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Alicja Brodzka
Wrocław University of Economics
e-mail: alicja.brodzka@ue.wroc.pl

GOOD TAX GOVERNANCE'S ROLE IN THE PROCESS OF RENEWING ECONOMIES

Abstract: The aim of the paper is presenting the most relevant issues of good tax governance matters. Soft-law initiatives, successfully implemented and refined, can improve states' fiscal management. It also can – through enhanced international cooperation in tax matters – increase international financial security and transparency. As implementing common tax standards can enhance the wide positive effects in the process of renewing economies, good tax governance has become the subject of interests of both individual states and international organisations.

Key words: good tax governance, fair tax competition, international tax optimisation, international tax policy.

1. Introduction

The perspectives of investing funds in territories which offer low levels of taxation and strict confidentiality have always been attractive for both individuals and business entities. Countries that have chosen to reduce their national fiscal revenues and introduce such benefits have always attracted numerous investors seeking so-called "tax-optimisation". The mobility of investments and savings has been further stimulated by the development of telecommunication and the increased integration of world financial markets.

The liberalisation of trade and capital markets increased the international competition and – as a consequence – augmented the mobility of capital, transferred internationally in the search for maximum profitability. Recent years have witnessed a sharp increase of capital flows, expressed in foreign and portfolio investments given in relation to GDP. The ratio of outward foreign direct investments to GDP, examined in the OECD area, rose from 10 to 39% between 1990 and 2009. At the same time the corresponding ratio of inward FDI increased from 8 to 31%, whereas the inward and outward portfolio equity investments grew from 1 to 7% of GDP [Owens 2011].

The increased mobility of capital has caused changes in states' tax policies. Countries wanting to attract cross-border investments were under pressure to reduce the taxes on investment returns, in order to keep their competitive positions. They also faced the growing problem of international tax optimisation, as more businesses (especially multinational corporations) started to use aggressive tax planning practices. Enterprises could maximise their post-tax profits by:

1) transferring earnings to low-tax countries through their subsidiaries (by using internal group leverage or special purpose vehicles);

2) shifting profits by using mispricing practices, e.g. setting prices for intra-group transactions in a way which is inconsistent with the market transactions between unrelated parties;

3) inventing methods leading to double-non-taxation, through exploiting differences in different tax systems (by using "hybrid" instruments) [Owens 2011].

The increasing globalisation and the lack of international coordination in fiscal affairs induced the major developed countries to focus their attention on the problems of domestic tax base erosion resulting from international tax avoidance and tax evasion through the use of offshore jurisdictions. They have pointed out that maintaining confidentiality of information and excessive use of harmful tax competition[1] strengthens the phenomenon of fraud, thereby helping to diminish the tax base in countries with transparent financial systems.

2. The scale of offshore money

The size of offshore capital flows makes it hard to measure precisely, as the nature of undeclared money and the culture of secrecy makes it hard to trace. OECD Analysis (2008) indicated that tax havens have attracted considerable amounts of USD 5–7 trillion, of which private offshore capital is valued at almost USD 1 billion, a figure five times higher than two decades ago [*Report on Promoting*… 2010, pp. 6, 12]. The figures from the tax authorities of developed countries confirmed the significant scale of "flight capital": the United States estimated that each year the losses suffered

[1] The OECD 1998 Report mentioned four main criteria for identifying harmful tax practices in relation to geographically mobile services: (a) no or low taxation on the relevant income, (b) lack of transparency, (c) lack of effective exchange of information, (d) the regime that is ring-fenced from the domestic economy (*Harmful Tax Competition: An Emerging Global Issue*, OECD, 29.04.1998). According to ECOFIN Council, when assessing harmful tax practices, account should be taken of, inter alia: (a) whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents, or (b) whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base, or (c) whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages, or (d) whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD, or (e) whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way (*Code of Conduct for Business Taxation*, Conclusions of the ECOFIN Council Meeting on 1 December 1997 concerning taxation policy, 98/C 2/01, Official Journal of the European Union, 06.01.1998).

due to the loss of tax revenue amounted to USD 54–70 billion USD, the United Kingdom identified the amount lost due to tax evasion as GBP 100 billion a year [*The shirts off*… 2005, p. 10]. The German tax office indicated that tax evasion costs the State budget EUR 30 billion per year [Benoit 2008]. Further assumptions of the American and British tax authorities showed that only about 5% of funds invested in tax havens were reported in their home country (USB case in the USA, US Senate (2008), Sullivan (2007) in the UK) [Tax havens… 2009, p. 11].

More recent IMF analysis [Lane, Milesi-Ferretti 2010] proved that the scale of undisclosed money held offshore has not diminished. Research based on IMF figures has shown a huge gap between investments and assets reported in offshore financial centres. In Luxembourg, portfolio assets held by foreigners were worth USD 1.5 trillion at the end of 2008, whereas investment liabilities were USD 2.5 trillion. Cayman Islands' data from 2007 showed USD 2.2 trillion of equity liabilities and only USD 750 billion of portfolio assets. The figures reflect a big discrepancy and – according to Milesi-Ferretti – "were unlikely to be entirely accounted for by the fact that some countries do not report their portfolio investments or their destination to the fund. And the fact that many undeclared funds in offshore accounts are held in cash deposits, not in portfolio investments, means the sum is likely to be much higher". Switzerland – the biggest private offshore financial centre – admitted to have USD 600–700 billion of undeclared assets (mostly held in cash). Liechtenstein was believed to have kept at least USD 200 billion of assets with offshore origin [Bain 2011]. All that led the IMF to the conclusion that the sum of the external assets and liabilities of all the offshore financial centres except Switzerland can reach the amount of USD 18 trillion.

Another subject of the IMF's research was the scale of illegal money flows (2001), with estimates of the amounts involved in money laundering at USD 600 to 1800 billion (e.g. 3–5% of global gross domestic product). In the process of analysing the growing problem of dirty money the IMF pointed out that the saturation of dirty money into legitimate financial sectors and national accounts could threaten economic and political stability also by wrong policies and inefficient allocation of budget expenditures, due to measurement errors in national account statistics and misreporting of income. Others were increased volatility of exchange and interests rates, caused by increased vulnerability to external shocks and to capital flight and the reduction in the scale of legal transactions as a consequence of fear of being associated with crime [*Money Laundering*… 1998].

Similar conclusions came from R. Baker's study. He estimated the flows of dirty money into the global financial system at USD 1 trillion. Half of the amount (USD 500 billion) was supposed to have come from developing countries and transition economies. The rest of the money came from tax avoidance and criminal activity of individuals (USD 250 billion), from "profit laundering" practices of multinational companies (USD 200 billion) and from the corruption of individuals and business entities (USD 50 billion) [Baker 2005].

3. Good governance and good public policies – in search of the definition

In times of increased uncertainty governments search for solutions which could not only protect their tax revenues against tax base erosion and fight tax evasion and tax avoidance, but also help to stimulate economic development. Among the issues important in the process of renewing the economies there is also the aspect of quality of governance. Good governance does not only mean the implementation of good bureaucratic and administrative policies (namely, building an effective state system which can deliver public goods and service to society), but also ensuring the stability of the country by creating a responsive society which can hold states accountable for their actions. All these factors help to secure property rights, business transparency, political rights, civil liberties, and the stable rule of law.

A number of definitions of "good governance" proposed by international organisations exist in literature. The World Bank's definition (1992) looks at the manner in which power is exercised in the management of a country's economic and social resources for development [*Governance and Development*… 1992, p. 1]. Sustainable development can take place only in the case of the existence of predictable and transparent framework of rules and institutions, which create an environment for private and public business activities. Good governance issues focus on:

1) the process by which authority is exercised in the management of a country's economic and social resources;

2) the capacity of governments to design, formulate and implement policies and discharge functions.

The United Nations perceive good governance as the exercise of economic, political and administrative authority to manage a country's affairs at all levels [*Governance for Sustainable*… 1997, pp. 2–3]. This comprises mechanisms, processes and institutions through which citizens and groups articulate their interests, exercise their legal rights, meet their obligations and mediate their differences. According to their definition, good governance is, among other things, participatory, transparent and accountable, effective and equitable, and it promotes the rule of law. In the UN's view, such understood good governance ensures that political, social and economic priorities are based on a broad consensus in society and that the voices of vulnerable groups are heard in decision-making over the allocation of development resources.

The OECD's concept (1995) of good governance denotes the use of political authority and the exercise of control in society in relation to the management of its resources for social and economic development. This broad definition encompasses the role of public authorities in establishing the environment in which economic operators function and in determining the distribution of benefits, as well as the nature of the relationship between the ruler and the ruled [*Participatory Development*… 1995, p. 14].

Good governance requires fair legal frameworks to be enforced by an independent judiciary, whose decisions are transparent or carried out in a manner that follows established rules and regulations. Since accountability cannot be enforced without transparency and the rule of law, accountability is a key requirement of good governance. This condition applies not only to governmental institutions, but also to all groups (i.e. the private sector and civil society organisations, which should be accountable to third parties, the public and their institutional stakeholders). According to A. Gurría [2007, p. 3], in all cases good governance is needed to take full advantage of the globalisation process, to maximise the benefits, while at the same time ensuring that they are fairly shared. It is also the most important factor in determining whether a country has the capacity to use resources effectively to promote economic growth and reduce poverty.

According to S.D. Sharma, there are several elements essential in building good governance and strengthening economic development. In his paper *Democracy, Good Governance, and Economic Development* Sharma mentions three factors: institutions, democracy and decentralisation. **Institutions**, composed of both formal (constitutions, laws, and regulations) and informal (such as social norms, customs, and traditions) rules that constrain economic behaviour, set the framework of rules and incentives affecting how people, organisations and firms utilise resources in political and economic decision-making. **Democracy** provides institutional advantages that support economic development through granting political and civil rights, improving the welfare of society and keeping an open dialogue in the process of development of values and priorities (i.e. a "constructive function" of democracy, which is very important for equality and justice). **Decentralisation** implies devolution of power (which may include the transfer of resources, responsibilities for public services, or decision-making authority) away from central government to lower political and administrative jurisdictions [Sharma 2007, pp. 46–62].

Such understood good governance not only promotes human rights and protects civil liberties, it is also correlated with economic development and the growing potential to deliver improvements in the living standards of societies. In an attempt to quantify the correlation between economic performance and good governance, D. Kaufmann, A. Kraay and M. Mastruzzi conducted the study. In search of the factors creating good public policies, they built the system of Worldwide Governance Indicators. For the sake of the research they defined good governance as traditions and institutions by which authority in a country is exercised, which included:

1) the process of government's selection, monitoring and replacing;

2) the government's capacity to formulate and implement sound policies in an effective way;

3) the respect of citizens and the State for the institutions that govern economic and social interactions among them.

The process of assessing how governments are selected, monitored, and replaced included two dimensions: *the Voice and Accountability* (that presented the perceptions to which extent a country's citizens were able to participate in selecting their government, as well as the level of freedom of expression, association, and a free media) and *the Political Stability and Absence of Violence/Terrorism* (that showed the perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means). In the area of **the capacity of the government to effectively formulate and implement sound policies,** researchers looked at: *the Government Effectiveness* (that captured perceptions of the quality of public and civil services and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies) and *the Regulatory Quality* (that showed perceptions of the government's ability to formulate and implement sound policies and regulations which permit and promote private sector development). **The respect of citizens and the State for the institutions that govern economic and social interactions among them**, this issue was analysed by the use of two dimensions: *the Rule of Law* (that captured perceptions of the agents which have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence) and *the Control of Corruption* (that presented perceptions of the extent to which public power is exercised for private gain) [Kaufmann, Kraay, Mastruzzi 2010, p. 4].

Kaufmann, Kraay and Mastruzzi, by analysing World Bank data (for the period 1996–2003), tracked the quality of governance in over 200 countries. The outcome of the study showed the strong correlation between dimensions and proved that the quality of governance determined long-term economic performance. The authors concluded that good governance was not only a factor crucial for development, but also a determinant showing whether the country has the capacity to use resources in an effective way in order to promote economic growth.

4. Good tax governance

Another relevant aspect of good governance is the fiscal system, as this plays a key role in state building and in overcoming the crisis in the global economy. Effective tax systems not only establish a framework for economic growth, but also support the states' efforts to build responsible governments. According to the OECD [*Citizen-State*… 2010, p. 9], appropriate standards in taxation can improve governance by:

1) developing a shared interest in economic growth, as governments which depend on taxes are more eager in implementing incentives for supporting economic growth;

2) developing the State apparatus, as one of the conditions for effective tax collection is a well-functioning administration and the process of improvement of the bureaucratic apparatus which can affect positive changes in the state's capacity elsewhere;

3) developing accountability and responsiveness, as states have incentives to improve governance in order to engage taxpayers in the politics and – by increased tax compliance – sustain tax revenues.

Recent years have brought a shift in studies concerning taxation issues. The traditional focus on maximising tax revenues, efficiency and compliance has been extended to the role of taxation in supporting the strategy for state building. Governments are still conscious that the core aim of tax policy is ensuring sufficient tax revenues to finance public expenditure while maintaining sustainable budget deficits and public debt ratios, but they have also started to look at the taxation system from a broader perspective. Implementing new standards can have a positive effect of increasing states' responsibility and accountability in the eyes of their citizens. It also leads to strengthening the state-society relationship and improving the state's capacity. This approach seems to be essential in the modern world, as strengthening national dialogues around taxation and supporting the effectiveness of administrative structures are indispensable to any long-term strategies for achieving revenue stability and self-sufficiency. An effective tax system should also help in minimising the distortions of the market and focus on creating as few obstacles as possible for investment, innovation, entrepreneurship and other drivers of economic growth.

In the common meaning, **"good tax governance"** includes a wide list of issues: from good tax administration, though certainty and taxpayers' compliance issues, national and international tax policy to strengthening transparency and tax information system. Issues of **administration and good work of tax collection** mechanisms focus on the willingness and ability of the administration to introduce tax standards sufficient for effective tax management at state level. At a national level this means setting clear and consistent rules of tax returns, collections and audits in state law, that allows to support the certainty and augment the State-society relationship. Efficiency in tax administration minimises costs devoted to revenue collection. Good tax policy, by setting "fair" tax rates and deterring evasion is more likely to achieve a high level of voluntary compliance.

The international aspect of tax administration also plays a significant role in strengthening good tax governance – through enhancing cooperation with other states. The cooperation helps to decrease the tax obstacles in transnational activities by creating an effective net of double tax treaties. However, there are some requirements indispensable for the effective removal of tax barriers. Provisions of tax treaties should not only be applied in a fair and consistent manner, but also have to guarantee the fair sharing of tax rights in tax treaties and the development of domestic laws. These initiatives should also ensure equal treatment to all similarly situated taxpayers regardless of their nationality. International cooperation demands improving the access to bank and financial information for tax exchange purposes – but simultaneously the information obtained from tax treaty partners should be safeguarded with the same or greater confidentiality as that required under domestic laws. The tax treaties network should be constructed in a way which does not encourage nor facilitate tax evasion or avoidance by residents of third states. The last important issue is to look at the matter of tax treaties from a dynamic perspective – there should be provided assistance to policy makers for the renegotiations of areas of mutual concern in existing tax treaties.

Good tax governance analyses also the aspect of **policy aimed at increasing tax payer compliance and certainty**. One of the requirements in this matter are clear rules of tax payers' rights, available services delivered by the tax administration in order to facilitate tax procedures, and fair rules of penalties, investigations and audits. The policy should ensure that compliance costs are kept at the minimum level necessary to achieve these goals. It should also include options of cooperation in crisis situations, when a taxpayer is not able to pay due to a lack of resources, but is eager to comply. A very crucial issue is using taxpayer's information only to the extent permitted by law. All these factors can help in developing and maintaining good working relationships with client groups and the wider community.

The most current issue on the international agenda seems to be the aspect of **transparency and tax information exchange**. This includes the matters of combating money laundering and tax fraud, implementing measures against harmful tax competition – both within their own national systems and the systems of cooperating countries (and also within the group of tax havens) and supporting information exchange. The transparency and tax information exchange issue means constant cooperation aimed at facilitating the exchange of information with treaty partners and providing feedback on the results. It also includes the scenario, when – through the standard procedure of regular audits – information will be provided to the treaty partners on a spontaneous basis. International rules assume that tax treaty partners will request the information only when the information is relevant, significant, obtainable and useable. The international cooperation in the exchange of information should also safeguard taxpayer's rights by informing them about the mutual agreement procedure (and the results of negotiations under the procedure). It should support the arm's length principle and the OECD guidelines on transfer pricing [*Principles of Good*… 2001].

Good tax governance issues go beyond the national dimension. Strengthening standards in taxation requires **enhanced cooperation in developing the tax policy at international level**. In this aspect good governance means working on a common position in the international arena – cooperation in implementing standards that would help in combating tax avoidance, opacity and tax system ineffectiveness. Very important here is also the efficient working on a network of treaties which help in decreasing tax obstacles, introducing the exchange of tax information and supporting cooperation between tax authorities.

5. Conclusions

Countries, interest groups and experts associated in international organisations, work on coordinating tax policies in order to meet the requirements of the changing investment environment and – simultaneously – protect their own tax bases. As the harmonisation of tax rules is not possible due to the wide differences in states' interests and the need for sustaining the tax sovereignty principle, the use of soft-law instruments gains importance. Joint initiatives of international organisations aimed at developing nonbinding, soft-policy norms and guidelines could coordinate global tax policy and simultaneously protect national tax policy goals. The soft-law concept involves political, social, and economic relationship among states and individuals that significantly impact on the types of tax norms that arise and take root internationally [Networks, norms… 2010].

Civil society organisations stress the need for changes in the taxation area. They consider as extremely important the shift in behaviour of developed countries. According to their view Europe's, OECD's and G-20's creditability depends on its willingness **to clamp down on tax havens on its own territory first as an example of good governance**. That is the major challenge for developed countries, as illicit capital outflows distort the international flows – especially from the perspective of poorer, less developed states. There is a huge role of aggressive tax planning, tax evasion and financial fraud in the context of developing countries. Estimates state that the combined illegal capital flight from developing countries represents 6.0–8.7% of their GDP (whereas tax revenues for the poorest countries amount to about 13% of GDP). Illegal money flows from these countries totalled USD 641-979 billion in 2006 [Tax havens... 2009, p. 64]. Civil society organisations list the difficult aspects of **cooperation with developing countries**: strong correlation between natural resources and poor governance in developing countries (no sufficient reports on payments of companies to governments) and the need for ending bad aid practices that weaken government capability and accountability [McDonald, Jumu 2008, p. 2].

According to the opinions of civil society organisations, tax systems and reforms should be designed with good governance, having as a core objective the importance of the link between a good tax system and good governance. This means **working with partners on projects that mobilise citizens as taxpayers** and increased **efforts on fighting corporate tax evasion**, together with ensuring that tax which forms a social contract remains central. Civil society organisations mention here a possible trap of perceiving tax policy as purely a technical discussion about how to raise revenue. They recommend priorities in taking **comprehensive measures to address harmful tax activities: country-by-country reporting and multilateral and automatic exchange of information** [*CSOs recommendations*… 2010].

Developing the idea of good tax governance could provide a level playing field in the tax area for cross-border activities. That could also ensure that all taxpayers meet their tax obligations. As a consequence, entities could benefit not from aggressive tax planning practices, but from the substantial reduction of the non-compliance scale. This would also let governments implement tax reforms towards reducing tax rates and widening tax bases [Hammer, Owens 2000]. It seems that future years will bring more discussions on the issues of good standards in taxation matters.

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ROLA DOBRYCH RZĄDÓW W DZIEDZINIE OPODATKOWANIA W PROCESIE ODNOWY GOSPODAREK

Streszczenie: Celem artykułu jest przybliżenie tematyki dobrych rządów w dziedzinie opodatkowania. Działania z zakresu *soft-law*, sukcesywnie wdrażane i udoskonalane, mogą wpłynąć na poprawę zarządzania podatkowego pojedynczych krajów, a także zwiększyć międzynarodowe bezpieczeństwo finansowe dzięki zacieśnieniu międzynarodowej współpracy w sprawach podatkowych. Dobre rządy w dziedzinie opodatkowania – mogąc przynieść pozytywne skutki w różnorakich obszarach – stały się przedmiotem zarówno pojedynczych krajów rozwiniętych, jak i organizacji międzynarodowych.

Słowa kluczowe: dobre rządy w dziedzinie opodatkowania, uczciwa konkurencja podatkowa, międzynarodowa optymalizacja podatkowa, międzynarodowa polityka podatkowa.