

A stylized world map composed of a grid of grey dots, with several dots highlighted in red to represent specific countries or regions.

# Tax Havens and the Taxation of Transnational Corporations

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- Tax avoidance and tax evasion by transnational companies and the role played by tax havens have recently received much media attention, when it transpired that prominent companies such as Starbucks and Apple pay virtually no income taxes on their massive international profits. The case of the world's largest commodity trader, Glencore, demonstrates that tax evasion by multinationals also affects developing countries. Tax issues and the detrimental role played by tax havens are now firmly on the international policy agenda, for example at the G20.
- Transnational companies employ a number of techniques to benefit from the cross-country nature of their transactions, as well as from loopholes and contradictions in the tax legislation of countries involved to evade and avoid taxes. The paper discusses the role of tax havens and preferential tax schemes, the abuse of intra-firm transfer pricing, and describes how different treatment of companies in different countries can result in »double non-taxation«.
- Various approaches to deal with these challenges exist, but have to be improved and strengthened. This goes for transfer pricing rules, transparency requirements (such as country-by-country reporting, centralised registers providing »beneficial ownership« information), and deductibility restrictions; anti-avoidance measures such as blacklists, the elimination of the abuse of double taxation agreements (e.g. »treaty shopping«); or the wider use of withholding taxes, especially in the case of developing countries. Given the tremendous shortcomings of the current transfer pricing system, a system change in the form of »unitary taxation« needs to be further thought through and tested.



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# 1. Globalisation, Tax Havens, and the Taxation of Transnational Corporations

## 1.1 Introduction

The taxation of transnational corporations (TNCs) has caused heated debates and generated strong criticism from civil society in recent years. In the United Kingdom (UK), protesters seized Starbucks branches in early 2013, accusing the company of evading taxes. Many of the large Internet and computer companies – but also companies from other sectors – based in the United States (US) are suspected of paying almost no taxes there, on their overseas profits. In 2011, Argentina accused Glencore, the world's largest commodity trader, of tax evasion. In spring 2013, the release of an extensive database on tax haven activities («offshore leaks») pushed the global debate even further.

The G20 have been examining the issue of tax havens for some time, stating in 2009 that «the era of banking secrecy is over». Together with the Organisation for Economic Co-operation and Development (OECD), they set up a blacklist of tax havens – which, however, was soon empty. In 2011, they renewed their commitment with strong rhetoric and released another blacklist. Currently, G20 finance ministers are again attempting to deal with the issue, and at their meetings in February and April 2013, took some preliminary decisions to intensify efforts to tax TNCs. In support of the G20, the OECD released its report «Addressing Base Erosion and Profit Shifting», which illustrates aggressive tax avoidance methods (OECD 2013). For the September G20 summit, the OECD will present an action plan to be endorsed by the heads of state.

This text is an introduction into the debate on taxing TNCs. It gives an overview of the primary techniques TNCs use to evade and avoid taxes, the role of tax havens for tax evasion schemes, and solutions to the problem. Given the complexity of the issue, this text is neither exhaustive on tax havens in general, nor on the taxation of corporations in specific, but shows how these issues are linked.

## 1.2 Corporate Taxation in the Globalised Economy

In general, the taxation of companies and business activities is a difficult task for states. While it is clearly reasonable to tax a share of a company's profit, it is less clear

exactly what should or should not be taxed; this includes, for instance, the question of which costs are deductible from the taxable profit. The problem is worsened by the fact that wealth is no longer strictly tied to tangible assets, such as factories, but also to intangibles, like intellectual property rights. This includes patents or licences that generate cash flow through royalty payments or fees.

The difficulties of taxation are multiplied by any transnational business activity. If there is a company that is active in two different countries, it is not easy to determine which country has the right to tax the profits: Is it the country where the parent company is located? Or is it the country where the affiliate is doing the actual business? And what about modern forms of business where activities are no longer tied to easily traceable factories, but can be undertaken from any place in the world with global outreach, or carried out in the virtual space of the Internet? On what basis can countries still claim the right to tax profits from these types of global or even virtual activities?

There can be no definitive answers to such questions, if for no other reason than the fact that all states are justified in defending their right to tax, in the interest of their citizens. In any case, some answers can be offered after first looking closer at the techniques and conditions that corporations use today to avoid and evade taxes and minimise their tax burden.

## 1.3 Tax Havens and Tax Competition

Tax havens add an additional element to the basic problem that globalisation means for taxation. Generally speaking, tax havens are jurisdictions that allow companies and individuals to evade taxes. This evasion can be illegal but there are also legal techniques that are routinely used by multinational firms in particular.

It is hard to define a tax haven. In their seminal book, *Tax Havens: How Globalization Really Works*, Palan, Murphy, and Chavagneux write: «There is no universally accepted definition of a tax haven» (2010). It is important to note that there are often certain practices that make up a tax haven and they can, to a certain extent, occur in almost any country in the world. This being the case, it is often more appropriate to speak of «harmful tax haven practices» than of some countries being «tax havens» and others not.

Notwithstanding the difficulties with the definition of a tax haven (practice), there are typically three criteria. First, there are low taxes or no taxes at all for certain assets (intellectual property rights, bonds, shares), often only granted to foreign residents. Second, there is a low level of regulation regarding legal entities such as companies, foundations, or trusts. This can mean, one does not need any initial capital to set up a legal entity, can hide the real ownership of that entity, or does not face strong due diligence requirements. Third, strong secrecy is guaranteed: for example, through secret bank accounts, no public registration of entities, or no cooperation with foreign tax authorities. A tax haven does not necessarily have to meet all three criteria, but they usually do.

Moreover, tax havens are not only remote islands or small countries such as Switzerland and Liechtenstein. Large developed countries also engage as tax havens and allow for such practices. For example, the US state of Delaware is home to affiliates of many TNCs. In Europe, the Netherlands provides very favourable conditions for some forms of business, and Ireland's entire »business model« has been based on low corporate taxation. Another example is the UK, but in this case one feature is particularly important, as Shaxson (2011) explains: here it is the combination of a financial centre in a developed country (the City of London) with a network of small island tax havens, which – despite a certain independence – effectively belong to the UK as so-called crown dependencies (like Jersey) or overseas territories (like the Cayman Islands, the Bermudas, or the British Virgin Islands).

There have been many lists that attempted to enumerate all of the existing tax havens, or at least make a quantification of a country's tax haven »quality«. This includes a blacklist by the OECD from 2009 – which, however, quickly became empty and currently does not list any countries at all. The OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes has undertaken an international review for a large set of countries, with many of them not meeting all of the necessary standards. Another example is the Financial Secrecy Index by the Tax Justice Network, which weighs the financial secrecy of a country with the size of its cross-border financial sector. It first appeared in 2009, then in 2011, and will be released again in November 2013. In 2011, the highest-ranking country was Switzerland, followed by the Cayman Islands, Luxembourg, Hong Kong, and the United States.

While some economists would argue that tax competition is a suitable means of preventing excessive taxation, the impact should not be downplayed. Tax havens are a threat to a fair economy and to a social and democratic state. The aggressive tax policy practised by tax havens forces other states to compete and to lower taxes as well. When countries are forced to lower taxes in this manner, eventually there will no longer be any countries able to generate sufficient tax revenues. Without the ability to tax corporations sufficiently, states will either have to increase taxes on labour, incur debts, or scale down their activities – with negative effects on social justice, public services, and infrastructure.

Most tax havens practices do not involve a transfer of real economic activity to these jurisdictions, but merely a shift on paper that allows for tax avoidance. This is not a fair competition but a dangerous race to the bottom, which ultimately benefits transnational corporations and their wealthy shareholders. Moreover, because tax havens favour big and transnational companies, small and medium enterprises or purely domestic firms normally cannot use them and are thus at a competitive disadvantage. Finally, tax havens set improper incentives, because investments are not solely determined by an efficient capital allocation but also by tax advantages. Hence, companies not only look for the best place to do business, but also for the best place to avoid taxes.

## 2. How Transnational Corporations Avoid and Evade Taxes

### 2.1 Figures on TNC Tax Avoidance and Evasion

The scale of revenue losses by states resulting from aggressive tax planning practices of multinational firms is difficult to estimate. As will be discussed later, the line between illegal tax evasion and legal tax avoidance is blurred, and any analysis of TNCs is limited by the lack of transparency of their business. Thus, any figure must be taken with great caution – which is particularly true for overall, global figures.

What remains largely unquestioned, however, is that corporate income tax rates have gone down in recent decades in almost all OECD countries. But as the tax base – profits that can be taxed – has often been

broadened, it is less clear how revenues from corporate income taxes have developed; for example, measured as a share of total tax revenue, or as a share of GDP. There are some studies that are reluctant to say that globalisation has had a strong effect on taxes paid.<sup>1</sup> Nevertheless, there is still strong evidence to suggest that there is an increase in the avoidance and evasion of corporate taxes.

In the US, researchers have estimated a minimum tax evasion by TNCs and international banks of 37 billion US dollars annually (Klinter et al. 2010). In the UK, the British NGO ActionAid has calculated an annual tax avoidance of 840 million British pounds for the 100 largest groups listed on the London Stock Exchange (2011). In Germany, where corporations have no strong reporting requirements, the availability of data is particularly poor. However, some studies have tried to calculate the gap in the profits reported by the TNCs and the sum that one could expect from macroeconomic data on the German economy. The gap ranged from 60 billion euro (Heckmeyer and Spengel 2008) to 100 billion euro per year (Bach and Dwenger 2007). This means that the annual tax loss for Germany reaches at least a two-digit billion euro sum.

Fuest and Riedel, who reviewed some of the studies and figures, offered a somewhat critical assessment of the evidence presented (2010). In their own calculations, however, they also found indications of tax avoidance facilitated by tax havens: »Among multinationals, the lowest average tax rate is faced by firms which belong to multinational groups with a tax haven linkage«.

A study commissioned by ActionAid, which is also a response to some of the criticism raised by Fuest and Riedel, found that TNCs operating in India that have tax haven connections report 1.5 per cent less profits, pay 17.4 per cent less in taxes per unit of asset, and pay 30.3 per cent less in taxes per unit of profit (Janský and Prats 2013).

Taken together, this provides a worrisome picture of tax avoidance by multinational corporations in general. But exactly how do they avoid taxes? This is explained in the following sections.

1. For more information, see and Kumar and Quinn (2012).

## 2.2 Low-tax Countries and Preferential Tax Regimes

A country's autonomy with regard to their national taxes provides an incentive to attract investment from abroad by lowering tax rates. Even though companies will not come to a country solely because of a low tax rate, they do take this into account when making investment decisions. To a certain extent, such a strategy pays out for this country. A particularly good example of this is Ireland. With general corporate tax rates of 10 to 12.5 per cent, Ireland has attracted a lot of investments in recent decades. With the revenues generated by investors, Ireland was able to bring its public debt level to the lowest in the EU.<sup>2</sup>

The tax policies of Ireland and a number of new member countries from the former Eastern Bloc, however, forced other countries in the EU to also lower their corporation taxes, in a race to the bottom or »downhill competition« for lower taxes, resulting in a decline of average corporate tax rates in the »old« (EU-15) member countries from 38 to 29 per cent between 1997 and 2007 (Genschel et al. 2011).

Instead of generalised low corporation taxes, countries can also provide tax exemption or tax reduction for certain investments, sectors (»tax holidays«), or geographical areas (e.g., export processing zones). There is no denying that part of the economic success of many countries – both developed and developing – is also based on special economic areas that have more favourable tax conditions.<sup>3</sup> However, this still undermines a country's tax base and could leave it with insufficient tax revenues.

It is not easy to say at which point a preferential tax regime should be considered as tax haven practice or, to put it differently, if such a regime is a harmful practice at all. As Palan, Murphy, and Chavagneux note, »the majority of states in the world offer a plethora of fiscal incentives to selected industries and sectors, described in academic and policy jargons as Preferential Tax Regimes. Because there is no clear line dividing PTRs from tax havens, the use of tax as the criterion for assessing

2. Yet during the financial crisis it became clear that Ireland is not a sustainable economy: after the bursting of a real estate bubble and a deep recession, it is once again among the countries with the highest public debt in the EU.

3. This includes China, for example, which has the highest illicit capital outflows in the world (GFI 2012).

whether a location plays a questionable role in the financial markets is always going to be fraught with difficulties» (2010). Hence, they concentrate on the secrecy element in defining tax havens.

Tax holidays can also be granted for certain legal types of corporations – such as holding companies that serve as umbrellas for affiliates around the world, collecting certain financial flows or assets. Preferential tax regimes for holding companies, for example, are offered by Belgium and Switzerland. A similar offer is a so-called conduit, which allows a corporation to channel money through a country and benefit from a favourable tax rate; this is possible, for instance, in the Netherlands, Luxemburg, and Mauritius. The attractiveness of such preferential tax regimes or conduit countries can be massive: for example, 30 to 40 per cent of all of India's investments come from the small island of Mauritius. However, this money did not actually come from Mauritius initially but from other countries, often even from India itself, and is thus just being circulated through Mauritius for tax reasons («round tripping»).

Similar investment patterns exist for other countries as well. In 2010, the British Virgin Islands were the second largest investor in China (14 per cent), after Hong Kong (45 per cent), and before the United States (4 per cent); whereas the top investor into Russia was Cyprus (28 per cent), followed by the British Virgin Islands (12 per cent), the Bermudas (7 per cent), and the Bahamas (6 per cent) (OECD 2013).

Holdings and conduits can still generate something similar to real economic activity in these tax havens; for example if some staff are administering the holding. As mentioned before, however, this is quite different from the real investments attracted by a low-tax country, because such holdings or conduits often do not in fact involve measurable – or at least appropriate – economic activity but are essentially letterbox companies.

Some countries – like the Netherlands, Cyprus, and Luxemburg – also allow for company-specific tax rulings where a tax rate is directly negotiated between the company and the tax authority; but this information is very hard to acquire. Special tax treatment for individual companies is not the preserve of tax havens. It is practised in many countries, often to attract foreign direct investment, even though not as bluntly and less extensively than in outright tax havens.

While it is correct that low taxes will not typically be the only criterion for a tax haven, aggressive tax offers – even if they are fully transparent – should also be seen as a tax haven practice. However, the levels from which low corporate taxes should be considered tax haven practices is debatable and answered differently in different countries.<sup>4</sup> Generally speaking, the question is whether companies end up paying (almost) no taxes, or if a jurisdiction is still upholding reasonable taxation for companies.

### 2.3 Transfer Pricing and Its Abuse

Today, global trade occurs not only between independent companies, but also between entities that belong to the same company – either between affiliates and the parent company, or between affiliates of the same parent company. Even if this intra-firm trade is not trade in a strict sense, it shapes the reality of trade today and companies need to find intra-firm prices for the flow of the goods. Estimates suggest that a large share of global trade is now intra-firm; for example, for the exports of eight OECD countries it ranges from 22 to 65 per cent (Lanz/Miroudot 2011).

Intra-firm trade makes it possible for TNCs to shift costs and profits internally and across borders from one country to another. This encourages one of the most prevalent methods of tax avoidance, because the company can shift costs and profits in a way that is most tax favourable for the corporation as a whole. The basic mechanism for this is simple: costs are shifted to companies in countries with high taxes, and profits are shifted to companies in countries with low taxes. The effect is that in the high-tax country, the costs will be deducted from the profit, so little or no taxes need to be paid there. And for the profit in the low- or no-tax country, little or no taxes are paid either. As a result, the TNC as a whole can save large amounts on taxes. The importance of such practices has been confirmed in a recent review study: »We synthesise the evidence from 23 studies and find a substantial response of profit measures to international tax rate differentials. (...) Our results suggest that transfer pricing and licensing is the dominant profit shifting channel« (Heckemeyer and Overesch 2012).

4. For two practical examples (Brazil, Germany) see p.14.

While it is reasonable that a TNC will structure its internal flows in the best way legally possible, it is also clear how massive the loss in tax revenues would be if transfer prices were independently determined by the TNC. That would mean that it could just sell worthless goods for millions. Even faked transfers can happen. Apart from such extreme examples of mispricing, the practice can also occur on a much smaller level.

Historically, the problem with transfer pricing has been primarily with physical goods, because they represented the bulk of international trade. However, the principle is applicable to all kinds of goods. As intangible goods – such as intellectual property rights (licences, patents, etc.) – have become more and more important in international business, so has their role in mispricing.<sup>5</sup> To illustrate: a TNC can set up a company in a tax haven, where it does not have to pay taxes for licencing fees. This company then holds the rights to the brands of the TNC. Any of its affiliates around the world will then have to pay the licencing fee to this company. The principle can also be applied to loans that are taken out by affiliates in high-tax countries – where interest payments reduce the company's tax burden – from affiliates in countries that impose no or low taxes on interest income, or where dividends are not taxed.<sup>6</sup>

It is hard to say how much tax revenue states lose due to transfer pricing, but various estimates indicate that this is a serious problem. In 2010, transfer pricing misuse was responsible for 80 per cent of the 859 billion US dollars in illicit outflows from developing countries, according to the Washington-based think tank, Global Financial Integrity (2012).

## 2.4 Qualification »Mismatches« and Derivatives

A relatively new form of tax avoidance is based on the different treatments of entities and financial instruments in different countries.<sup>7</sup> Such cases seem to be a growing concern for many tax authorities but there is also uncertainty on how often they indeed happen. There are various forms of this, but one example is as follows (Figure 1). A parent company in country A has an affiliate company in country B. The affiliate establishes a so-called hybrid entity, which is not clear in its final affiliation: coun-

try A assumes that it belongs to the parent company for tax purposes, while country B assumes that it belongs to the affiliate. If the hybrid entity takes out a loan, country A and country B will both allow the parent and the affiliate to deduct the interest from the profit. So the interest is deducted twice and there is a double non-taxation based on one loan. A similar problem can arise if a country allows for so-called dual-residence companies – i. e., countries that have their residence in two countries at the same time. Ireland, for example, has companies that are legally based in Ireland but at the same time based in another country – typically a tax haven, such as the Bermudas – with no or low taxation of corporate profits.

A similar effect can occur with derivatives, which are financial instruments that derive their own value from the value of an underlying asset like a commodity price. Derivatives were actually invented to hedge price risks of companies. However, as even derivatives textbooks admit, derivatives can also be used for tax avoidance. This can be the abuse of different treatment in different jurisdictions, as described above; or derivatives can be used to implement a hedging pattern that does not make sense in terms of maximising profits, but is in fact only designed to shift profits between subsidiaries and parent companies to reduce the tax burden.

## 2.5 The Examples of Glencore, SAB Miller, IKEA, and Apple

One of the most striking examples of tax evasion practices is the multibillion corporation Glencore, the world's largest commodity trader. Based in Switzerland, Glencore channels its profits through various tax haven structures. Fortunately, Zambia, a country affected by Glencore's activities, has decided to examine Glencore's activities more closely. Unsatisfied with the tax information provided by Glencore in relation to its investments in the Mopani Copper Mine (MCM), the Zambian government commissioned an independent audit by Grant Thornton and Econ (2010). The results of the audit clearly showed that Glencore evades taxes by the following methods, amongst others:

- Unreasonably high operating and labour costs: the report found that »at least USD 50 million of the USD 90 million is (...) unexplainable«. Glencore apparently doubled its staff costs within one year without any increase in the number of employees.

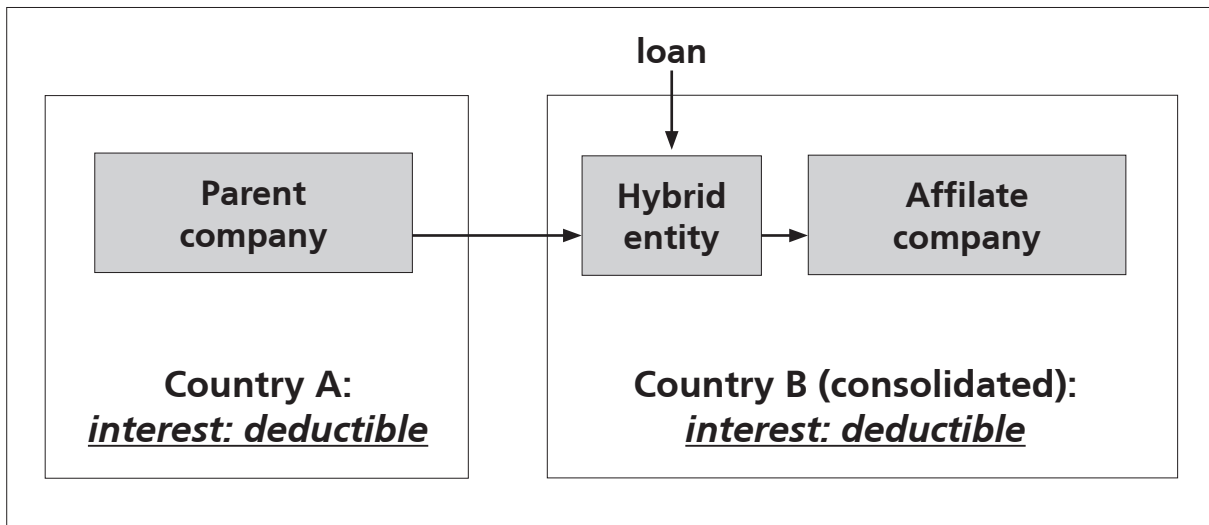
5. For information on patents, see Karkinsky and Riedel (2012).

6. For more information, see Dharmapala and Riedel (2012).

7. For an overview, see OECD (2012).



Figure 1: Hybrid mismatch



- Unreasonably low production: the report found »it is not to be trusted that Mopani has an extraction percentage of cobalt that is half that of other producers«. The activity of the mine is obviously understated in order to assign less taxable profits to it.
- Unreasonable sales: the report found that copper and cobalt were sold at deflated prices – compared to London Metal Exchange prices – from Mopani to Glencore International. This means that the mine would have made an unfavourable deal for itself, but a favourable one for the Swiss-based Glencore International, which pays little tax for its commodity trading.
- Unreasonable use of derivatives: the report found that »the hedging pattern (...) is more equal to moving taxable revenue out of the country than true hedging«. The problem with Mopani’s use of derivatives was that the mine was actually securing low prices for itself, while the mine normally should be expected to use hedging to achieve exactly the opposite – i. e., securing high prices.

The British NGO ActionAid has estimated that through these methods, Glencore paid an estimated 76 million British pounds fewer taxes between 2003 and 2008 per year in Zambia (2012).

Another example is the world’s second largest brewery, South African Breweries Miller (SAB Miller). Even though it is able to expand rapidly and has affiliates in

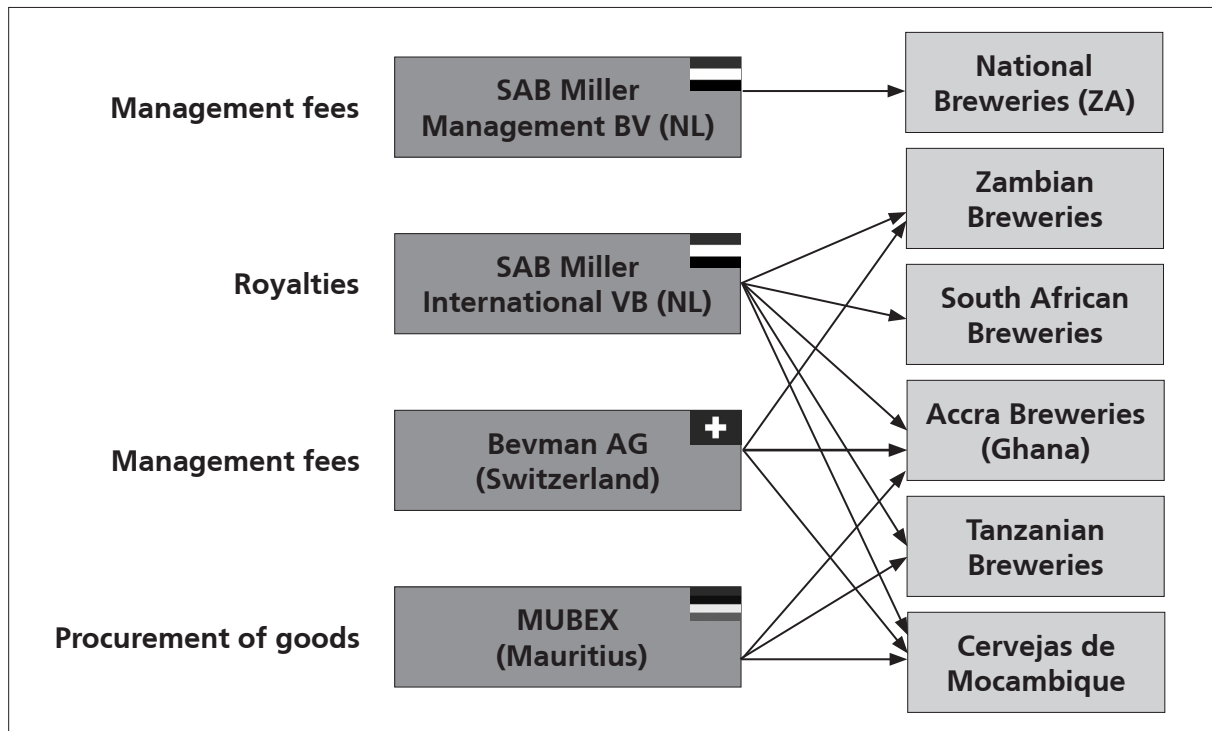
many countries around the world, particularly in Africa, it had reported little or no taxes in many of the affiliates’ host countries. The reason for this, as research by ActionAid (2010) has shown, is a worldwide net of tax haven affiliates through which all profits are being channelled (Figure 2). Amongst others, there are affiliates in the Netherlands and Switzerland that take management fees, there is another affiliate in the Netherlands that takes royalties for using brands, and there is an affiliate in Mauritius that is responsible for the procurement of goods. While there may be other reasons than taxes – such as centralised services, etc. – the effect of this tax haven net appears to be a huge tax gap for many countries where SAB Miller operates. To investigate this gap, several African governments started an investigation into SAB Miller’s tax planning, which is ongoing.

A third example is the world’s largest furniture and home interior company, IKEA. Its founder, Ingvar Kamprad, is not only one of the richest men in the world, but he also lives in a Swiss canton where his taxes are based only on the value of his house – not on his income. But Kamprad is not only trying to avoid personal taxes; he has set up a tax haven network for his company, which allows IKEA to drastically lower its tax rate. IKEA’s shops all pay royalties to a holding company called »Inter IKEA Systems«, which is based in the Netherlands and where the royalties can be amassed tax-free. Other payments go to foundations in the Netherlands and in Liechtenstein. It has also been reported that IKEA affiliates take





Figure 2: SAB Miller’s affiliates



Source: Hearson 2011.

out loans from one holding entity in Switzerland, which allows them to deduct the interest paid to the holding entity, which can collect the interest itself again tax-free (Jarass/Obermair 2007).

Fourth, various examples of how a preferential tax regime in combination with certain favourable tax rules end up in tremendous tax savings are provided by a number of well-known, US-based TNCs such as Apple, Amazon, and Google. They can use a rule in the US tax law, which says that profits in foreign countries are not taxed in the United States as long as they are not brought back («repatriated») to the US. They avoid taxation abroad; for instance, by setting up a structure of wholly-owned subsidiaries famously dubbed the «Double Irish with a Dutch sandwich», which involves Ireland, the Netherlands, and the Bermudas – a scheme that was first practised by Google Inc. in 2003. The Irish affiliate has dual-residence with the Bermudas and is channelling the profits through another Dutch affiliate. Through this scheme, profits are shifted to the Bermudas, which are not taxed at all because the Bermudas don’t impose corporate income tax. Apple is reported to have an effective tax

burden on its foreign business of only 4.7 per cent (Sullivan 2012). This tax level is in sharp contrast to the economic success that they publicly celebrate. Furthermore, even though Apple would be taxed when they repatriate the profits to pay out dividends to their shareholders in the United States, they can simply circumvent the repatriation – and subsequent taxation – by using loans to finance such payments, as they have recently demonstrated.

### 3. International Rules and Solutions

#### 3.1 Transfer Pricing Rules: Arm’s Length Principle and Substance Clauses

As has been shown, the problem underlying almost any tax evasion problem associated with TNCs is that relationships that normally occur between separate entities from different owners occur between entities belonging to the same owner. Therefore, the core solution to this problem has thus far been to compare intra-firm transactions with comparable transactions between unrelated entities or enterprises – and then require the

intra-firm trade to be the same as the extra-firm one. This approach became known as the »Arm's Length Principle« (ALP).

While this solution sounds logical and simple at first glance, one can also imagine where the problem lies: it takes a lot of work to determine whether a company is following the ALP for all its transactions. Furthermore, the correct comparable price is not easy to find, since many transactions are unique. To sidestep this problem, there are various methods that attempt to improve the calculation of comparable prices; they include, for example, the »cost plus« method, where the production costs of the goods are calculated, and then a reasonable profit margin is added.

However, there are many goods that are hard to compare, no matter which calculation method is applied. This is particularly the case for intangible goods such as intellectual property rights. Patents or licences are by definition unique. This is exactly why they are property rights. It is therefore extremely difficult, if not impossible, to find a comparable price for these goods.

The application of any transfer pricing rule – and any other tax rule – is normally attached to the condition that there is real economic activity by the separate entities. Thus, the definition and control of this condition has a vital role for fighting tax evasion. The space between obvious letterbox companies and large-scale factories is vast. Nevertheless, there are indications that although many countries do not permit letterbox companies on paper, the reality is different.

In the Netherlands, for example, it is apparently enough to register a company and have an address to be accepted as a real company. Even if it is not that simple all the time, it is often possible to engage in large-scale sales, etc. with very little staff. With its tax privileges for holding companies, Switzerland has attracted affiliates of all big commodity multinationals and is now the biggest commodity trading location in the world – even though it has almost no commodities of its own. This is how large amounts of money move to Switzerland and are no longer taxable in the extraction countries; which sheds light on the problem that, even if there is real economic activity in Switzerland, it does not actually mirror the economic activity in the different countries concerned. If the main business is still in the extraction countries, it is inappropriate that Switzerland gains a large part of the profits.

Given such problems with the adequacy of a company's activity compared to the taxable income, stricter criteria for what constitutes economic activity could be a partial solution to the problem.

### 3.2 Country-by-Country Reporting and Beneficial Ownership

Transparency is key to many problems around tax evasion. Accordingly, information on transnational companies is required that reveals the geographical distribution of their corporate figures – assets, staff, sales, etc. – on the one hand, and their payments to governments, including taxes, on the other; this often referred to as »country-by-country reporting« (Murphy 2012). It is then possible to compare the two across countries and detect any mismatches between them.

At the international level, the Extractive Industries Transparency Initiative (EITI) has reached an important first step. They have established the EITI Standard – a programme that countries can sign up for voluntarily and which checks their transparency. As of 2013, 37 countries are taking part, with 21 of them being currently compliant with the EITI rules. The information can now be used to detect not only corruption cases, but also to give an indication of where companies do not pay proper taxes. In the case of Glencore, for example, the figures show that the Mopani Mine is paying much less taxes than comparable mines. While such knowledge in itself does not prevent tax evasion, it can be the base for further investigations. In the US, the Dodd Frank Act from 2010 has brought considerable progress with regard to US commodity companies, which are now required to publish their payments to governments all around the world. A similar rule was adopted by the EU in April 2013 in a transparency law for listed companies (European Commission 2013). In this case, forestry is also included together with commodities. But a general rule for all companies was watered down in the lawmaking process.

Another transparency requirement – which is not only important for tax reasons, but also to prevent money laundering – is the so-called »beneficial ownership information«. This means information on the natural person who actually owns an asset, and thus eventually benefits from it economically. This information can be collected at different levels of transparency. According to the in-

ternational standards set by the Financial Action Task Force (FATF 2012), all entities dealing with money and valuable assets need to conduct proper checks of their clients. Not only does this concern banks, but any profession dealing with money and high-value assets – for example, lawyers or real estate agents.

A stronger form of transparency is provided by centralised registers for various legal entities, including companies, trusts or foundations. These registers could be available only to the authorities or, even better, be open to the public. This would allow tax authorities and the public to be sure that a company has correctly listed all of its subsidiaries, and it would ensure that income or assets could no longer be hidden. Globally, there is a fairly diverse situation with such registrations, and even within countries they often differ between different legal entities. Given the enormous problems with tax evasion and money laundering, registers open to authorities should be a minimum standard. This would allow them to check whether a corporation has revealed all its affiliates to the tax authorities as required by the respective tax law.

### 3.3 Deductibility Restriction, Anti-Avoidance Rules, and Blacklists

Many tax avoidance schemes are based on the fact that one asset is simultaneously not taxed in one country and deductible from the tax base in another, which in effect leads to double non-taxation. The direct restriction of deductibility can end such effects. It is then often called a »subject-to-tax clause«, which makes the tax advantage dependent on a (minimum) taxation in one country. Such a restriction is normally designed regarding specific assets or taxes. It can be a full or only partial restriction. In Germany, for example, interests between the different affiliates of one corporation are only deductible to a certain extent in order to prevent abusive structures that abuse the deductibility of interest (»thin capitalisation«).

In the EU, the European Commission has tabled several proposals to restrict the deductibility in cases where effective double non-taxation would take place otherwise.<sup>8</sup> The laws governing interest and royalty payments and dividends within transnational companies should be revised by adding subject-to-tax clauses.

8. For an example, see European Commission (2011a).

Tax avoidance can also be related to the fact that companies can often deduct former losses in later years from their profits, or that the losses of a subsidiary can be used to offset profits in another subsidiary or the parent company. While such rules are pretty common in most countries to help businesses cope with losses, they can lead to zero taxation over time if permitted in an excessive manner. They should therefore only be possible under very narrow conditions. Beyond this, the transnational intra-group deduction of losses and profits, possibly between jurisdictions with very different rules, can be a source of tax losses. They should therefore also be restricted in double taxation agreements and other transnational tax law.

Some countries have rules to prevent abusive tax schemes or planning in general.<sup>9</sup> The idea is to prohibit any tax planning by companies that have as their only aim – or one of their main aims – tax avoidance but no economic motivation. It is clear that the line between legal and illegal planning is blurred to a certain extent. However, such a rule can be used to deter companies and prohibit planning that is clearly not intended by the law. To give companies a higher degree of security about the legal status of their planning, some countries let the tax authorities test planning schemes and approve them. However, this also lessens the deterrence and therefore some countries just apply the rule afterwards.

A special category of anti-avoidance rules are provisions that do not accept purely artificial entities for tax purposes and »look through« this artificial entity. For example, the US, Japan, and the UK have a controlled foreign corporation (CFC) rule that allows taxing an entity in another country controlled by a US, Japanese, or UK parent company under certain circumstances. If, for instance, the parent company has an affiliate that is not really an independent entity, which is also taxed abroad, the income of this CFC will be taxed as part of the parent company's income.

Another, very strong, anti-avoidance measure is a blacklist, which can serve to identify harmful countries. The consequence is often that business relations of a parent company with affiliate companies in the listed country are penalised – e.g., by denying the tax deductibility of payments to the affiliate or through withholding taxes.

9. For an overview see OECD (2012).

One example is the Brazilian blacklist, which labels any country with less than 20 per cent effective tax rate for corporations as a tax haven. Another list is set up in France, where banks can even lose their licence if they engage with tax havens. Germany does not have an explicit blacklist, but in some respects denies tax benefits to the German parent company if an affiliate is based in a country that is a »low-tax country«, which is usually the case when the effective corporate tax rate is below 25 per cent. In this case, the income from the affiliate in the low-tax country is taken into account for the German parent company and then taxed.

### 3.4 Double Taxation Agreements

Double taxation agreements (DTAs) are bilateral agreements that have actually aimed in the past at preventing double taxation for companies active in the two countries concluding the agreements. DTAs treat the subsidiary and parent company as separate entities, according to where the real business is deemed to take place. Based on this separate entity approach, there are normally two ways to tackle double non-taxation: either by exemption from all taxation in one of the two signatory states, or by crediting the tax paid in one state for the tax due in the other. This means that a company will at most pay the tax in the country with the higher tax rate or even in the one with the lower, but nothing more.

There are two internationally important model agreements for DTAs: one by the OECD, and another one by the UN. The latter is more or less based on the OECD model, but with some rules more favourable to developing countries. Regarding intra-firm relations, the model agreements both assume that a parent company and its subsidiary are separate entities that should interact in the same way as with third parties – i. e., based on the Arm's Length Principle.

Recently, there has been a shift in what a DTA should aim for. The problem of double non-taxation is now on the agenda again, for example in the EU (European Commission 2012). It is not yet clear how far this new agenda will go. But the proposals include limiting the exemption method insofar as it should not result in an effective non-taxation – for example, by restriction of deductibility, withholding taxes, or anti-avoidance rules. Finally, these proposals also contain clauses that pro-

hibit so-called treaty shopping, which is when a transnational corporation sets up a branch or subsidiary in a particular country for no other reason than to benefit from a favourable rule of a DTA, to which it would otherwise have no access; for example, because before it had no affiliate in this country. The Netherlands is a good example in this respect, because they have a network of favourable DTAs with many countries that can be accessed through a Dutch affiliate. While some of such anti-abuse rules are already in place in various DTAs, there are still loopholes.

### 3.5 Withholding Taxes

Withholding taxes are imposed at the source of the tax base and can be much more powerful than any direct anti-avoidance efforts. There are different forms of withholding taxes, but they all prevent shifting money so that it will no longer be subject to taxation. A withholding tax, for example, can tax a production facility directly, based on the staff working there, and irrespectively of its profits and losses. In Germany, a tax is assessed by the municipalities (*Gewerbesteuer*), which at least to a certain extent does tax the company regardless of the revenue.

Withholding taxes are also used for many types of capital gains, because such gains are particularly easy to shift in order to evade taxes. They are especially important for countries that do not host the parent companies but only the subsidiaries. Without a proper taxation of the economic surplus of the subsidiary at its source, its host country would have no taxable base at all. This is also why in the United Nations Model Double Taxation Convention between Developed and Developing Countries, developing countries are advised to aim for sufficient withholding taxes for licences and interests (United Nations 2011). This allows them to keep a fair share of the profits in their country. Without withholding taxes, the country of the parent company, still often based in a developed country, receive the tax revenue on the profits. Finally, withholding taxes are also used as a means of enforcing compliance; for instance, by the US for the implementation of their Foreign Account Tax Compliance Act.

While some forms of a withholding tax are a good instrument to prevent tax avoidance and evasion, there are also problems with it. In Germany, for example, the

government decided to switch from the taxation of capital gains as part of the income tax, to a withholding tax deducted by the banks directly from the accounts. While this more effectively ensures that no one will just hide capital income from the tax authorities, the German solution was not only combined with anonymous payments but also with a huge tax cut: formerly, capital gains were taxed according to the tax payers' income tax rate of up to almost 50 per cent, but with the withholding tax, capital gains are taxed at a flat rate of only 25 per cent. Unlike in this example, however, withholding taxes should normally not result in tax gifts to capital owners.

### 3.6 Unitary Taxation

The unitary taxation is a system change in fighting tax avoidance by TNCs.<sup>10</sup> It departs from the approach that treats branches and subsidiaries of TNCs and the parent company as separate entities, for which the ALP applies in dealing with inter-firm transactions.

Instead, under unitary taxation, the parent company with all its subsidiaries is treated as one entity or unit. Internal transactions are no longer relevant as the company is assessed on the basis of its consolidated accounts covering all its operations. The company is required to have a combined report, depicting its entire activity for the whole entity and in the different countries of operation. The report is similar to country-by-country reporting but goes further in the breakdown of the activities. The profit of the entire corporation is then distributed to the countries of operation according to an apportionment formula that relies on features that should give a picture of real economic activity and cannot be shifted just on paper – e. g., assets, staff, or sales.

Unitary taxation is not just an idea, but has been already implemented – or at least important elements of it – in a number of federal systems where constituent states have their own taxing powers. Some US states like California have been applying unitary taxation for decades. With the emergence of the film industry, California was worried that film companies would locate their headquarters in the neighbouring state of Nevada where taxes were lower. Thus, they taxed the companies according to their activities in California. The formula used in California to

measure the activity is based on an equal weighting of assets, wages, and sales. Yet there is a broad divergence with the formulas between the different US states. It must be also noted that the practice in the US does not always seem to be based on a combined report for the entire corporation, but can resemble a withholding tax based on some economic factors.

Plans for a unitary taxation have also reached the political agenda in the European Union. Under the name Common Consolidated Corporate Tax Base (CCCTB), a fully formulated draft directive was tabled by the European Commission (2011b), and approved in March 2012 by a large majority in the European Parliament. It is now under consideration by the Council of Ministers. However, the directive proposal by the Commission only foresaw a voluntary application at the discretion of the companies. This would of course have the effect that the companies would always choose the option that best suits them, thus minimising their tax burden. This is also why many EU States rightfully did not agree with the proposal. It is currently open whether there will be any agreement on a different version in the near future.

Sometimes, at least elements of a unitary taxation are being applied. An example is the »profit split« rule in US law, which is an alternative to ALP and splits the profit between the different entities of a company, based on similar criteria of real economic activity, like unitary taxation. Even some methods applied by the OECD standards for transfer pricing such as the Transactional Net Margin Method (TNNM) imply a profit division that goes a bit in the direction of unitary taxation. The TNNM looks at the appropriate base in a transaction – such as costs, sales, assets – normally by comparison with similar transactions by the same company with unrelated parties (Picciotto 2012).

While unitary taxation has undeniable advantages in dealing with profit shifting by TNCs, it will not easily solve all the problems that have arisen with globalisation and tax havens. New problems may also emerge – for example, how to agree on a joint formula at a global or even regional level, or the application of various formulas by many different countries – which could lead to unforeseen difficulties (Spencer 2013).

Despite that, the tremendous shortcomings of the current transfer pricing system mean that unitary taxation needs to be considered further and tested. According

10. For an overview, see Picciotto 2012.

to the Tax Justice Network, unitary taxation »(...) is not a magic bullet. But by placing international coordination of taxation on a more realistic foundation, it could be made much simpler and more effective« (2013).

#### 4. Conclusion and Recommendations

The taxation of transnational corporations will remain an important and difficult issue as long as we have a globalised economy. There will also probably be certain forms of tax havens or tax haven practices, or at least tax competition between states. There will be no global tax policy in the foreseeable future. Thus tax evasion and aggressive tax avoidance by transnational corporations will remain on the agenda.

Tax avoidance by corporations involves the use of low-tax countries and preferential tax regimes. It is often connected with transfer pricing of intra-firm trade, for physical goods, but increasingly also for intangibles involving fees and royalties – which can be heavily abused in order to lower the tax burden for the corporation as a whole. Methods that have gained importance in recent years involve the abuse of qualification mismatches between different jurisdictions for hybrid entities, financial instruments, and derivatives.

Despite the difficulties in tackling tax avoidance, governments must not abandon their national and international efforts in this direction. However, the current solutions to tackle aggressive tax avoidance and tax evasion only mitigate some of the problems. Obviously, they are often incomplete or insufficient. Consequently, policymakers, civil society, and the public at large need to rethink how to ensure a sufficient tax base.

The following measures should be taken:

- Improve the existing transfer pricing system with the Arm's Length Principle as much as possible – e. g., by applying profit split and similar methods;
- Strengthen anti-avoidance rules;
- Set up public centralised registers of companies, trusts, foundations, and similar legal entities, which display the economic beneficiary of the entity;
- Restrict the deductibility of certain capital gains such as interest, particularly in the case of effective non-taxation (subject-to-tax clause);
- Apply withholding taxes, particularly for income on intellectual property rights, but not with the result of lowering taxes;
- Improve the rules on the economic activity of companies in order to prevent letterbox companies;
- Include the above recommendations in double taxation agreements, and use the crediting principle instead of the exemption principle as a general rule;
- Introduce comprehensive country-by-country reporting for all types of corporations;
- Investigate and apply a compulsory and comprehensive unitary taxation, either at regional or even at global level.

The G20, at their heads of state summit in 5–6 September 2013, as well as countries around the world need to act in order to prevent TNCs from avoiding and evading their taxes. While some of the problems discussed here can be solved unilaterally, there are others that could be dealt with more effectively through intergovernmental cooperation at the regional or global level.



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