayers, including multinational corporations, pay their fair share of taxes in the countries where they operate. Therefore, since global tax system is constantly evolving, ongoing efforts are needed to ensure that it remains fair, equitable, and effective in the face of globalization and digitalization.

Progress made, Challenges and Loopholes

The OECD launched the BEPS Project in 2013 to address tax avoidance strategies employed by MNEs. This project resulted in 15 Actions aimed at improving international tax rules, including countering harmful tax practices, Addressing Tax Challenges of the Digital Economy. Preventing the Artificial Avoidance of Permanent Establishment Status and Strengthening Dispute Resolution Mechanisms. In 2021, over 130 countries agreed to implement a global minimum corporate tax rate of 15%. This aims to prevent a "race to the bottom" in corporate tax rates and ensure that MNEs pay their fair share of taxes. A Permanent Establishment (PE), in the context of international tax law, refers to a fixed place of business through which an enterprise of one country carries out business activities in another country. There was also an establishment of Pillar One and Pillar Two of global tax. Pillar One focuses on taxing the profits of large MNEs in markets where they have customers, regardless of their physical presence. It aims to ensure that digital companies pay taxes in countries where they generate revenue. Pillar Two of the global tax deal establishes a global minimum corporate tax rate of 15%. It aims to ensure that MNEs pay at least this rate, regardless of where they operate. Despite these initiatives finding equitable solutions for taxing the profits of multinational digital companies remains a key challenge. The OECD's Base Erosion and Profit Shifting (BEPS) project, while aiming to address global tax challenges, has been criticized for its limited focus on the concerns of developing countries and its potential to further marginalize them. As noted by Zucman (2023), the BEPS project, despite its ambitious goals, risks exacerbating existing inequalities if its implementation does not prioritize the needs of developing countries. The implementation of BEPS recommendations also faced challenges, including uneven adoption across countries and concerns about the effectiveness of certain measures.

Furthermore, the role of international financial institutions (IFIs) like the International Monetary Fund (IMF) and the World Bank in shaping tax policies in developing countries has raised concerns. While these institutions can provide valuable technical assistance and capacity building, their influence can sometimes lead to policy recommendations that prioritize debt sustainability and fiscal consolidation over equitable revenue mobilization (Bird & Zolt, 2000; Stiglitz, 2002; UNCTAD, 2012). This result in regressive tax policies that disproportionately burden the poor and exacerbate social inequalities.

Despite ongoing efforts, the current international financial architecture remains inadequate in providing the long-term financing needed to tackle global challenges. Emerging issues demand innovative financing solutions and systemic reforms. Initiatives undertaken by the United Nations, international financial institutions, and Member States to enhance development finance and reform the international financial architecture have gained significant momentum. Building upon this progress, the FfD4 Elements Paper has put forward several proposals for a reformed taxation system to improve domestic resource mobilization globally. These proposals could encompass strengthening international tax cooperation, promoting fairer tax systems, supporting developing countries addressing illicit financial flows and promoting transparency and accountability. While the FfD4 Elements Paper recommendations offer a comprehensive framework for enhancing the taxation system and improving domestic resource mobilization, it is crucial to acknowledge potential challenges and limitations and suggest areas of improvements.

Suggested Areas of Improvement in Adoption of FfD4 Elements Paper Proposals for Reforming the Taxation System and Empowering Developing Nations:

The recommendations presented in the FfD4 Elements Paper cover a wide range of crucial aspects, including strengthening tax systems, promoting progressive taxation, enhancing international cooperation, and leveraging technology. Notably, the emphasis on gender-responsive budgeting and taxation, alongside the commitment to supporting developing countries, underscores a focus on equity and inclusivity.

The 15% tax-to-GDP ratio target provides a clear and ambitious goal for developing countries, encouraging them to strive for higher levels of domestic resource mobilization. However, despite being ambitious, this target presents a potential challenge. If not carefully considered, this target could inadvertently stimulate tax competition among developing countries, potentially harming economic growth. Aggressive tax increases, if not well-designed and implemented, may negatively impact economic growth and investment. It should also be taken into account that it not only crucial to raise tax to GDP ratio, efficiency and transparency in the disbursement of tax revenue must also be emphasized.

Addressing the Power Imbalance:

The current international tax architecture, largely shaped by developed countries, often fails to adequately address the unique needs and priorities of developing nations. This power imbalance, evident in the historical dominance of the Organization for Economic Co-operation and Development (OECD) in setting international tax standards, results in a system that may not fully reflect the needs and realities of these countries, potentially leading to policies that inadvertently disadvantage them. This has contributed to a crisis of legitimacy in the current international tax system, particularly in its treatment of developing countries. To address these challenges, a fundamental rebalancing of the global tax system is urgently needed. Augmenting FfD4 Elements Paper recommendations, this requires a shift towards a more inclusive and equitable framework that empowers developing countries to exercise their taxing rights and generate sufficient revenue for sustainable development, as emphasized by UNCTAD (2023).

Building Political Consensus for Successful Implementation

Implementing the FfD4 Elements Paper recommendations may face significant political challenges. Tax reforms, particularly those targeting high-net-worth individuals and multinational corporations, may encounter resistance from powerful economic and political interests. Sustained political will and commitment are crucial for successful implementation. This necessitates building broad-based political consensus through stakeholder engagement, including civil society, the private sector, and academia. Strengthening democratic institutions and ensuring public participation in decision-making processes such as engaging in broad-based consultations with stakeholders, including civil society, the private sector, and academia. Strengthening democratic institutions and ensuring public participation in decision-making processes.

Addressing External Pressures and Mitigating Risks

The influence of external factors, such as international financial institutions, may sometimes prioritize debt sustainability and fiscal consolidation over equitable revenue mobilization, potentially undermining the effectiveness of these recommendations. Global economic shocks, such as pandemics and financial crises, can significantly impact tax revenues and undermine progress in domestic resource mobilization. Therefore, it is imperative to ensure that tax reforms do not disproportionately burden the poor and vulnerable. Implementing progressive tax policies that ensure those with greater ability to pay contribute a larger share is crucial.

Strengthening the voice and representation of developing countries

There is a need to strengthen the voice and representation of developing countries in international tax fora is crucial. This can be achieved through increased participation in decision-making processes, such as the OECD/G20 Inclusive Framework on BEPS, and the establishment of dedicated platforms for dialogue and consensus-building between developed and developing countries.

Regional cooperation, facilitated by platforms like the African Tax Administration Forum (ATAF), is crucial for strengthening tax administrations and enhancing their capacity to combat these illicit flows.

Furthermore, within the context of the African Continental Free Trade Area (AfCFTA), establishing regional knowledge networks is also vital. These networks will empower countries to enhance their capabilities in combating money laundering, recovering stolen assets, and ultimately mitigating the impact of crime-related IFFs on African development. Furthermore, there is a need to support the development of a robust and equitable United Nations (UN) framework on international tax cooperation is essential. This framework should provide a level playing field for all countries, regardless of their size or economic development level, and ensure that their voices are heard in the global tax debate. Thirdly, ensuring that all companies, including MNEs, pay their fair share of taxes in the countries where they operate and create value is critical. This requires strengthening international tax rules to address the challenges of digitalization and the evolving business models of MNEs. The recent agreement on Pillar One of the BEPS Inclusive Framework, which aims to reallocate taxing rights to market jurisdictions, represents a significant step in this direction. However, further efforts are needed to ensure that developing countries can effectively benefit from this new framework.

Improve Capacity Building for Effective Implementation

Many developing countries lack the necessary human and institutional capacity to effectively implement these reforms proposed in the FfD4 Elements Paper. Building this capacity requires significant investment of time and resources. Therefore, further to the proposed recommendations there is a need investing in human capital development and providing adequate resources for tax administrations.

Insufficient data and limited analytical capacity in most African countries can also hinder effective tax policy design and implementation. Therefore, the need to strengthening data collection and analysis capabilities. Complementing the FfD4 Elements Paper proposal, there is also a need to enhance tax transparency and information exchange to combat tax evasion and avoidance. This can be achieved through the implementation of robust automatic exchange of information standards (AEOI) and the creation of a global beneficial ownership registry. However, it is essential to provide adequate support to developing countries to build the capacity to effectively utilize and analyze this information.

Strengthening International Tax Cooperation

Establishing a robust and equitable international tax framework is crucial. This requires a level playing field for all nations, prioritizing the needs of developing countries and ensuring their voices are heard in global tax policy discussions, as emphasized by UN General Assembly resolutions. Furthermore, ensuring that all companies, including multinational corporations (MNCs), pay their fair share of taxes in the countries where they operate is paramount. This necessitates strengthening international tax rules to address the challenges of digitalization and evolving business models, as recognized by the OECD (2024). While the BEPS Inclusive Framework represents a significant step, further efforts are needed to ensure developing countries can effectively benefit from this new framework, as highlighted in the FfD4 Elements Paper.

Ensuring Fair Taxation for Multinational Corporations

Ensuring all companies, including multinational corporations (MNCs), pay their fair share of taxes in the countries where they operate and generate value is critical. Addressing the challenges posed by digitalization and evolving business models necessitates strengthening international tax rules, as recognized by the OECD (2024). While the BEPS Inclusive Framework, particularly Pillar One, represents a significant step, further efforts are crucial to ensure developing countries can effectively benefit from these reforms, as highlighted in the FfD4 Elements Paper.

Align the fiscal system with SDGs

Aligning fiscal systems with the SDGs is crucial for sustainable development. This requires a multi-pronged approach, including leveraging digital technologies to enhance tax administration and combat evasion, supporting increased tax-to-GDP ratios in line the FfD4 Elements Paper and exploring innovative financing mechanisms like global solidarity levies. By integrating these strategies, African governments can ensure that public resources are effectively allocated to address critical development challenges and contribute to the achievement of all 17 Sustainable Development Goals.

Rebalancing the global tax system requires a concerted effort from all stakeholders, including developed and developing countries, international organizations, and civil society at large. By working together to create a more inclusive and equitable framework, they can ensure that the benefits of globalization are shared more fairly and that developing countries have the resources they need to achieve sustainable development goals.

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