United Nations
Economic Commission for Africa

ECA POLICY BRIEF

Reforms to improve taxation of multinational enterprises in Africa[1]

This policy brief analyses the problems facing Africa related to 'base erosion and profit shifting' by multinational corporations.[2] It builds on the Report of the High Level Panel on Illicit Financial Flows (IFFs) from Africa (African Union and Economic Commission for Africa, 2015) to look beyond that Report's analysis of how base erosion and profit shifting (BEPS) are carried out in Africa, into specific policies that can be used to prevent such flows.

BEPS in Africa present a serious challenge to financing for development in Africa. They are able to persist because of gaps in national legal frameworks and international taxation agreements in which African countries are involved, as well as weaknesses in their enforcement. The BEPS actions of the Organization for Economic Cooperation and Development (OECD) while useful for African countries in some cases, do not address many of the main priorities for tackling BEPS in Africa and are not in the best interest of African countries in some cases.

This policy brief is structured around two key messages. The first key message is that African Governments have much to gain from improving taxation of multinational enterprises (MNEs), especially if efforts are substantial, coordinated between public institutions and national stakeholders, and in collaboration with other African countries. The second key message is that it is also advisable to strengthen alliances and advocate for a global tax authority that better accommodates developing country concerns and that supports appropriate reforms in that regard.

1. Tackling base erosion and profit shifting in Africa as a priority that requires action at both the African and global levels

The success of African nations in making progress on achieving the 2030 Agenda for Sustainable Development is not only strongly related to mobilizing more domestic financial resources, but also to retaining more of the wealth generated within their borders. According to ECA (2018a), Africa now loses about US$ 100 billion annually in IFFs. One of the major sources of IFFs are activities labelled Base Erosion and Profit Shifting (BEPS), conducted mainly by MNEs. BEPS refer to activities that exploit gaps, mismatches, and loopholes in tax legislations, as well as the capacity constraints of tax authorities, by transferring financial resources to low or no-tax jurisdictions, and thereby avoiding taxation in the country of operations (ECA, 2018b).

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1 This policy brief was produced under the overall guidance and support of Adam Elhiraika, Director of the Macroeconomics and Governance Division of the Economic Commission for Africa. It was coordinated by Gamal Ibrahim, Chief of the Economic Governance and Public Finance Section of the Macroeconomic and Governance Division, with substantive input by Deniz Kellecioglu.

2 The policy brief is based on ECA (2018), *Base erosion and profit shifting in Africa: reforms to facilitate improved taxation of multinational enterprises*. Addis Ababa.

It is very difficult to estimate the amounts lost through BEPS, given its hidden character and lack of transparency from MNEs. One estimate from 2010, conducted by OECD, indicates that African nations lose about 1.8 per cent of their GDP through BEPS. This would amount to approximately $40.6 billion every year, given the 2017 GDP level of the entire continent. In Malawi, according to ActionAid (2015), loopholes in tax treaties resulted in losses of $43 million from a single company.

2. BEPS exploit weak enforcement and legal loopholes

In carrying out such illicit activities, MNEs are, in effect, exploiting circumstances of poor governance systems, weak administrative capacities, corrupt values and behaviour, as well as the externally imposed policies that have failed to transform African countries. MNEs also often successfully influence powerful nations and leaders to maintain policies and regulations at the global level that are ineffective in tackling BEPS and IFFs in Africa (ECA, 2018b).

BEPS usually either exploit loopholes in double taxation agreements exempting their activities from tax, or use intra-company transactions that erode their taxable profits in high-tax countries and shift profits to low-tax jurisdictions. For example, the High-Level Panel on Illicit Financial Flows from Africa identified a multinational tax avoidance scheme using a number of transactions routed through multinational subsidiaries in Ireland and the Netherlands (AU and ECA, 2015). MNEs usually employ advisors at powerful audit firms that provide legal support and justifications for their tax avoidance schemes.

Though the OECD BEPS package includes some useful recommendations, African countries should develop their own approaches to tackle MNE tax abuses

In 2013, OECD and G20 launched a package to tackle BEPS, culminating in 15 action points. This policy package was intended to have global outreach and invitations to participate were extended to all nations. South Africa was the only African country included from the onset, being a member of the G20. As of August 2018, 117 jurisdictions (21 from Africa) were members of the inclusive framework on BEPS, which details implementation of the OECD BEPS package. However, the inclusive framework does not address revision of the BEPS package or alternative solutions (OECD, 2018). Moreover, although OECD indicated that it would take into account the perspectives of developing countries, the interests of developing countries (aside from the few that participated in the process) were never taken into consideration when the base erosion and profit shifting agenda was developed.

Perhaps as a result of this, the OECD BEPS package fails to address some of the priority base erosion and profit shifting concerns for Africa, in particular weaknesses in tax governance at the national level and the granting of non-strategic tax incentives.[3] Moreover, not all of the BEPS actions proposed by the OECD are relevant to African countries or in their interest (ECA, 2018b).

Furthermore, the Arms-Length Principle (ALP) exhibits severe shortcomings for combating transfer mispricing. This is a major component of BEPS in which companies associated with one and the same MNE set prices on goods and services at strategic levels in order to manufacture profits or losses in the MNE accounting that are able to minimize taxation in a specific jurisdiction. The ALP transactions take place between different parts of the multinational group and should be conducted under the same terms that would be used for a comparable transaction between companies that are not part of the same multinational group. However, monitoring such transactions requires a legion of information, analyses of functions, assets and risks as well as searches for prices of goods and services for use in ensuring that transfer pricing respects the arm's length principle, very difficult to realize even for rich countries (ECA, 2018b).

3. There are a number of "low hanging fruits" in tax reform that could have a significantly positive impact on revenue collection in African countries

There are a number of policy measures that African Governments are able to implement to generate

3 For example, the country case study on the United Republic of Tanzania conducted for ECA (2018b) identified that non-strategic tax incentives were having a significantly negative effect on physical resources in that country.

swift and positive impacts on domestic resource mobilization. Examples of these "low-hanging fruits" often involve strengthening the enforcement of tax laws, closing domestic tax loopholes, building tax treaty negotiating capacity, coordinating ministries and agencies dealing with tax treaty issues, improving access to data, ending the granting of non-strategic tax incentives and removing those that have already been granted, strengthening cooperation between African countries on tax matters and providing staff development, for instance, through training, education, and technical tools. In Africa, the key challenge of tax collection is the limited capacity to enforce existing laws.

Governments would do well to invest in such administrative improvements, including combating and removing incentives and opportunities for corruption. Another affordable, yet efficient policy measure is to enact and enforce laws that genuinely protect whistle-blowers. For instance, article 19 of the International Covenant on Civil and Political Rights of the United Nations, provides guidance in this regard (United Nations, 2016). Another promising policy fruit is to ensure that accounting, audit, and legal firms are transparent about their affairs with MNEs. Furthermore, relevant public agencies need to build capacity that can better tackle the international profit-shifting practices and better counter them (ECA, 2018b).

4. African countries should take an alternative approach to international taxation

There are also a number of constructive and feasible policies that provide for an approach to international taxation that would be preferable for African countries.

In terms of negotiating international tax treaties, African countries should consider guidelines prepared by the United Nations for this purpose, which are generally more favourable to capital-importing countries than capital-exporting ones (most African countries fall into this category). These include the United Nations Model Double Taxation Convention, the Handbook on Double Tax Treaties for Developing Countries; and the United Nations article on curtailing BEPS regarding service fees (ECA, 2018b).

An alternative to the OECD ALP is the proposal to pursue unitary taxation and formulary apportionment, which treats a MNE as a single firm and allocates taxation rights to the various countries in which it operates according to an agreed formula, thereby removing transfer mispricing practices. In fact, formulary apportionment variations have for long been exercised with relative success in federal nations, such as in Brazil, Canada, Switzerland and the United States of America. Also, in October 2016, the European Commission re-launched the Common Consolidated Corporate Tax Base, which is a form of formula apportionment (FA) to calculate each European Union member State's tax share of MNE profits (ECA, 2018b). However, the competitiveness of individual African countries may suffer if they adopt such approaches unilaterally. It may be advisable to further investigate unitary taxation formulary apportionment under the auspices of a global tax body.

Another potentially powerful policy instrument would be to make the MNEs report publicly available information. At the moment, the OECD BEPS package includes a standard of Country-by-Country Reporting (CBCR) to tax authorities. Civil society has argued that these reports should not be made publicly available; sensitive commercial information can be redacted from the reports. The intention is to allow researchers, journalists, and activists an opportunity to analyse these reports, and hold MNEs accountable when possible. The proposals are also expected to shift the playing field between wealthy and developing countries in favour of the latter, given that the former group often successfully protects their MNEs in the global economy (ECA, 2018b).

5. Conclusions and policy recommendations

The discussion above highlighted the importance of tackling BEPS in Africa, and pointed out important shortcomings with the OECD BEPS actions in terms of their suitability for Africa. Thereafter, attention was drawn to "low hanging fruit" that could generate significant additional tax revenues. This was followed by an analysis of the interests of African countries regarding international taxation agreements.

At the national level, African countries should design national responses to base erosion and profit shifting

that are better adapted to their needs and priorities than those proposed by the OECD (though in many cases, these may include at least some of the actions proposed by the OECD as part of its BEPS package). This can include boosting administrative capacities, closing domestic tax loopholes, building tax treaty negotiating capacity, coordinating ministries and agencies dealing with tax treaty issues, improving access to data, ending the granting of non-strategic tax incentives and removing those that have already been granted.

National efforts to address BEPs should be supported by regional cooperation, particularly sharing information on the pricing of internationally traded goods and services (to support transfer pricing analysis), automatic exchange of tax information among African countries, and cooperative efforts to investigate illicit financial flows.

At the global level, African countries can push for the establishment of a global tax body that is open to all United Nations Member States. This can be complemented by a push for public country by country reporting by multinational corporations.

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