tax justice network

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Tackling the Problems of Capital Flight, Tax Evasion

Tax Competition in the Mediterranean Region

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Summary

The related problems of capital flight, tax evasion and tax competition impact on the majority of countries on the Mediterranean rim and is encouraged and facilitated by failures of the international financial architecture.

A large proportion of the capital flight from the countries in the Mediterranean region is motivated by political risk, corruption, tax evasion and illicit commercial transactions. Transnational banks and other financial intermediaries, typically based in tax havens, encourage and facilitate the capital flight process and tax evasion, and the secretive arrangements of the offshore financial system provide cover for vast flows of what can be described as 'dirty money.'

This problem ranks in terms of priority alongside debt relief, development aid and improved trade arrangements, and should be confronted by the international community without delay.

Capital flight and the Mediterranean region

In a briefing paper entitled *The Price of Offshore*, published in March 2005, we have estimated the value of flight capital owned by individuals to offshore finance centres at approximately US$11.5 trillion. We calculate that if the income on that stock of capital averaged 7.5 per cent per year, and if the applicable tax rate on this income were 30 per cent, the amount of taxes being evaded is about US$255 billion annually. This sum is about four times greater than the combined aid budgets of all the OECD countries and would be sufficient to cover the entire financing needs of the United Nations Millenium Project. The problems of capital flight and the mass tax avoidance of the rich is therefore one of the defining crises of our times.

The available data for capital flight shows that the volume of capital flight from selected Mediterranean countries has more than doubled over the past 20 years and in 2002 stood at about US$214 billion – *table 1*.

Table 1: stock of flight capital from selected Mediterranean countries

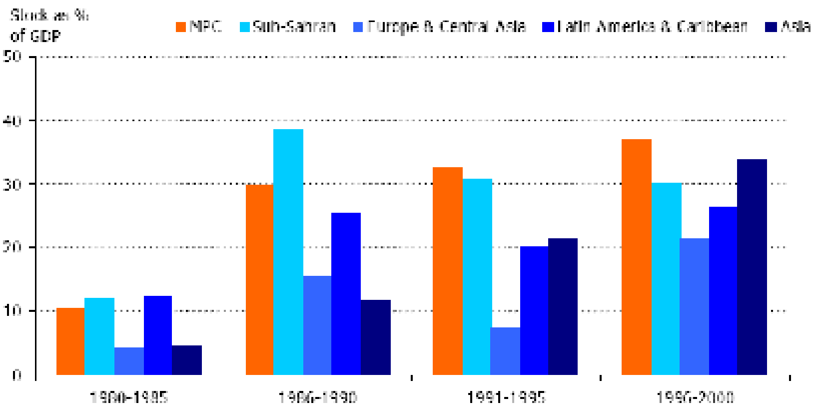
Stock of capital flight (US$ bn)

	1980-1985	1986-1990	1991-1995	1996-2000	2001-2002
Algeria	17.7	25.7	29.1	29.7	22.7
Egypt, Arab Rep.	27.9	41.8	32.1	30.9	30.0
Jordan	2.8	6.5	8.1	7.5	7.8
Morocco	12.6	21.5	22.8	23.0	19.0
Tunisia	4.0	6.8	9.2	11.2	11.8
Turkey	21.0	41.2	63.2	96.3	122.5
MPC	85.9	143.5	164.5	198.6	213.7

Source: European Investment Bank, 2005

Flows of capital flight vary from country to country. For example, capital flight from Turkey has risen consistently over the past two decades whilst Algeria suffered a steep increase in the 1990s followed by a significant decrease in recent years, no doubt reflecting the increased relative political stability of that country. Overall, however, the Mediterranean region has a higher rate of capital flight than other regions, with the stock of flight capital estimated at approximately 37 per cent of regional GDP compared to about 34 per cent for Asia, 30 per cent for sub-Saharan Africa, and 26 per cent for Latin America and the Caribbean – *chart 1*.

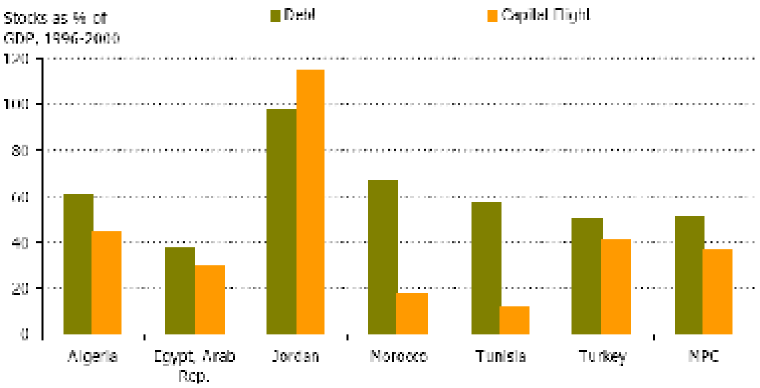
Chart 1: Ratio of capital flight to GDP by region – 1980 to 2000



source: European Investment Bank, 2005

The ratio of capital flight to total debt varies considerably between countries, with Jordan suffering from both a high level of debt (at approximately 100 per cent of GDP) and capital flight (about 115 per cent of GDP) whereas Tunisia has a relatively low level of capital flight but an above average debt level – *chart 2*.

Chart 2: Capital flight and debt to GDP ratio – selected countries



source: European Investment Bank, 2005

The ease with which wealth holders can shift their assets and income offshore to evade tax makes capital flight a serious problem for both developed and developing countries. Capital flight slows growth rates by reducing the stock of domestic savings available for investment and lowering tax revenues for investment in physical and social infrastructure.

Governments have been forced to react to this rupture of domestic capital resources by either incurring external debt, which is an expensive way of financing both revenue and capital expenditure, or through privatisation programmes and offering tax holidays and other inducements to attract inwards investment. Much of the inwards investment consists of capital held illicitly offshore by residents who use offshore structures to give their investments the appearance of being foreign investment in order to benefit from offshore tax planning schemes and onshore tax concessions to foreign capital. This process, known as 'round-tripping', is prevalent in many countries.

The problem of capital flight has been largely ignored by the international finance institutions and by the G8 countries. Although the current focus on debt reduction and increased aid is, of course, to be welcomed, without a coordinated international effort many states on the southern and eastern Mediterranean rim will remain vulnerable to capital flight and consequently dependent on expensive inwards investment rather than being able to mobilise domestic capital resources for investment and economic growth.

Capital flight undermines social cohesion, viz Algeria in 1988, and its continuance threatens the long-term stability and security of the region. A widespread public perception that resources, particularly natural resources, have been expropriated and exported by political and business classes has generated deep-rooted resentment and social friction. The result of capital flight has been under-investment in public goods and services, including education and vocational training, and insufficient private investment in job-creating activities. According to one commentator on North Africa, capital flight has been a cause of «entrenched resentment, unemployment, a lack of education, and a general lack of opportunity». The failure to tackle the problem inevitably undermines the security of the region.

Tax havens and the offshore economy

The offshore economy has grown rapidly in the past three decades:

- In the mid-1970s there were 25 tax haven jurisdictions. Our most recent list includes 72 jurisdictions, 11 of which are located in the Mediterranean region;

- The value of personal assets held offshore, either tax free or subject to minimal tax, is estimated at US$11.5 trillion, which is over one-third of global GDP;
- Offshore companies are being formed at the rate of about 150,000 per year and now number in the millions. Offshore trusts and foundations are not registered and there is no means of knowing anything about them. Their numbers probably run to the tens of millions.
- At least half of all world trade appears to pass through tax havens, even though these jurisdictions account for only about 3 per cent of global GDP;
- 60 per cent of international trade consists of intra-company transactions, i.e. firms trading with themselves and much of this is passed through tax havens which charge low or zero rates of tax on profits.

Tax havens represent a massive problem for the globalised economy and for social cohesion. In addition to being used to hide the proceeds of criminality and corruption, tax havens impact upon developing countries in four major ways.

First, secret bank accounts and offshore trusts encourage wealthy individuals and companies to escape paying taxes. Studies of offshore wealth holdings have shown that rich individuals in the South hold a far larger proportion of their wealth in offshore tax havens than their North American and European counterparts. For example, over 50 per cent of the total holdings of cash and listed securities of rich individuals in Latin America is reckoned to be held offshore. This figure rises to 70 per cent in the case of the Middle East. Anecdotal evidence for some of the countries on the Mediterranean periphery suggests that the volume of private wealth held offshore in centres such as Monaco, Malta, Cyprus, Switzerland and London is likely to be comparable to the situation in the Middle East.

Second, the ability of transnational corporations to structure their trade and investment flows through paper subsidiaries in tax havens provides them with a significant tax advantage over their nationally based competitors. Local businesses, no matter whether they are technically more efficient or more innovative than their transnational rivals will be competing on an uneven field. In practice this biased tax treatment favours the large business over the small one, the international business over the national one, and the long-established business over the start-up. It follows, simply because most businesses in developing countries are smaller and newer than those in the developed world and typically more domestically focussed, that this inbuilt bias in the tax system generally favours transnational businesses from industrialised over their domestic competitors in developing countries.

Third, banking secrecy and trust services provided by globalised financial institutions operating offshore provide a secure cover for laundering the proceeds of political corruption, fraud, embezzlement, illicit arms trading, and the drug trade. The lack of transparency of international financial markets contributes to the spread of globalised crime, terrorism, bribery of under-paid officials by businesses, and the plunder of resources by business and political elites.

Fourth, the offshore economy has contributed to the rising incidence of financial market instability that destroys livelihoods in poor countries. Offshore finance centres are used as conduits for rapid transfers of portfolio capital into and out of national economies which can have a highly destabilising effect on financial market operations. Under pressure from the International Monetary Fund many developing countries are required to hold large hard currency reserves to protect their economies from financial instability. These reserve holdings are an expense that few developing countries can afford, but in the absence of international agreement on other, more effective measures to reduce market volatility, for example a currency transaction tax, they have little choice in the matter.

The predatory role of financial intermediaries

The principal catalysts of capital flight are, first, banking secrecy laws and related confidentiality arrangements in major OECD and EU financial centres including related tax havens and, second, tax free treatment of interest on bank deposits and income from other interest bearing instruments.

Bank secrecy— either *de jure* or *de facto* — prevents governments from exchanging information about cross-border payments of income. This enables a resident of one country to make a bank deposit or place financial assets in an offshore trust completely free of all tax. This lack of an exchange of information both facilitates and encourages capital flight and tax evasion.

The absence of a global policy framework for discouraging capital flight and aggressive tax avoidance by transnational companies has left nationally based tax regimes floundering. The legions of tax planners operating through tax havens are able to run circles around tax officials in developing countries who are constantly hampered by the lack of transparency and cooperation from the financial services industry.

Lawyers, accountants and bankers abuse their professional status to facilitate harmful and anti-social behaviour purely for the sake of the high fees earned in tax planning work. Their attitude towards democracy and society in general is perfectly illustrated by a British accountant who told the press in 2003 «no matter what legislation is in place, the accountants and lawyers will find a way around it. Rules are rules, but rules are meant to be broken.» This attitude is unacceptable in any context, but is particularly inexcusable when the victims of this predatory culture are the poorest and most vulnerable people on the planet.

The insidious nature of unregulated tax competition

Faced with the pressures of globalisation of capital movement and the threat that companies will relocate unless provided with concessions on lower regulation and lower taxes, governments have responded by engaging in tax competition to attract and retain investment capital. Some states with limited economic options have made tax competition a central part of their development strategy, though this will inevitably undermine the growth prospects of other countries and stimulate a race to the bottom.

The case for tax competition is without theoretical base. At the micro level of the firm competition can stimulate improved economic efficiency through the exercise of consumer choice, but states do not compete with each other to attract the expenditure of their citizens. Neither, contrary to the argument of those who support it, will tax competition exert pressure on governments to be more efficient. Governments are not profit-maximisers in the economic sense of that term and do not collude with one another to raise tax levels in the way that businesses might collude to raise price levels. In a democratic system governments are accountable to their electorate, who are highly conscious of tax levels and must be allowed to decide to choose between high tax / high spend and low tax / low spend governments.

But in addition to being fundamentally anti-democratic, unregulated tax competition is enormously harmful to the efficient functioning of global trade. Tax competition distorts investment flows by diverting investment to territories where, in many cases, it is inefficiently used. The only winners in such a process are the mobile businesses that can play one government off against another in order to secure tax advantages and subsidies. Local businesses almost always loses out as a result, which is why the pressure for tax competition has been so closely related to the rise of globalised business.

Although the impact of tax competition on developing countries has not been thoroughly researched, a study of investment flows into China, Brazil, Mexico and India by McKinseys (a consulting firm) concluded in 2003 that fiscal inducements including tax holidays and subsidised finance had negative and unintended consequences. Additionally, empirically based research in the United States has found –

> «Little grounds to support tax cuts and incentives – especially when they occur at the expense of public investment as the best means to expand employment and spur growth. Tax increases used to enhance public services can be the best way to spur the economy. By stimulating growth, generating jobs, and providing direct benefits to residents, improvements in state and local public services can be one of the most effective strategies to advance the quality of life of citizens.» (Economic Policy Institute, 2004)

If this conclusion applies to a relatively high tax economy like the United States, it is even more applicable to economies on the Mediterranean rim, where social and economic development is held back by under-investment in public infrastructure, education and health services.

Proponents of unregulated tax competition have never answered the crucial question of how far it should be allowed to go before it compromises the functioning of a viable and equitable tax regime. Taken to its logical extreme unregulated tax competition will inevitably lead to a race to the bottom, meaning that governments will be forced to cut tax rates on corporate profits to zero and subsidise companies to invest in their countries. This is already happening in some jurisdictions. The implications for tax regimes and democratic forms of government around the world are dire.

International initiatives against capital flight and tax havens

The problems imposed on poorer countries by capital flight and tax avoidance have been exacerbated by what appears to have been a failure on the part of the multilateral institutions to pay sufficient attention to the implications for the tax regimes of developing countries when promoting their policies of trade liberalisation. Political pressure from the World Trade Organisation and International Monetary Fund to liberalise trade regimes has led to a dwindling of revenues from trade taxes such as taxes on imports and exports. Unable to increase the relatively low revenue yields from direct taxation because of capital flight, tax avoidance and the pressures of tax competition, poorer countries have switched the tax burden onto consumers through sales taxes. This trend has become increasingly pronounced over the past 30 years and is widely agreed to be regressive since lower income households spend a higher proportion of their income on consumption. Unfortunately this issue does not appear to have been addressed by the multilateral development agencies.

Nor are there currently any global initiatives under way to abolish secret banks accounts and offshore companies and trusts, and to implement a global framework for automatic information exchange of relevant tax information, though there are a variety of initiatives being pursued by the OECD, the EU and the UN, with the latter moving towards creating an institutional structure that might offer an appropriate forum for future progress towards tax justice.

The EU has established the principle of automatic information exchange through the Savings Tax Directive, which comes into force on 1st July 2005. Despite the obvious shortcomings of its scope, the EU-STD, which applies solely to EU residents and is currently restricted to private bank accounts and does not cover offshore companies, trusts and foundations, indicates the way towards the creation of a global model for cooperation on tax matters.

Separately, the OECD has also been working on the mechanics of automatic exchange of information. Their focus is on the procedures and systems for transmission of information between national tax authorities, and the coordination of Tax Information Numbers (TIN) in the jurisdiction where the income has its source and the jurisdiction where the recipient of the income resides. These details are a crucial part of the process of improving global cooperation on tax matters.

Neither the OECD nor the European Union has taken action against capital flight from third countries into financial centres in OECD countries and related tax havens. This lack of action to prevent capital flight from third countries is deeply prejudicial to the interests of developing countries. Furthermore, the OECD's initiative to tackle what they describe as 'harmful tax competition' – they do not define in what circumstances tax competition can be benign - appears to have made no progress since 1998 and is strongly resisted by special interests.

The United Nations provides the only multilateral forum within which steps to counter capital flight, tax avoidance and tax competition can be effectively negotiated and subsequently monitored. The UN has expressed its interest in these issues on a number of recent occasions.

The UN Report by the High-Level Panel on Financing for Development of June 2001 (also known as the Zedillo Report, after Chairman Ernesto Zedillo, former President of Mexico) stated:

> «The Panel proposes that the international community should consider the potential benefits of an International Tax Organization…. Developing countries would stand to benefit especially from technical assistance in tax administration and tax information sharing that permits the taxation of flight capital.»

The UN International Conference on Financing for Development in 2002 called on developing countries to mobilise resources for development, especially domestic capital resources. The Monterrey Consensus encouraged, among other things:

> «Strengthening international tax cooperation… and greater coordination of the work between the multilateral bodies involved and relevant regional organizations, giving special attention to the needs of developing countries and countries with economies in transition.»

The UN Convention against Corruption (December 2003) proposes that bank secrecy can be over-ridden in the case of domestic criminal investigations of offences established in accordance with Article 40 of the convention. The UN should consider a similar position to over-ride bank secrecy, and to implement automatic exchange of information, in international tax matters.

The 11th Meeting of the UN Ad Hoc Group of Experts on International Cooperation in Tax Matters in December 2003 in Geneva considered the issue of bank secrecy, capital flight, and tax competition. Since 2003 the ad hoc group has been elevated into the Committee of Experts on International Cooperation in Tax Matters, which will hopefully continue to consider the issues of bank secrecy, capital flight and exchange of tax information. The Tax Justice Network will be monitoring the work of this new Committee and will participate at its forthcoming meeting in Geneva in December 2005.

The Joint Proposal of the IMF, World Bank and OECD

The IMF, OECD and World Bank in the 2002 report *Developing the International Dialogue on Taxation: A Joint Proposal by the Staffs of the IMF, OECD and World Bank,* indicated that their staff would assist developing countries in improving the effectiveness of their tax administrations, thereby increasing governmental revenues of those countries. Despite this, it is unclear whether they will advise developing countries on how to improve their tax administrations to try to prevent capital flight to OECD and non-OECD financial centres.

The Lula Group

The September 2004 Report of the Technical Group on Innovative Financing Mechanisms (the Lula Group) in its section on Tax Evasion and Tax Havens, has stated:

> «Tax evasion is a phenomenon of great magnitude that impairs fiscal revenue of governments and is especially detrimental to the domestic efforts to increase tax revenue in developing countries. Yet rebuilding these countries' tax bases is essential to their efforts to finance their fight against poverty, improve social expenditure, support economic development activities an increase productivity levels. Serious efforts made at the domestic level have encountered significant leakages by firms and individuals operating via tax havens. Consequently, there have been lower tax proceeds or higher taxation on non-mobile income earners, sectors that evidently are mostly below the high-income brackets.»

The Tax Justice Network encourages the Lula Group to focus its efforts on mechanisms to confront capital flight, banking secrecy and tax competition.

Conclusion

A starting point for tackling these problems lies with recognition that the principal incentives for capital flight out of developing countries are banking secrecy and confidentiality laws in tax havens, and the tax-free treatment of interest on bank deposits and other interest bearing financial instruments. The environment of secrecy provided by tax havens prevents governments from exchanging information about cross-border payments of income. The absence of information exchange both enables and encourages capital flight and tax evasion.

An International Tax Organisation is required which will have as its prime objective the task of ensuring that national tax systems do not have negative global implications. The ITO would also define minimum standards of transparency and enable the development of global networks of cooperation. A first step in this direction would be an agreement for automatic information exchange between tax authorities across the world which would include all investment vehicles including private bank accounts, offshore companies and trusts.

Tackling the issues of capital flight, tax evasion and tax competition would go a long way towards eradicating global poverty and enhancing social equity. This task should be a priority for the United Nations during the next decade of the Millenium Project.

Recommended reading:

Avi-Yonah, R. (2003) *'Globalization and Tax Competition: implications for developing countries'* conference paper presented to the 11th meeting of the United Nations Ad Hoc Group of Experts on International Cooperation in Tax Matters, Geneva, 15-19 December

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Hampton, M.P. (1996) *The Offshore Interface: tax havens in the global economy*. Basingstoke: MacMillan.

Mitchell, A., Sikka, P., Christensen, J., Morris, P., and Filling, S. (2002) *'No Accounting for Tax Havens'*, Association for Accountancy & Business Affairs, Basildon, England

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Tanzi, V. (2000) *Globalization, Technological Developments and the Work of Fiscal Termites,* Washington DC, International Monetary Fund (WP/00/181).

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