Tax Haven and Development Partner: Incoherence in Dutch Government Policies

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Abstract

This paper focuses on a relatively new issue in the debate on policy coherence for development: the incoherence between tax and aid policies, using a case study of the Netherlands as illustration. Although the Netherlands cannot be considered a 'pure' tax haven like the Cayman Islands and the British Virgin Islands, evidence indicates that it does play a key role as 'conduit' country in tax planning structures of multinationals that wish to channel funds to 'pure' tax havens. This paper shows that as a consequence of the Dutch fiscal regime, other countries, including developing countries, are failing to collect important tax revenues which otherwise could have been used to finance health care, education and other essential public goods and services. It is estimated that developing countries miss about € 640 million in tax revenue – about 15 % of Dutch ODA. This suggests the Dutch tax policy is incoherent with the Dutch policy on development cooperation.

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1 Introduction

Traditionally, discussions on policy coherence for development have centred on policies such as agricultural and trade. In this paper, we focus on a relative new issue: the incoherence between tax policy and development policy – with a case study of the Netherlands.

A key element of sustainable development is developing countries' ability to raise sufficient tax revenue to finance infrastructure, schooling and health as well as reduce their dependency on development assistance. In addition it has been argued that apart from raising revenue taxes also play a "central role in building and sustaining the power of states, and shaping their ties to society" by enhancing the accountability between the state and its citizens. (Braütigam *et al.*, 2008).

There are, however, signs that multinational companies and wealthy individuals are increasingly using complex fiscal structures to shift income to tax havens and avoid taxes in the countries where they operate or reside. As a consequence both poor and rich countries fail to collect important tax revenues that could have been used to finance public goods.

A few studies that have estimated the amount of tax revenue forgone suggest that the effects for developing countries are severe. Oxfam (2000) estimated that developing countries miss out on US$ 50 billion in tax revenue each year as a consequence of tax evasion and tax avoidance strategies by multinational companies using tax havens in different parts of the world. According to the African Union more than US$ 150 billion is "looted from Africa through tax avoidance by giant corporations and capital flight using 'a pinstripe infrastructure' of western banks, lawyers and accountants".

The main aim of this paper is to analyse the consequences for developing countries of the tax haven features of the Netherlands and investigate the possible incoherence between the Dutch tax and aid policies.

The paper starts with a broader discussion on policy coherence for development, followed by a discussion on the harmful effect of tax havens on development. In section two, the paper presents an overview of the Dutch tax regime and how it relates to international tax planning structures. Descriptive information is provided on the number of intermediary financing companies as well as associated capital and income flows through these companies from and to developing countries. Section four we explore the consequences of tax avoidance via the Netherlands, specifically for developing countries. Next, we estimate the tax revenues

foregone in developing regions as a consequence of tax avoidance constructions involving Dutch entities. The report ends with conclusions and recommendations.

2 Policy coherence for development

The concept of policy coherence for development (PCD) reflects the high relevance of various policy areas and financial flows, other than development assistance, for poverty reduction and sustainable development. There exists no universally agreed definition of PCD, though (McLean Hilker, 2004; Hoebink, 2005, ECDPM/Particip GmbH/ICEI, 2007). For the purpose of this paper, a definition from a previous study will be used: "PCD means working to ensure that the objectives of a government's development policy are not undermined by other policies of that government, which impact on developing countries, and that these policies support development objectives where feasible" (Mclean Hilker, 2004, p. 5).

Debates on the relation between various aspects of external policy emerged in the early 1990s and resulted in a clause in the Treaty on the European Union (Maastricht Treaty) in 1992, requiring the European Union (EU) to ensure consistency of external relations, security, economic and development policies. Over the past ten years, donor governments started to establish PCD mechanisms, such as coherence units and consultation procedures, and attention for PCD is becoming more systemic (ECDPM/Particip GmbH/ICEI, 2007).

Apart from incoherence within development cooperation itself and internal coherence between development and other external policies, PCD currently covers coherence between development policies and other policies as well (Hoebink, 2005). Trade policy is by far the most widely included in PCD initiatives (European Commission, 2007a). In a recent working paper, the European Commission identified twelve relevant policy areas: trade, environment, climate change, security, agriculture, fisheries, the social dimension of globalisation, migration, research, the information society, transport, and energy (European Commission, 2007b). Note that this list does not include taxation or financial aspects of globalisation. By contrast, a list of six key policy areas identified by the OECD includes foreign investment, and mentions that PCD actions by developed countries could involve 'minimising recourse to special tax and other incentives which could unduly distort location decisions to the detriment of less developed countries'(OECD, 2003).

The present paper follows a broad approach to coherence between tax and development policies that includes decisions on the location of real business activities as well as on the location of profits within a multinational. The focus will be on the occurrence and prevention

inconsistencies, which is referred to in the first part of the definition of PCD cited above, rather than on enhancing synergies between development policy and other policy areas.

Causes of incoherence can be classified along three dimensions (Hoebink, 2005). First, policy incoherence can be intended, if a government deliberately prioritises other interests, or unintended, if a government does not notice the conflicting outcomes. Second, incoherence can be structural, in case different interests are inherently conflicting, or temporary, in case different interest groups need time to adjust to a new situation. Third, the nature of the causes can be institutional, for instance due to the compartmentalisation of government departments, or political, due to conflicting interests and ideologies. This classification will be used as a framework for analysis of the case study presented in the second part of the paper.

3 Tax havens, Tax avoidance and Development

Tax havens undermine the interests of poor countries in a number of ways (Murphy, Christensen and Kimmis, 2005).

First, tax havens offer MNCs (and rich individuals) the possibility to avoid or even evade paying tax in developing countries by routing capital flows through shell companies in tax havens. Due to the combination of high capital mobility, differences in national tax systems and the secrecy that surrounds many tax havens, multinationals have considerable flexibility to engage in 'profit laundering' - shifting profits from (high-tax) countries where the economic activities take place, to tax havens – often without violating national laws. This happens in two ways: (1) by manipulating prices of goods that are traded internally, so-called transfer pricing, and (2) by manipulating intra-company financial flows such as interest, royalty and dividend payments.

Second, apart from missed tax revenue, the use of tax havens to escape taxation also provides MNCs with unfair competitive advantages vis-à-vis smaller companies that do not have the capacity to organise this type of fiscal structures or national companies for which it is not relevant. As companies in developing countries are generally smaller and typically more domestically focussed, the existence of tax havens tends to favour business from the North over competitors in developing countries.

Finally, banking secrecy and offshore trusts offered by financial institutions in tax havens make it possible to launder the proceeds of political corruption, illicit arms deals, embezzlement, and global drug trade. The lack of transparency in international financial

markets contributes to the spread of global crime, terrorism, bribery and the looting of natural resources by the elite.

Recognising the harmful effects of tax havens in general, the OECD started an initiative against Harmful Tax Practices in 1998. Currently, the Harmful Tax Practices initiative focuses on the conclusion of bilateral Transparency and Information Exchange Agreements (TIEAs) between OECD member states and tax havens. Although this approach increases possibilities for OECD countries to detect tax evasion, it is of little help to developing countries and it therefore not suited to promote PCD. A more promising initiative to address the consequences of tax havens for developing countries is the recently established International Task Force on the Development Impact of Illicit Financial Flows, lead by the Norwegian government.

4 The Netherlands: A tax haven?

4.1 Definition of tax haven

'Tax haven' is a controversial term which is often used with different meanings and for different purposes. There also does not exist one list of countries that can be considered as tax havens.[1] Hence, for the purpose of this paper, it is important to make the distinction between 'pure' tax havens, and countries that exhibit harmful preferential tax regimes. Both types of tax havens have in common that its laws and practices that can be used to evade or avoid which may be due in another country under that other country's laws.

'Pure' tax havens, also referred to as off shore financial centres, are jurisdiction characterised by: (1) zero or very low tax rates; (2) lack of transparency; (3) secrecy laws that prevent information exchange, and (4) "ring-fencing" of regimes (preferential tax regimes are partly or fully insulated from the domestic markets to protect own economy). Examples of 'pure' tax havens are the Bahamas, Cayman Islands and Bermuda.

The second group of tax havens consists of countries with a diversified economy and industrial base which have a normal tax system but with certain, often very lucrative, exceptions for certain activities or types of corporation. In addition, such countries are commonly characterised by the presence of specialised lawyers and accountants who assist companies with their tax planning and a large number of tax treaties which make it possible to minimise taxation.

[1] See Booijink and Weyzig (2007) for an overview of definitions and classifications of tax havens.

The Netherlands is clearly not a 'pure' tax haven. However as the next section will show, the Netherlands is a country which is characterised by a preferential harmful tax regime. Other examples of countries with such a regime are Ireland, Switzerland, the UK (in particular the City of London), Cyprus and Luxembourg.

4.2 The Dutch fiscal regime and special financial Institutions.

For more than 30 years the Netherlands has been known as international tax planning centre for MNCs (Van Dijk *et al.*, 2006). One particular mechanism that makes the county so attractive is the 'conduit' arrangement. From a tax perspective, this arrangement makes it very beneficial for MNCs to channel Foreign Direct Investment (FDI) as well as interest, dividend and royalty flows between the parent company in one country and subsidiaries or affiliates in other countries via entities in the Netherlands. Key underlying elements of the Dutch tax regime that facilitate the conduit arrangement are the large Double Taxation Treaty network, zero withholding taxes on outgoing interest and royalty payments and special features of the tax system.[2]

The conduit arrangement is harmful because as a result of certain conduit arrangements companies avoid paying taxes elsewhere, including developing countries. Moreover, by acting as conduit country, the Netherlands plays an important role in routing financial flows to pure tax havens, where many of the licensing and financing subsidiaries are located, and no tax is paid. Often the ultimate parent companies of these tax haven entities cannot be easily identified, because of a lack of transparency.

As a result of facilitating conduit arrangements the Netherlands hosts a large number of entities that are used for tax planning purposes. The Dutch Central Bank (DNB) maintains a special register for this type of entities which are referred to as Special Financial Institutions (SFIs).[3] SFIs include both 'mailbox' companies (i.e. shell companies) and other tax planning vehicles. Mailbox companies are companies administrated by trust offices and therefore have no substantial commercial presence of their own – according to information from the Chambers of Commerce, they mostly employ either zero or one person. They merely perform an administrative function with the overall aim of reducing the tax burden of the multinational that owns it.[4] Trust offices incorporate legal entities on behalf of their clients, mostly

[2] See Van Dijk *et al.*, 2006 for a technical discussion of these issues and a detailed description of the various conduit arrangements.

[3] See DNB Statistical Bulletin (2003) for a defintion.

[4] Although tax planning appears to be the main purpose of mailbox companies, occosianally mailbox companies are established

multinationals, and provide them with an address, management and administration. These are essential requirements to give the company 'substance', in other words a real presence, in the Netherlands, which are required to be able to make use of certain features of the Dutch tax regime.

Apart from mailbox companies SFIs also include tax planning entities that are not managed by a trust office. Most of these are part of very large multinationals that, given the scale and complexity of the transactions, probably do not prefer to contract out their financial management. The size and scope of these entities vary from small units which employ only a handful of administrative staff, to departments of large regional or financial head offices of multinational corporations (MNCs) in the Netherlands. According to DNB about 75% of SFIs are represented by trust offices (DNB Quarterly Bulletin, 2007).

In conformance with their purpose, DNB (2004) identifies three types of SFIs. The first are financing companies. They take up and on-lend funds obtained from international capital markets, from the parent company, or from other financing affiliates. Examples of multinationals with Dutch financing companies are SABMiller and BHP Billiton. The second are holding companies. These manage foreign participations, act as dividend conduits and perform acquisitions on behalf of the parent company. Some examples are Mittal Steel, EADS, ENI, Trafigura, Premier Oil, BHP Billiton and Pirelli.[5] It is likely that most of these companies also perform financing activities. The third type are royalty and film right companies that exploit licences, patents and film rights. There is no public data on transactions associated which each type of SFI but DNB states that "considering the magnitude of their cross-border transactions, the financing companies are the largest type of SFIs, followed by holding companies" (DNB, 2004).

Figure 1 depicts the number of SFIs for the period 1977-2006. It clearly shows the steady increase overtime. In 2006, DNB recorded 12.000 SFIs.[6] DNB also presents figures for gross transactions (the sum of total in and outflows) of SFI, which increased from € 782 billion in

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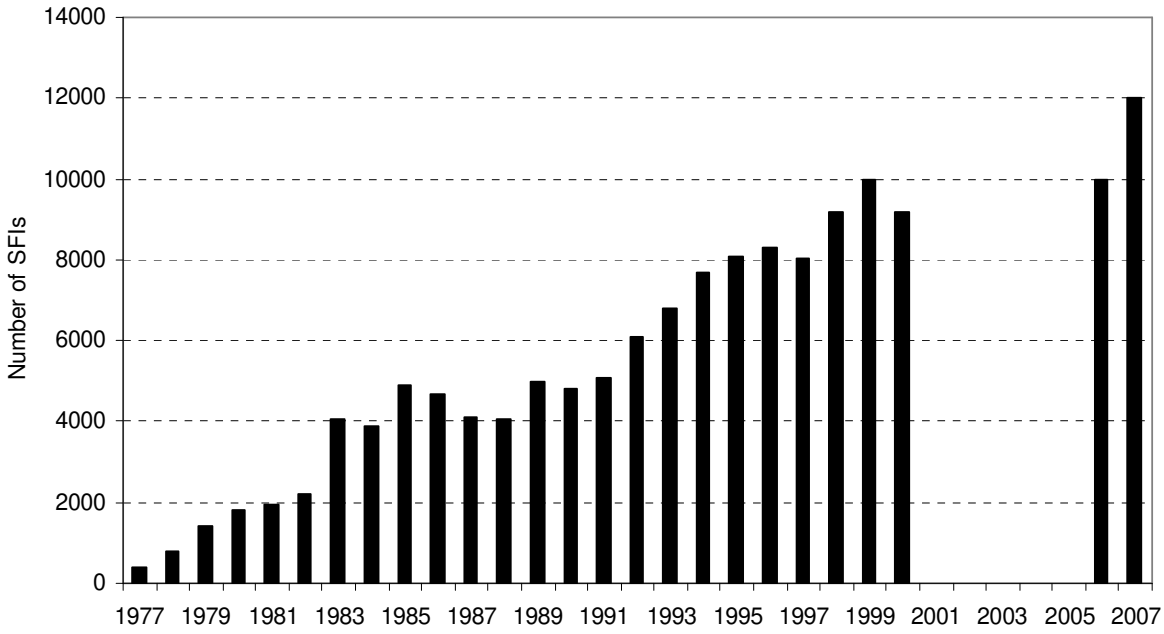
in the Netherlands to benefit from foreign investment protection under Dutch Bilateral Investment Treaties (BITs).

[5] The examples mentioned in this section are based on research by the authors. They do not represent data of DNB and it is therefore unknown whether these companies are included in the DNB SFI register.

[6] On the basis of the trust office register of DNB Van Dijk *et al.* (2006) estimated the existence of about 20,000 mailbox companies in the Netherlands. It seems that a considerable part of mailbox companies falls outside the DNB definition of SFIs. Possible explanations are that DNB uses a strict definition of SFIs, which excludes certain types of mailbox companies, for instance, mailbox companies which are part of a Dutch group structure or are which serve for other purposes than onlending activities. Further, the estimation of 20,000 mailbox companies probably also includes a number of inactive entities that are not part of the DNB SFI register.

1996 to a staggering € 4,600 billion in 2006 – almost nine times Dutch GDP. This also confirms the increasing activity of SFIs in the Netherlands.

Figure 1: Number of and SFIs, 1977-2006.



Source: DNB Statistical Bulletin, various issues and DNB Quarterly Bulletin, various issues.

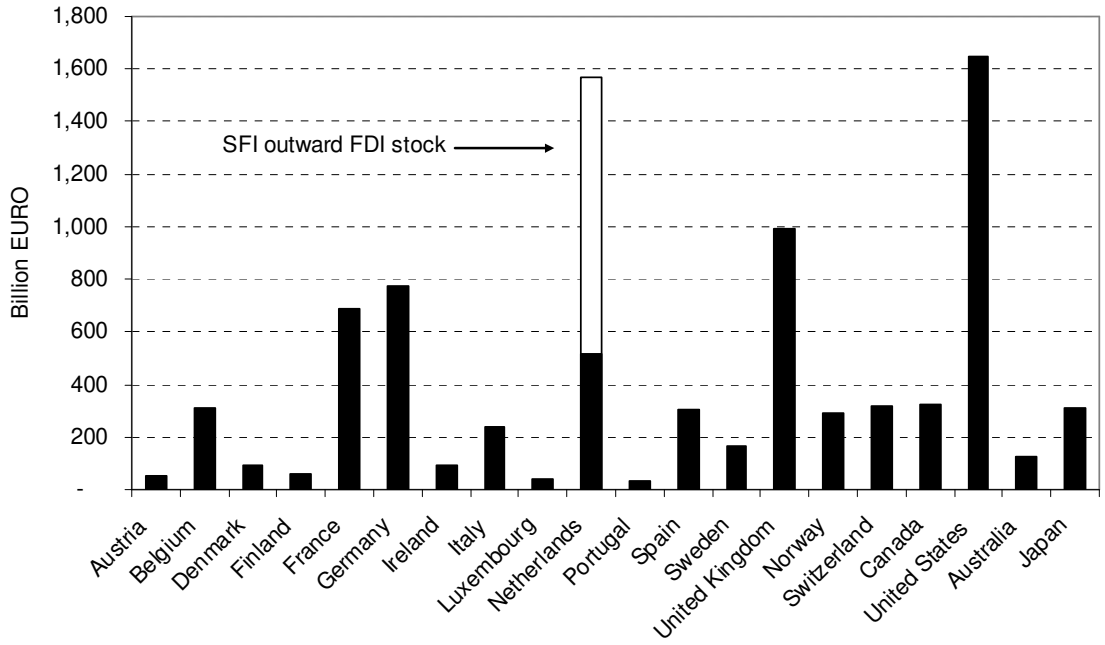
Note: The figures presented for 1977-1999 are based on charts and therefore not exact. There is no reliable date for 2001-2005.

4.3 Foreign direct investment via SFIs

SFIs mainly serve to route funds through the Netherlands and therefore have very few relationships with the Dutch economy. Hence, in order to separate FDI related with real operational business from that driven by tax avoidance strategies, DNB has decided to present annual FDI statistics net of SFI transactions.[7] In order to obtain a better understanding of the scope of SFI transactions in the global economy, Figure 2 compares the Dutch outward FDI stock *including SFIs* to the FDI data of some other economies.

[7] One of the reasons why DNB maintains a register of SFIs is to 'clean' certain statistics. The transactions of SFIs are so enormous that they would blow up the balance of payments and international investment position figures, rendering them useless for the analysis of international financial flows.

Figure 2: Outward FDI Stock, selected countries, 2005



Source: FDI stocks from UNCTAD (2006) and SFI FDI stocks from T5.11 and T5.15, DNB website: http://www.statistics.dnb.nl/index.cgi?lang=uk&todo=Balans (04-05-07).

Note: US$ values in World Investment Report have been exchanged in Euro using average exchange rate € 1 = $1.24, <http://www.statistics.dnb.nl/index.cgi?lang=nl&todo=Koersen> (02-05-007). Outward FDI stock of special entities comparable with SFIs for other countries, such as Luxembourg and Ireland, is not shown due to lack of data.

The figure shows that the outward FDI stock of SFIs by far exceeds the outward FDI stock of Dutch companies. When SFI transactions are not taken into account, the Netherlands comes fifth in terms of the size of outward FDI stock. However when SFI investments are included the Netherlands is the second largest foreign investor in the world, just behind the USA and far ahead of the UK, the number three largest investor. Not surprisingly, the figure for Inward FDI stock (not presented) shows the same pattern as that for outward investment stock. [8]

5 Consequences for developing countries

The Dutch tax regime that facilitate conduit structures and the presence of SFIs have important consequences for developing countries. These are summarized in the next section.

[8] In Europe, Luxemburg, Ireland and Cyprus (and possibly also Denmark) are frequently mentioned as countries with a favorable tax regime for conduit arrangements similar to those offered by the Netherlands. Outside Europe, Hong Kong is known for being used for round-tripping investments from and to China (UNCTAD, 2006; ECB, 2004). If data on special entities comparable with SFIs on such countries (not available) were also included in the figure, their total outward FDI stock might also have been substantially higher. However, given the longstanding reputation of the Netherlands as suitable for tax planning purposes and the already very high level of FDI stocks controlled by Dutch companies, it is unlikely that other countries' FDI stock including SFIs would have been higher than that of the Netherlands.

5.1 Negative effects

Conduit constructions and treaty shopping

The large and growing number of SFIs indicates that multinational companies increasingly use the Netherlands to plan their group tax structures. Channelling intra-group income and capital flows through Dutch finance, holding and royalty companies, in order to make use of the beneficial Dutch tax regime, suggests that tax is avoided in other countries. This tax would have been paid if the Netherlands had not been used as a conduit country to decrease withholding tax on interest and royalty payments. Through such constructions, income is sometimes shifted from a subsidiary in a developing country to a subsidiary in a pure tax haven in the form of royalties or interest. The direct result is a lower total tax burden for the multinational corporation, no or very low tax revenues on the income shifted to the pure tax haven, and some tax revenue on the operational margin in the Netherlands, at the expense of the developing country.

Regarding conduit constructions, there could be differences between industries. To shift income in the form of royalties, multinational corporations require intangible property, such as a registered trademark, brand name or patent, for which substantial royalties can be charged. It therefore seems that relatively R&D intensive multinational corporations, , which generate more intangible property, and companies which heavily depend on trademarks and brand names, have more opportunities for income shifting. This includes the pharmaceutical, electronics industry and food industry. However, there are also indications that royalties and interest are to some extent substitutes for income shifting (Grubert, 1998). If a multinational corporation does not hold substantial intangible property in pure tax havens, it might therefore use financing strategies to achieve tax avoidance instead.

The size of the income shifted through Dutch conduit subsidiaries and the associated negative consequences for developing countries are not known. The data required for such an analysis are not available. However, supporting data on the financial flows between SFIs and developing countries presented above, the promotion of such constructions by tax advisors (see Van Dijk et al, 2006), and anecdotal evidence of the use of such structures involving developing countries indicates they are used in practice.[9]

[9] An example of profit shifting using a royalty conduit structure is the case of SAB Miller, an Anglo-South African brewery. According to information in a magazine (Noseweek 2003a, 2003b) for over 25 years the company paid millions in royalties to its Dutch mailbox subsidiary that owned the trademarks of several of its beer brands. Through this, during the apartheid years, SAB avoided the exchange controls that were imposed in South Africa and successfully avoided paying any taxes in South Africa on the money's sent to these subsidiaries.

Group interest box, hybrid securities and hybrid entities

In 1997, the Netherlands introduced a special regime for Group Financing Activities (GFA). This regime offers an effective tax rate of 6-10% on the balance of interest received minus interest paid on loans to and from foreign affiliates. In 2003, the GFA regime was found to violate EU competition law and it is now being phased out. Less than a hundred companies were admitted to the GFA scheme, including large multinationals such as BHP Billiton and SAB/Miller[10], and for most companies the scheme expires in 2007 or 2008. A new law, replacing the GFA regime and offering similar benefits, currently awaits approval from the European Commission.

Multinational corporations using the scheme can increase loans from a Dutch group financing company to a subsidiary in a developing country to avoid taxation. The direct result is a lower total tax burden for the multinational corporation and a higher tax revenue in the Netherlands at the expense of the developing country.

There is some evidence from recent academic studies as well that multinational corporations indeed use intra-group financing strategies to reduce their total tax burden (Mintz and Weichenrieder, 2005; Grubert, 2003; Riesco *et al.* 2005). These studies are based on detailed financial data from individual subsidiary and parent companies. Other constructions, such as those involving hybrid participating loans or hybrid BV1/BV2 entities with a US parent, have similar effects for a developing country (Weyzig and Van Dijk, 2007).

Competition

The Dutch tax system provides opportunities for multinational corporations to reduce their tax burden, as described above. This provides them with a competitive advantage over smaller and less internationalised companies, including domestic competitors in developing countries. As the competitive advantage from tax avoidance is unrelated to operational performance, it is likely to distort market efficiency and does not contribute to economic development.

Facilitation of money laundering

As mentioned above, tax havens are often used for money laundering, embezzlement or other illegal financial activities. That this also applies to the Netherlands is corroborated by a recent study that concluded that the Dutch financial regime and SFIs are vulnerable to money laundering (Unger *et al.*, 2006). This could indirectly support undesirable activities in developing countries as well, such as corruption and illegal arms and drugs trade.

[10] Reports filled at the Chamber of Commerce by these companies mention the use of the CFA regime.

5.2 Discussion of negative effects

There have been questions as to whether the strategies mentioned above would make sense for operations in developing countries, because many multinational corporations obtain tax holidays or other tax incentives when they invest in these countries. As a consequence, subsidiaries in developing countries are exempt from corporate tax and pay withholding taxes only, so there would be no corporate tax to avoid in the first place. However, even though many foreign investors do enjoy generous tax incentives in developing countries, this does not mean that *all* foreign investment is completely exempt from corporate tax for an indefinite period. Academic studies using micro data show that some multinational corporations do pay corporate taxes in developing countries (Mintz and Weichenrieder, 2003; Grubert, 2003; Desai et al., 2003). A loss of corporate tax revenues is therefore still possible. It should also be recognised that corporate income taxes constitute a much larger proportion of total tax revenues in developing countries than in developed countries (Tanzi and Zee, 2000).

If tax avoidance strategies lower the tax burden on the operations of MNCs in developing countries, this could make it more attractive to invest in these countries. Thus, apart from income shifting effects, there may also be an effect on real business operations, and there is some evidence for this from actual behaviour of MNCs (Grubert, 2003). Higher levels of investment would mitigate the negative consequences of tax avoidance. It is unlikely that this would fully compensate for the loss of tax revenues, though, because tax avoidance would have similar effects as formal tax incentives and these effects are generally limited. This will be discussed in the section on coherence with development policy.

5.3 Positive effects

Apart from the negative effects above, the Dutch tax policy also has some positive aspects for developing countries. These would include the following:

- The participation exemption: The participation exemption, instead of a credit system, encourages investment in countries with a corporate tax rate lower than that in the Netherlands.
- Tax sparing credits: tax sparing credits encourage investment by allowing MNCs to benefit from tax holidays in developing countries without residual taxes applying in the Netherlands. Offering tax holidays is not always in a country's own interest, though. This will be explained in the next section.
- DTTs based on the UN model convention; The DTTs concluded between the Netherlands and developing countries all use the UN model convention for tax

treaties. In contrast to the OECD model treaty, they generally do not reduce withholding taxes on royalties and interest to zero but to some 10%. This is relatively favourable.

- Higher withholding taxes allowed under DTTs.

Apart from these specific aspects of the Dutch tax regime, it has been pointed out that the most important positive effect of signing a DTT is that it will help developing countries to attract more foreign investment. Although there are some studies which demonstrate a positive impact of tax treaties on FDI in rich countries, only very limited research on this topic has been undertaken with respect to developing countries. A recent study did find a positive relation between signing a tax treaty and FDI in developing countries, but noted that this finding only applied to middle income countries and not to lower income countries (Neumayer, 2006). Hence, there is no conclusive evidence that the overall effect of concluding a DTT with the Netherlands is positive for a developing country.[11]

6 Coherence with aid policy

6.1 Previous studies on coherence between Dutch aid and tax policy

The Netherlands aims to enhance coherence of government policy in other areas with its policy on development cooperation. Tax policy is highly relevant in this respect. The Dutch government is committed to providing high levels of donor financing, and its ODA expenditures have been fixed at 0.8% of GNP. Part of this sum is directly provided to governments of developing countries as bilateral budget support and as debt relief. Enabling multinational corporations to avoid taxes in developing countries, which lowers government revenues in these countries, therefore seems inconsistent with high levels of ODA to raise these budgets. There is also a more direct link between tax policy and the UN Millennium Development Goals (MDGs), aimed at halving extreme poverty by 2015. Tax issues related to MDG 8, which is supportive of the other seven MDGs, and more specifically to two of the seven more concrete targets that have been set for MDG 8. Almost by definition, international tax issues form an integral part of a financial system that is supportive of development and of a comprehensive solution for the debt problems of developing countries.

There has already been some attention paid to tax issues in Dutch development policy, especially from 2001 to 2004. In 2001, the Erasmus University Rotterdam (EUR) prepared a

[11] Even if it is assumed that DTTs will lead to more investment in developing countries, this does not automatically mean the effects are positive (see Summer, 2005).

position paper on tax competition among developing countries for the Ministry of Foreign Affairs (Bols *et al.*, 2001). The main conclusion of the paper is that tax incentives are not usually a decisive factor for MNCs when deciding whether or not to invest in a certain developing country, so they are usually ineffective. In January 2002, two months before the Financing for Development Conference in Monterrey, Mexico, former minister for development cooperation Herfkens referred to this in a speech:

"More state financing – ODA – cannot be the only response. We also need to work out more incentives for the middle income countries.[MICs] (…) But the MICs also have to do their own homework and revise present practices. I recently learned from an Oxfam report that development countries lose large amounts of income because of the so called fiscal measures (tax holiday). (…) The developing countries should realize that foreign investors first of all consider the enabling environment before deciding on investment. They will not deny the fiscal advantages but this is not what will attract them." (Herfkens, 2002).

The largest initiative on taxation from the Ministry of Foreign Affairs came in 2003, when it commissioned two major studies on tax policy and Dutch relations with developing countries. One study was conducted by the International Bureau on Fiscal Documentation (IBFD) and focussed on DTTs and tax administrations in developing countries (De Goede et al., 2004). The conclusions of the study included the following.

- "Generally the attribution of taxing rights in a tax treaty will limit the taxing rights of developing countries (…) and may thus lead to (…) a short-term budgetary loss.(…)
- A tax treaty can be viewed by the developing country as an important tool to promote its investment climate by providing foreign investors with more certainty about the tax consequences of their investment (…). Such improvements may generate additional foreign investment and employment and thus lead to increased tax revenue by way of additional corporate taxes, wage taxes, and sales taxes;
- Tax treaties are important instruments for tax administrations to counter tax avoidance and evasion through exchange of information and mutual assistance in the collection of taxes;
- Finally, it may be important from a political point of view for developing countries to conclude tax treaties (…) to strengthen international co-operation."

The study also notes that in view of the lack of quantitative data, it is difficult to draw a definitive conclusion from the qualitative analysis, but it can safely be assumed that the

hundreds of tax treaties that developing countries have concluded with developed countries indicate that many developing countries on balance attribute positive effects to these treaties.

The other study was again conducted by the EUR, and focussed on tax incentives offered by developing countries and income shifting through transfer pricing in trade with the Netherlands. With regard to tax competition, the study concludes that tax incentives might in theory be effective in attracting certain types of valuable FDI that are relatively tax sensitive, but in practice such considerations are not taken into account by developing countries when granting tax incentives, which makes them largely ineffective (Muller et al., 2004). The effect of tax avoidance on the size of foreign investment is similar to the effect of tax incentives.

The research finds little evidence of transfer pricing manipulation in trade with the Netherlands at the expense of developing countries. Although worldwide transfer pricing is one of most important mechanisms for income shifting and tax avoidance and evasion, this result might have been expected, because the relatively small differences in statutory tax rates do not allow large gains from transfer pricing in trade with the Netherlands.

With hindsight, it is striking that the Ministry of Foreign Affairs commissioned elaborated studies on all main tax issues relevant to developing countries, except tax avoidance through financing and royalty constructions. It is remarkable that even the IBFD study on tax treaties left out these issues, while they may be the single largest source of concern with regard to the coherence of Dutch government policy on tax and development. Other studies on tax and financing for development tend to overlook these particular issues as well (e.g. Martens, 2006).

It seems that since 2004, the Ministry of Foreign Affairs has not been considering Dutch tax policy and tax issues in general as a priority. Apparently, this is partly a result of the findings from the two studies conducted by the IBFD and EUR, which did not indicate any inconsistency between tax and development policy. In its MDG 8 progress reports of 2004 and 2006, the Ministry did not mention Dutch policy on tax issues at all (Ministry of Foreign Affairs, 2004, 2006).

6.2 Estimate of missed tax revenues

In order to illustrate the magnitude of consequences for developing countries, a rough estimate can be made of the missed tax revenues in those countries due to tax avoidance constructions involving Dutch SFIs. Data made available by DNB on the geographical

composition of SFI inward and outward investment stocks and flows confirms that SFIs are also used as vehicles for investment in developing regions. Estimates of missed tax revenues still involve many assumptions, however, because the calculations require other data as well, for example about the composition of SFI income, that is not readily available. The estimates are therefore necessarily imprecise. Furthermore, the DNB data distinguishes continents and geographical regions rather than groups of developing countries or low income countries. The regions below include important middle income countries according to the World Bank classification, such as South Africa, Brazil, China, as well as low income emerging economies, notably India. Only corrections made for high income countries are excluded these from the regional data.

The first three data columns in the table below, labelled 'FDI via SFIs', present investment positions of SFIs in the main developing regions of Africa, Latin America, and Asia, for the years 2003 to 2005. These investment positions are the total outward FDI stocks of SFIs, including equity investment as well as loans and other financial transactions to subsidiaries, parents, and other related companies that are part of the same group. SFI investments in Central America have been corrected to exclude tax havens in the Caribbean. Total inward FDI stocks in mainland Central America and in the Caribbean, from all sources worldwide, are roughly of the same size (UNCTAD, 2006). However, it may be expected that SFIs have relatively large investments in tax havens, and therefore it has been conservatively assumed that only 20% of SFI investment in the region is in mainland Central America, where it is strongly concentrated in Mexico. SFI investments in Asia, excluding the Middle East and Japan, have been corrected to exclude Singapore, Republic of Korea, Taiwan and Hong Kong. Inward FDI stocks in these four countries account for 59% of global investment of the region (UNCTAD, 2006) and for 68% of Dutch investments by non-SFI companies (DNB FDI statistics). Using these benchmarks, it has been conservatively assumed that the other countries in the region, including China and India, receive only 35% of total SFI investment in the region.

Table 1: Inward FDI stocks via SFIs and an estimate of missed tax revenues for 2005

Region	FDI via SFIs			Total FDI	Share	Tax missed	
	2003 (€ bn)	2004 (€ bn)	2005 (€ bn)	2005 (€ bn)[c]	SFIs (%)	Est. 1[d] (€ bn)	Est. 2[e] (€ bn)
Total Africa	10	10	13	213	6%	0.098	..[h]
Latin America excl Caribbean	32	40	46	555	8%	0.342	0.039
Central America excl Caribbean[a]	*13*	*18*	*21*	*192*	*11%*	0.155	0.009
South America	*19*	*23*	*25*	*363*	*7%*	0.186	0.030
Asia excl Middle East, JP, SG, KR, TW, and HK[b]	28	28	30	462	7%	0.199	0.062
Total developing regions	**≈ 70**	**≈ 80**	**≈ 90**	**≈ 1,200**	**7%**	**≈ 0.64**	**≈ 0.11**
Total all countries	**919**	**946**	**1,033**	**≈ 7,800[f]**	**13%**	**≈ 6.8[g]**	**≈ 1.8**

Source: DNB, unpublished data on SFIs, UNCTAD (2006).

Note: a 20% of total Central America to correct for the Caribbean; b 35% of total Asia excl Middle East and Japan (JP) to correct for Singapore (SG), Rep. of Korea (KR), Taiwan (TW), and Hong Kong (HK); c using average exchange rate € 1 = $ 1.24; d Estimate 1: assuming 5% -point of taxes missed on 15% return on investment on inward FDI stocks; e Estimate 2: assuming € 1 bn missed through financing constructions, proportional to non-equity stocks per region, and € 0.8 bn through royalties, proportional to total royalty payments per region; f excl SFIs and other FDI in the Netherlands; g based on all countries excl the Caribbean and Luxembourg; h estimate cannot be calculated due to data problems.

It is interesting to compare the investments of SFIs in developing countries with the total inward FDI stocks in these countries as reported in UNCTAD (2006). The total stocks are shown in the column 'Total FDI 2005' and the proportion of total investment for each region that is channelled through SFIs is shown in the column 'Share SFIs'. This proportion ranges from 4% for North Africa to 11% for Central America. On average, some 7% of all foreign investments in the main developing regions is held through Dutch SFIs. As a point of reference, the bottom row of the table shows the total for all countries worldwide, similar to the total in table 1, but excluding the Netherlands itself.

Estimating missed tax revenues requires a few further assumptions. For a relatively simple estimate, it is assumed that the pre-tax return on investment on operations in developing countries is 15%. This is in line with historical data.[12] Note that total income on FDI received by SFIs was approximately 5% (€ 53 billion of income on FDI over € 1,033 billion of total FDI stocks abroad). The income reported by Dutch SFIs does not consist of pre-tax profits, however, but of interest payments and of dividends and capital gains from after-tax profits. There could also be a significant effect from errors and omissions in the data. Still, it cannot be fully explained why total income on FDI received by SFIs is relatively low compared to

[12] UNCTAD, Foreign Direct Investment in Africa: Performance and Potential, UNCTAD/ITE/IIT/Misc. 15 (Geneva:UNCTAD, 1999), p. 18.

their total investment stocks abroad. Therefore it might be safer to use the more robust rate of 15% pre-tax return on investment.

It is further assumed that missed tax revenues amount to 5% of this pre-tax income, which is the same as assuming that on average the effective corporate tax rate abroad is lowered by 5 percentage points. This percentage can only be estimated. In reality, it may be lower, for example because SFIs are not that effective or because tax savings may be unevenly distributed among regions. SFI subsidiaries may also benefit from local tax breaks that should not be attributed to the SFIs or may use other tax avoidance mechanisms too, such as transfer pricing, that do not necessarily involve Dutch SFIs. However, as the main purpose of SFIs is to reduce the tax burden of multinational corporations, the percentage may be much higher as well. It is also possible that investments through SFIs in some developing regions are underestimated because they may sometimes be channelled via other developed countries, such as Hong Kong, Singapore, or Cyprus. Any estimate for missed tax between 1% and 10% of pre-tax income can probably be defended.

Note that the net gain to multinationals is always lower than the taxes missed in developing countries, due to the costs of tax planning and the lower tax charges that arise in other countries to which income is shifted. The latter include tax on the operational margins of SFis in the Netherlands, which is more than € 1 billion. The total missed tax revenues in all other countries worldwide must therefore be assumed to be at least as large as this, and probably several times as large. The simple estimate described above implies total missed tax revenues worldwide of € 6.8 billion, of which some € 640 million in developing regions and roughly € 76 million in Sub-Saharan Africa. The estimate is shown in the table as 'Tax missed, Est. 1'.[13] Note that it is also assumed here that the revenue effect of lower effective taxes is not substantially offset by increased foreign investment, as discussed in the previous section.

Only part of these missed tax revenues would be recovered were the Netherlands to take effective measures to eliminate possibilities for international tax avoidance. There are two reasons for this. Firstly, it is sometimes argued that without the international tax avoidance opportunities offered by the Netherlands, the investments in developing countries would not have taken place in the first place. However, we expect that this only has a marginal effect

[13] If is assumed that missed tax due to financing constructions is proportional to SFI debt financing stocks in a region instead of total SFI investment stocks yields a second estimate, shown in the table as 'Tax missed, Est. 2'. This estimate is more conservative with total tax avoidance of € 1.8 billion, and taking into account that total missed taxes worldwide must be well over € 1 billion, it is in fact a minimum estimate. It also yields a more conservative distribution over regions, with developing regions carrying a smaller proportion of the burden. Developing regions are therefore missing out on at least € 100 million of tax revenues. See Weyzig and Van Dijk (2007) for details.

because tax considerations are usually of secondary importance in international investment decisions, especially for production or sales locations. The second reason is more important. If harmful conduit and group financing structures would no longer be possible via the Netherlands, many multinationals using these would change their tax planning strategies and use subsidiaries in other countries to achieve the same effect. The alternative strategies will probably be somewhat less attractive and less tax would therefore be avoided in developing countries. However, tax avoidance will continue via other countries. Therefore international cooperation to fight harmful tax avoidance is essential.

6.3 Causes of policy incoherence

Although no specific written policy of the Dutch Ministry for Development Cooperation on tax revenues in developing countries could be found, the facilitation of corporate tax planning constructions can be considered incoherent with the bilateral ODA and the general commitment of the Dutch government to MDG 8. The causes for this policy incoherence will now be analysed, applying the three dimensions of the analytical framework presented in Section 2.

First, the lack of PCD appears to be largely unintended. In a debate in the Dutch Senate and in meetings with the Ministry of Finance, is was emphasised that Dutch tax policies were not intended to harm developing countries. Any harmful effects for those countries were described as unwanted side-effects.

Second, the incoherence is structural in nature rather that temporary. The interest of large MNCs to minimise their global tax burden through profit shifting is inherently conflicting with the interest of developing countries to increase their tax revenues. The Ministry of Finance is mainly concerned about the Dutch business climate and has a track record of actively attracting financing activities of large multinationals.

Third, the lack of PCD appears to have both institutional and political causes. Currently institutional shortcomings are dominant, because neither the Ministry of Finance nor the Ministry of Development Cooperation assesses the impact of Dutch tax policies on developing countries. However, if institutional arrangements to compare policy goals and impacts were present, this would expose the inherently conflicting policy priorities of the development and finance departments and could therefore reinforce the political barriers to PCD.

7 Conclusions

The main aim of this study has been to investigate if and to what extent the tax haven features of the Netherlands are harmful for developing countries and whether there is an incoherence between the Dutch Aid and tax policies. The study presented new data and calculations on the operations of Special Financial Institutions (SFIs). These are Dutch subsidiaries of foreign multinationals used for international tax planning constructions. At present, the Netherlands hosts 12,000 SFIs. The amount of foreign direct investment (FDI) that is channelled through these SFIs is enormous. Together, they control over € 1,000 billion of assets or 13% of global inward FDI stock. If this data would added to FDI by Dutch companies, the Netherlands would be the second largest investor worldwide, just after the US and far ahead of the UK, the third largest investor. In 2005, SFIs had invested approximately € 90 billion in developing countries. This was 7% of total FDI in these countries.

SFIs can be divided into financing companies, holding companies, and royalty companies. The financing companies generate the largest volume of transactions. Some of the most important potentially harmful tax avoidance constructions used by SFIs are royalty and financing conduits and the Dutch Group Financing Activities (CFA) regime, which is being phased out. It has been replaced by a new 'group interest box' that is currently being investigated by the European Commission and has not yet entered into force. Some of these regulations, such as the previous CFA regime and a future group interest box, are unique for the Netherlands. Other constructions, such as royalty and financing conduits, could in principle use alternative conduit countries as well.

Apart from being a tax haven for MNCs, the Netherlands is also a donor country for international development. As such, it supports the UN Millennium Development Goals (MDGs) of halving world poverty by 2015, including the instrumental MDG 8 to develop an international financial system that is supportive of poverty reduction. In 2006, the Dutch government provided € 4.3 billion in Official Development Assistance (ODA). This report has estimated that as a consequence of the tax haven features of the Netherlands, developing countries are missing € 640 million in tax revenue per year. This equals 15% of the Dutch official aid budget. A more precise estimate would require more detailed data on the composition of SFI income.

In addition, the Dutch tax regime that causes a market distorting tax advantage for MNCs over smaller domestic competitors in developing counties. Finally, it should be noted that Dutch tax policy also has some positive aspects for developing countries. However, there is

insufficient data available to substantiate the positive effects, let alone to sustain claims that these would compensate for the negative effects.

The Netherlands being a tax haven for multinationals therefore has important negative consequences for developing countries. This raises the question of whether Dutch tax policy is coherent with Dutch policy on development cooperation. The Ministry of Foreign Affairs already recognised the coherence aspect of tax policy and development policy in the past. However, it appears that the large role of SFIs in tax avoidance and the associated amount of missed tax revenues in developing countries have largely escaped attention until recently. The lack of PCD is therefore unintended, which is related to the lack institutional arrangements to align tax and development policies. However, the causes of policy incoherence are also structural and political in nature.

Finally, it should be recognised that tax avoidance is an international problem. If the Netherlands were to eliminate opportunities for harmful tax avoidance while other countries, such as Luxembourg and Switzerland, continue to offer this type of construction, a large part of the missed tax revenues would not be recovered. It is likely that many multinationals would simply continue avoiding taxes using constructions via those countries instead. On the other hand, Dutch financing conduits may also facilitate tax avoidance via other countries as they can be used as a conduit to reinvest the untaxed income. Ending such structures could have a broader impact beyond the use of Dutch SFIs as well.

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