

ROADMAP

Title of the initiative: **Communication on "Tax and Development: Cooperating with Developing Countries on Promoting Good Governance in Tax Matters"**
Type of initiative (CWP/Catalogue/Comitology): CWP
Lead DG/contact person/details: DG Development and relations with African, Caribbean and Pacific States and DG Taxation and Customs Union
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Initial IA screening & planning of further work

A. Context and problem definition

What is the political context of the initiative? How does this initiative relate to past and possible future initiatives, and to other EU policies?

Scene-setting

At the Financing for Development Conference in Monterrey in 2002 the international community highlighted the importance of *"mobilizing domestic resources, increasing productivity and reducing capital flights"* in developing countries. Six years later in the Doha declaration governments committed to *"step up efforts to enhance tax revenues through modernized tax systems, more efficient tax collection, broadening the tax base and effectively combating tax evasion."*

On 28th April 2009, the European Commission issued a Communication on Good Governance in Tax matters with the intention to launch a debate about concrete actions that could be taken to better promote the principles of good governance in tax matters (i.e. transparency, exchange of information and fair tax competition) both within the European Union and towards third countries. The general objective is to improve fighting tax evasion and avoidance on as broad a geographical basis as possible. On the 18th of May 2009 the GAERC Council invited the Commission to propose concrete EU action "on dialogue with, and assistance to, developing countries on promoting Good Governance in tax matters and more effective national tax systems in order to achieve development goals". Against this background of increasing EU and international interest in tax matters, and following discussions with the upcoming Spanish Presidency, which has made this subject a top priority, DG DEV and DG TAXUD began preliminary work towards the preparation of a Communication addressing the issue of tax governance in development cooperation. Subject to the approval of this Road Map and of the 2010 Commission programme, this Communication would be part of the so-called Spring Package ('Monterrey package') to be adopted at the GAERC of May/June 2010.

As mentioned above, the proposed Communication on Good Governance in Tax Matters in the Context of Development Cooperation is a response to the Council Conclusions of 18th of May on "Supporting developing countries in coping with the crisis"[, whose paragraph 10 reads as follows:

What are the main problems identified?

In most developing countries the sustainable provision of public services that is necessary to achieve the Millennium Development Goals requires the mobilisation of increasing domestic resources. Rising domestic revenue not only creates additional fiscal space for supporting high-priority spending, it also allows a country to maintain spending consistent with its policy priorities when aid is phased out, and is a critical element in terms of 'state building'. Moreover, domestic revenue is considered less uncertain and volatile than aid flows. Whilst there has been an improvement in revenue performance in developing countries in the past decade or so, progress remains however insufficient and most of these countries continue to be over-dependent on aid to finance a significant share of public services and goods.

The Communication attempts to address the problems at the relevant domestic and international levels.

(i) Domestic constraints: When attempting to increase tax revenue to GDP developing countries are confronted with several domestic constraints inter alia linked to their level of development, the structure of their economy, domestic policy objectives and the increasing integration into international markets. Large informal sectors, heavy reliance on subsistence agriculture together with low capacity in the tax administrations, the frequent use of tax exemptions and derogations aiming in some cases to encourage foreign direct investments – they all impact negatively on domestic resource mobilisation. Moreover, the potential revenue from import and export and corporate profit taxes is further affected by the liberalisation of trade and of movements of capital.

(ii) International constraints: The existence of harmful tax practices, both in developed and developing countries, is detrimental to developing countries. Whilst harmful tax practices and lack of transparency and information exchange have a negative impact on developing countries' revenues, a perhaps even more negative impact is the fact that non-cooperative jurisdictions contribute to maintaining a vicious circle in developing countries whereby institutional development is hampered by tax evasion and avoidance that insufficient institutional capacity is unable to prevent in the first place.

The constraints identified at the country level as well as those factors related to the international environment have to be taken into account when designing tax systems and strengthening tax administrations as well as furthering international cooperation on respect of good governance principles in the tax area.

Who is affected?

Several hundreds of millions of poor in developing countries suffer from deficient public services and infrastructure, also as a result of lack of domestic resources to fund development policies and much needed public investments. Indirectly, European tax payers are also concerned since lack of domestic resources in developing countries increases pressure on official development assistance levels, including in the long term.

(i) Is EU action justified on grounds of subsidiarity? (ii) Why can the objectives of the proposed action not be achieved sufficiently by Member States (necessity test)? (iii) As a result of this, can objectives be better achieved by action by the Community (test of EU Value Added)?

(i) Addressing the domestic constraints is primarily the role of developing countries themselves.¹

The role of the donor community in this context is twofold: first to support developing countries efforts to establish effective and efficient tax systems and second to contribute to the creation of an international environment that discourages harmful practices and promotes fair and transparent behaviours that are relevant and beneficial for developing countries. Both concern development cooperation where the EU enjoys competence for conducting a common policy and carrying out measures therein.²

Donor coordination and effective EU division of labour are key in this context.³

Up to now dialogue and support on tax matters at country level has been mostly led by international financial institutions where broader governance issues, including on public financial management, did not always figure prominently on the agenda.

(ii) and (iii) Some Member States, i.e. Germany, UK, France, Spain, have been active in support to tax administrations in their bilateral relations with developing countries. In the meantime, progress in increasing domestic resource mobilisation has been modest over the recent years. It appears therefore necessary to scale up the amount of aid devoted to assistance to tax reform and to give increased attention to the fight against tax evasion and other harmful tax practices in developing countries.

Furthermore, Member States assistance to developing countries looks scattered. There is therefore a clear need to develop a common framework that is expected to increase the efficiency of the Commission's and Member States' efforts in this area of cooperation. Key principles, such as more demand-driven approaches, better coordination and division of labour, improved articulation between the different aid modalities, is expected to foster a more efficient and coherent EU contribution to increased domestic tax revenues. The Commission initiates this process given its specific role in EU development coordination and its leading role in the aid effectiveness agenda. A good example regarding the need for enhanced EU coordination is the intrinsic link between improved revenue management and budget support. Given the multiplicity of donors in the field of budget support it would be counterproductive to any meaningful policy dialogue on public financial management when individual donors were to conduct separate and uncoordinated dialogues with the authorities in a given country. This would undermine policy coherence, overburden scarce institutional capacities at the level of national authorities and lead to possibly conflicting and thus very costly choices in terms of policies and actions. Be more explicit about why efficiency and coordination problem cannot be addressed at MS level?

¹ The August 2008 Pretoria Communiqué of the International Conference on Taxation, State Building and Capacity Development clearly states that the prime responsibility to improve their tax systems lies with developing countries, in partnership with the donor community.

² "In the areas of development cooperation, the Union should have competence to carry out activities and conduct a common policy; however the exercise of that competences shall not result in Member States being prevented from exercising theirs" (art 4, consolidated version of the Treaty of the Functioning of the EU, JO C115/47 of 9.5.2008). It is foreseen in the Treaty (art 210) that "in order to promote the complementarities and efficiency of their action, the Union and the Member States shall coordinate their policies on development cooperation".

³ According to the European Consensus on Development "to promote sound and transparent management of public finances" is a common objective of development cooperation for both the Community and the Member States (5.2, art 26). The EU Code of Conduct on Complementarities and Division of Labour (Council Conclusions 15.03.2007) provides a framework for increasing the effectiveness of EU cooperation.

In terms of addressing the international factors hampering the ability of developing countries to strengthen their tax systems in terms of efficiency and being in line with international standards, it is again a joint Member States-Commission effort.

The Commission has a specific role to play in promoting EU good practices in that field at a more global level. The Communication on promoting good governance in tax matters adopted on 28 April 2009 refers also to EU international policy on good governance in the tax area and ongoing actions in relation to third countries. It also addresses the issue on how to strengthen the principle of good governance in the tax area within the EU and internationally (ongoing initiatives, EU-level arrangements with third countries, development cooperation incentives, international tax policy coordination).⁴

Being a major player in the development field, and playing in parallel an important role in international tax matters, it is the role of the Commission to ensure better coherence between both dimensions and to propose a single policy framework in that respect.

B. Objectives of EU Initiative

What are the main policy objectives?

In line with the identification of problems highlighted above, the Communication will recognise the fact that both domestic and international factors hamper the ability of developing countries to build efficient tax systems and raise domestic revenues. In that respect, its core policy objectives will be:

(i) Stepping up and improving the effectiveness of EU support to developing countries' capacity to mobilize domestic resources through the establishment of tax systems that are fair, effective and growth enhancing, and tax administrations that are efficient.

At the centre stands support to build capacity in partner countries to design and implement tax policies and administrative reforms. EU aid will strengthen the focus on tax matters at all level of cooperation, from political dialogue, to governance assessment criteria and governance commitments, budget support related dialogue and progress monitoring, specific capacity building programmes at national and regional level.

(ii) Strengthening international dialogue, cooperation and structures in tax matters with a view to promoting the recognition, adoption and application of international standards on fighting tax evasion and harmful tax practices.

Developing countries, and namely LDC, need to be more effectively represented in those international fora where they can participate and their interests will have to be better recognised in those where they cannot directly participate. . The Commission will consider the suitability and feasibility of country-by-country reporting and to what extent this and measures to fight mispricing can be effectively supported in the context

⁴ COM (2009) 201 Promoting good governance in tax matters, p. 7, 9

of development cooperation. The EU will also increase its involvement in the Extractive Industry Transparency Initiative..

Both these objectives and their respective instruments are seen as complementary to one another. Addressing both objectives in a single policy framework enhances complementarity and coherence.

Does the objective imply developing EU policy in new areas or of strategic importance?

No, it strengthens the pertinence and impact of present policies and improves the coherence amongst them. In particular, it builds on the policy initiatives contained in the Communications of 8 April 2009 and 28 April 2009. In addition, Art 88 of the European Consensus on Development (2006) states that "the Community will continue to be a key player, in co-ordination with the Bretton Wood institutions, in supporting economic and institutional reforms... The Community will continue to pay close attention to the impact of reforms, in terms of growth, improved business climate, macroeconomic stability and the effects on poverty reduction...Particular Emphasis will also be placed on improvements in public finance management, as fundamental to combating corruption and promoting efficient public spending". Art 22 (1) of the Partnership Agreement ACP-EC (adopted 2000, revised 2005) states that "Cooperation shall support ACP efforts to implement a) macroeconomic growth and stabilisation through disciplined fiscal and monetary policies that result in the reduction of inflation, and external and fiscal balances, by strengthening fiscal disciplines, enhancing budgetary transparency and efficiency, improving the quality, the equity and composition of fiscal policy". Domestic tax revenue is a key component of any country fiscal policy and a building block of any public financial management system.

C. Options

What are the policy options? What legislative or 'soft law' instruments could be considered? Would any legislative initiatives go beyond routine up-date of existing legislation?

Option 1: Refrain from developing a policy framework on good governance in tax matters in the context of development cooperation. Given the growing international emphasis on domestic revenues as a means to finance development, this option would increase the reliance of developing countries on aid or on tax practices having harmful effects on both EU MS' and developing countries' public finances, and is therefore considered unsatisfactory.

Option 2: Develop further a policy framework with an exclusive focus on supporting the strengthening of countries' tax systems in a purely domestic context. This would mean that the Communication would not focus on the international factors hindering the capacity of developing countries to strengthen their tax systems (i.e. capital flight, harmful tax practices, etc). Harmful tax practices and lack of transparency and information exchange don't only have a negative impact on developing countries' revenues (estimated by some experts to be higher than the ODA inflows to these countries), but also contribute to maintaining a vicious circle in developing countries whereby weak institutional capacity facilitates illegal capital flight, and tax evasion and capital flight in the next instance restrict the development of institutions. In that context, it is considered that an exclusive focus on strengthening domestic tax systems, although critical, would be too limitative.

Option 3: Develop further a policy framework as proposed, with a dual focus on enhancing assistance in building developing countries' capacity to strengthen their tax systems in a domestic and in an international context. The responsibility of strengthening tax systems is primarily the one of developing countries themselves – *with the support of the international community*. This was a key component of the August 2008 Pretoria Communiqué of the International Conference on Taxation, State Building and Capacity Development, supported by the European Council. In parallel, however, as underlined in other recent fora, such as the 2008 Doha Financing for Development Summit, harmful tax practices are detrimental to developing countries. The proposed Communication will try to encompass both domestic and international dimensions of good governance in tax matters, and ensure better complementarity and coherence between the two. It would further elaborate the principles for a comprehensive and coherent policy framework on the matter that would guide both external Commission and EU policies. The Communication is likely to lead to a renewed policy focus and impetus when it comes to external policies, especially in terms of development cooperation. Internal policies on tax matters and related areas are not expected to be altered in the near future as a result of the proposed Communication, nor does the Communication propose to create new instruments or significantly increase funding on tax and revenues matters. It will propose a policy framework towards strengthening the effectiveness of current instruments and the complementarity and coherence between these instruments (European Development Fund, Development Cooperation Instrument and the European Neighbouring Policy Instrument)

None of the options would directly imply legislative initiatives. The existing regulations led by different DGs and the cooperation strategies with third countries remain adequate frameworks. The global and EU policy frameworks on development and EU Division of labour remain relevant. The Communication proposed would enhance coherence around common principles, and guide on operational arrangements to enhance cooperation, synergies and possibly joint initiatives between Commission services, Commission and EU Member States as well as regarding EU positions in international tax fora.

Does the action proposed in the options cut across several policy areas or impact on action taken/planned by other Commission departments?

The action proposed cuts across and is jointly taken by several Commission departments (DG Development, the rest of the RELEX-family, and DG TAXUD). It may also have implications for DG TRADE and DG MARKT.

Explain the options respect the proportionality principle?

Communication is a non binding instrument and serves only as guidance for implementation in external cooperation and related international dimensions of internal policies, where the competence is shared between the European Commission and the Member States.

D. Initial assessment of impacts

What are the significant impacts likely to result from each policy option (cf. list of impacts in the impact assessment guidelines), even if these impacts would materialise only after subsequent Commission initiatives?

Only option 3 will be considered in this paragraph since it was demonstrated in section C that the other two options are inappropriate policy alternatives.

The Communication, through its dual dimension described above, aims ultimately at strengthening tax systems and raising domestic revenues in developing countries. Meeting this objective could have a variety of social, economic and indirectly environmental impacts.

On the **social dimension**, the resulting strengthening of tax systems and increase in domestic revenues would allow an increase in social and other priority expenditures in developing countries. This would have a particular impact on the most vulnerable parts of the population. The increase in domestic revenue would also help the beneficiary countries to better mitigate external shocks and aid volatility, therefore reducing the chances of cuts in social and other priority expenditures resulting from those shocks. Strengthening transparency of revenue from natural resources through the Extractive Industries Transparency Initiative should encourage commodity-rich countries to use these resources in a more development-orientated way than in the past.

On the **economic dimension**, strengthened revenue mobilization contributes to economic stability, particularly in countries dependent on external financial flows. Rising domestic revenue not only creates additional fiscal space for supporting high-priority spending, it also allows a country to maintain spending consistent with its policy priorities when aid is reduced. By mitigating the adverse impact of volatility and uncertainty in aid flows and commodity prices, increased mobilisation of domestic revenue can also significantly facilitate budgetary management. From a European perspective and in the long term, increased domestic resource mobilisation in developing countries would be the basis for an exit strategy towards reducing dependence on ODA.

In terms of environmental objectives, higher tax revenue would increase the resources potentially available for financing adaptation measures. In addition, strengthened tax systems would create opportunities for the establishment of more environment-friendly taxes. Currently, many tax expenditures in developing countries have detrimental environment effects, whilst the focus should be more on taxing negative externalities (such as on factors causing and/or accelerating climate change).

In terms of direct impacts, the Communication will provide a framework for a more coordinated, efficient, and coherent approach in terms of support to tax systems. This will be achieved through a broader approach to tax reforms, a greater integration of tax matters in budget support frameworks and an enhanced focus on division of labour, in particular at the EU level. In addition, by supporting an enhanced participation of developing countries in relevant international fora and the adoption and implementation of international standards in tax matters, the Commission will help strengthening the overall coherence of international tax efforts.

<p>Could the options have impacts on the EU-Budget (above 5 Mio €) and/or should the IA also serve as the ex-ante evaluation, required by the Financial Regulation?</p>
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The EU budget provisions under the European Development Fund, Development Cooperation Instrument and the European Neighbouring Policy Instrument would remain relevant to the EU action and the development of a more coherent EU action in the matter. As the policy

actions relate more to increasing the effectiveness of current initiatives as opposed to the development of new ones, it is not expected that the proposed Communication will lead to the need of substantial additional resources for tax matters. In the long run, the resulting increase in domestic revenues in developing countries, if accompanied by economic growth, should lead to a decline in ODA.

Could the options have significant impacts on simplification/administrative burden or on relations with third countries?

The actions are directly related to the objective of increasing the effectiveness of EU support to tax systems in developing countries, as well as improving international tax cooperation and dialogue, in order to make these more beneficial to developing countries. The actions related to the first dimension would have a direct link on relations with third countries, especially in terms of development cooperation. Impact on simplification and reduced administrative burden is likely, given the resulting increased policy coherence, but unclear at this stage.

Who is affected?

The actions would involve Commission services, Member States and their dialogue with third countries, with a focus on developing countries. It would aim at increasing the EC/EU effectiveness in supporting tax systems and the coherence and complementarity between this support and the Commission's and Member States' policy and positions on international tax matters, such as expressed at the OECD, the UN or the G20. Indirectly, it will also be of benefit for EU citizens as a strengthened approach to tax matters for developing countries should reduce possibilities for tax evasion across the globe, and potentially allow EU MS to reduce their levels of taxation, if current losses are material and are reduced.

E. Planning of further impact assessment work

When will the impact assessment work start?

No formal impact assessment is envisaged. Justify why not. Indeed, the impact of this Communication would be mainly an improvement of third country policies and systems in the context of development cooperation. It will not have far-reaching impacts in terms of the nature *per se* of the instruments the Commission is using to support tax systems. Rather it aims at improving the effectiveness of current tools by supporting a more coordinated and coherent use of the different instruments. However, an extensive process of consultation took place during the period October 2009 to March 2010.

(i) What information and data is already available? (ii) Will this impact assessment build on already existing impact assessment work or evaluations carried out? (iii) What further information needs to be gathered? (iv) How will this be done (e.g. internally or by an external contractor) and by when? (v) What type and level of analysis will be carried out (cf. principle of proportionate analysis?)

(i) Assisting developing countries on tax matters is not new. The financial crisis, however, highlighted the need to step up work in this field and improve international cooperation. Some multilateral and bilateral donors have been implementing tax projects in the past. There is a large amount of literature available about tax policy in developing countries, prepared by NGOs, academics, and implementing agencies as well as international organisations such as

the OECD, the IMF and the World Bank. The European Commission participates in the International Tax Dialogue, a collaborative arrangement that encourages and facilitates discussion on tax matters among tax officials, international organisations and other stakeholders.

The Commission services of DG DEV and AIDCO, using as a basis this literature, have prepared a comprehensive issues paper (see annex 1) to highlight what they see as the main challenges in terms of strengthening tax systems in developing countries, and present possible policy proposals to address these challenges. This paper, which has been informally discussed with Member States experts (who largely supported its content), will provide valuable input into the work on defining specific proposals for inclusion in the proposed Communication. The paper has benefited from an analysis on "Strengthening the fiscal management capacity of developing countries and supporting the fight against tax evasion, capital flight and corruption", recently prepared by the Spanish Presidency.

The High Level EC/EP Conference *Tax and Development To Fight Against Poverty Reduction*, held in Brussels on 9th of December 2009, was the occasion to provide further information, and to further reflect on the critical link between the internal and international factors hindering developing countries' capacities to strengthen tax systems.

(iii)-(v) In the context of the preparation of the proposed Communication, additional information is being collected about what exactly EU Delegations and Member States are doing on the ground when it comes to tax/revenues matters as well as regarding the main challenges they face in assisting developing countries in strengthening their tax systems. It is in that context that a comprehensive questionnaire (annex 2) has been sent to ACP and RELEX Delegations. The answers provided a critical input to the first dimension of the Communication (strengthening capacity to support tax systems). Another input into the Communication is the replies of the EU Member States to the Monterrey Questionnaire on Financing for Development and the results of a Donor Mapping currently undertaken by the International Tax Compact.

Since no impact assessment is foreseen (ii) is not applicable.

Which stakeholders & experts have been/will be consulted, how and at what stage?

Already consulted informally:

-*Commission services*: They are being consulted through an informal inter-service meeting on good governance on tax matters, which held its first meeting on 20th November to discuss the above-mentioned issue paper. At the end of November Delegations have been asked to comment the draft issue paper and reply to the questionnaire.

-*ES and DE*: an informal meeting took place in Brussels on 1 October with Spain, the incoming Presidency who has included the issue of good governance in tax matters in the context of development cooperation among its priorities, and Germany, a MS active on tax matters and the organiser of the International Tax Compact meeting planned on 25-27th of January (co-chaired by DE, ES and the Commission). The discussion essentially focused on the draft issue paper mentioned above.

- *EU Member States*: a first tax experts meeting took place on 23rd of November. Member States were supportive of the approach proposed in the draft issue paper and made a number of contributions on the issue paper, and more specifically its section 5 on "Harnessing EU instruments to provide enhanced support".

Further consultations:

- *EC services*: Exchanges on draft documents (Communication and Staff Working Document) took place in the context of the inter-service group during the period beginning of February to beginning of March in order to receive feedback on specific policy proposals.
- *EU Member States*: A second tax experts meeting took place on 8 February in Brussels.
- *Civil society*: Civil society from Europe and developing countries, as well as the private sector, were consulted during the Conference on Tax and Development (9 December) and later at the occasion of the International Tax Compact meeting on the 27th of January. In addition, numerous bilateral meetings took place with NGOs working in this field, e.g. Tax Justice Network, Christian Aid, Actionaid, Eurodad, Global Financial Integrity, etc.
- *Tax Authorities from Developing Countries*: Consulted during the International Tax Compact workshop (25 and 26 January).