Eurodad fact sheet: Capital flight diverts development finance

"Europe (...) accounts for 68% of the value of foreign direct investment in Africa. But the other unique factor that strengthens these ties is the steadfast support shown by Europe over 40 years as the leading donor of official development assistance."
Louis Michel, European Commissioner for Development and Humanitarian Aid.

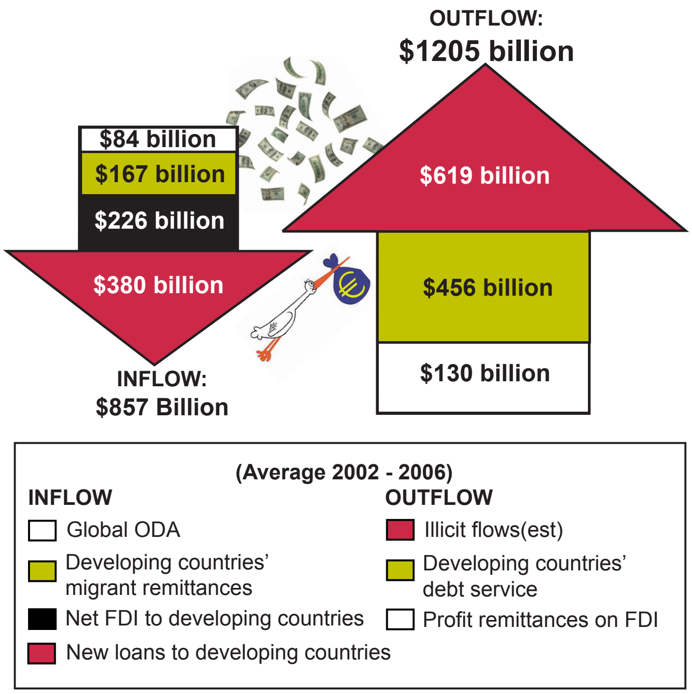
It is a contradiction to support increased development assistance, yet turn a blind eye to actions by multinationals and others that undermine the tax base of a developing country."
Trevor Manuel, South African Finance Minister.

This fact sheet provides statistics, explanations and links that Eurodad members can use to understand and advocate on capital flight, the process whereby individuals or companies deposit funds and assets offshore. For each dollar that goes to the South in terms of aid, more than 7 dollars come back to the North through illicit proceeds.[1] This flow of resources out of developing countries creates deficits, increases dependence on aid, makes recipients vulnerable to conditionality and renders debt cancellation less worthwhile. European NGOs have a responsibility to popularise this issue and to press their governments to introduce regulation for tax havens and companies to ensure that wealth can be retained and used for development purposes.

A. What is the problem? A hidden financing gap

Official estimates show a big financial deficit on plans to achieve the MDGs
Developing countries pay far more on debt servicing than they receive from official donors.
Developing countries pay even more in capital flight than they do on debt servicing.

The UN estimated in 2005 in its practical plan to achieve the MDGs that US$348 billion will be needed to cover MDG costs up to 2010 and US$529 billion up to 2015. But official donor commitments fall short of this:
-Global ODA averaged US$90 billion/year between 2003 and 2006. This amounts to US$24.6 million per day,
-Global debt cancellation under HIPC and MDRI initiatives amounted, as of end 2007, to US$67.7 and US$47.9 billion respectively. But HIPC countries are still servicing more than US$2.4billion per year. Moreover, low income countries pay every year US$35 billion in debt service, and debt service paid annually by all developing countries amounts to US$540 billion.



Some CSO experts estimate that between US$424 and US$589 billion of debt should be cancelled in order to achieve the development goals. This amounts to 31-43% of all outstanding debt, affecting 70-90 poor countries and at least half of them would need 100% debt cancellation.

The ODA-Debt gap is just the tip of the iceberg: Illicit outflows from developing countries are estimated to account for US$500-US$800 billion a year.[2] This means that developing countries are losing between US$ 1.3 and US$ 2.2 billion per day. Much of these flows travels through secretive structures established in tax havens and ends up lodged in Northern bank accounts. If we consider this "off the record" massive flow from the South, the financial North South gap is far higher.

This situation makes developing countries net creditors of donor countries.[3] While rich countries are providing ODA and some debt relief with one hand, they are receiving much more with the other through tax avoidance, profit remittances and other practices. While some of these capital outflows are legal and a normal part of doing business, others are or should be illegal, reflecting bad deals, hidden payoffs and fraudulent transactions.

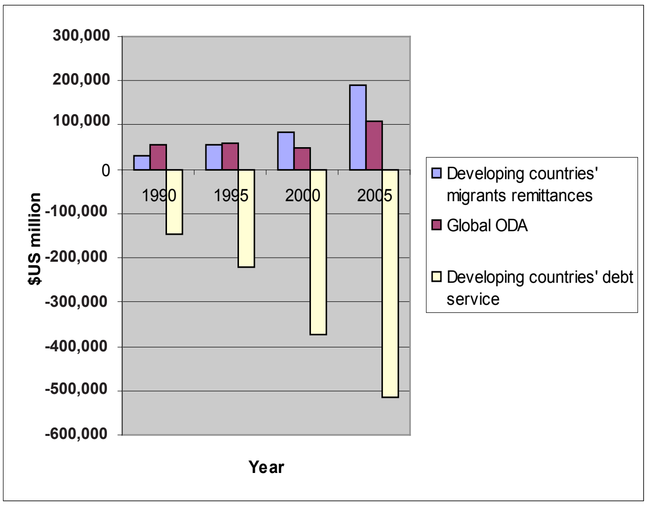
1 Calculation based on an annual ODA average of $90 billion between 2003 and 2006 and annual illicit flows from developing countries average estimate of $635 billion.
2 Raymod Baker, 2005.
3 See Léonce Ndikumana and James K. Boyce, "New Estimates of Capital Flight from Sub-Saharan African Countries: Linkages with External Borrowing and Policy Options", April 2008.

B. How do South-North capital flows work?

Capital flight from developing countries is more a case of tax avoidance than of corruption or crime according to leading experts such as Raymond Baker. The losses to developing countries through commercial tax avoidance account for about US$350 to US$500 billion[4] a year, more than three times global ODA.

Tax avoidance is the legal utilisation of tax regimes in order to minimise the amount of taxes to be paid. The main means are transfer mis-pricing and using tax havens as a base for corporate activity.

Transfer mis-pricing in trade[5] is where two or more businesses –controlled by the same people- trade with each other at prices arranged to avoid taxes. A company will export or import goods or services at a very low or high price in order to avoid taxes in the place of origin and take profit elsewhere. Examples include an American firm importing plastic buckets from its subsidiary in the Czech Republic at $972.98 per unit. Today more than 60% of global trade is intra-firm trade between subsidiaries of transnational companies.[6] Most transnational companies use transfer mis-pricing schemes and tax havens in order to minimize taxes.



Source: Global Development Finance, 2007 & OECD

Corruption is only a small part of the problem but the primary focus of official efforts.

Efforts from decision makers and international institutions like the World Bank focus mainly on the issue of Southern corruption, turning a blind eye to the supply side of corruption, which involves international banks, investors and tax havens[7].

Illicit capital flows from Developing Countries
(from a total estimate of $US 500-800 Billion)

COMMERCIAL - 64% | CRIMINAL - 31% | CORRUPT MONEY - 5%

Tax havens: secrecy jurisdictions

Capital flight is channelled through countries or parts of countries known as tax havens. These provide one or more of these features:

- low or zero taxes
- high levels of secrecy to hide the beneficiaries of companies, trusts, and bank accounts;
- no requirement of economic substance to the transactions booked in the jurisdiction and
- a ring-fence between their domestic tax regimes and the regime offered to non-residents to encourage profit and income shifting from other countries.

C. Europe's responsibilities, hosting tax havens and facilitating capital flight.

European countries are aiding and abetting capital flight and can do much to stop it. Many European governments do not yet accept that financial regulation to prevent capital flight is a necessary part of the development agenda. European governments host many tax havens that channel capital flight. While the OECD only considers a list of three non co-operative tax havens today (Monaco Liechtenstein and Andorra), Tax Justice Network considers that more than 70 territories do so.
Some of the most important tax havens are located in Europe: Andorra, Belgium, Cyprus, Germany (Frankfurt), Gibraltar, Hungary, Iceland, Ireland, Italy (Campione d'Italia & Trieste), Latvia, Liechtenstein, Luxembourg, Malta, Monaco, Netherlands, Portugal (Madeira), San Marino, Spain (Melilla), Switzerland, UK (city of London). Others are currently under review: Austria, Denmark and Macedonia. The city of London alone accounts for 40% of all tax haven-related activities.[8] Many others are dependencies or overseas territories of European countries, such as: Anguila, Bermuda, British Virgin Islands, Cayman Islands,

4 Global Financial Integrity, 2007.
5 Transfer mis-pricing: (Simon J. Pack & John Zdanowic (2002 & 2006)
6 Sony Kapoor, "Exposing the myth and plugging the leaks" in "Impossible architecture', Social Watch report 2006.
7 For a detailed critique to the World Bank and Transparency International vision of corruption see : http://www.taxjustice.net/cms/upload/pdf/0701_Mirror_Mirror_corruption.pdf
8 Christian Chavagneux and Ronen Palan, 2007.

Gibraltar, Guernsey, Isle of Man, Jersey, Montserrat, (UK dependencies), Aruba and Netherlands Antilles (dependencies of the Kingdom of the Netherlands),

According to Tax Justice Network research:

- The Netherlands, Belgium and Switzerland provide "conduit" arrangements that allow dividends, royalties and other capital flows like foreign direct investment (FDI) to move through those states with almost no tax, often on their way to a tax haven. These practices generally happen in intra-company channels. According to one estimate, the Dutch tax haven features facilitate a net loss of €640 million in tax revenue in developing countries, which amounts to approximately 15% of national ODA.
- Ireland offers artificially low tax rates to encourage the reallocation of profits to be taxed there.
- Many other European countries offer strong banking secrecy, such as Switzerland, Andorra, Monaco, Liechtenstein, Luxembourg, Malta and Cyprus.
- Other common practices led in European countries consist of transfer mis-pricing between companies and their subsidiaries.

Many transnational companies and wealthy individuals take advantage of these arrangements to hide their financial affairs and avoid tax payments. As they are not public such flows are hard to calculate. But several institutions and experts have made credible estimates of the amount of money flying from developing countries toward Northern banks and transnational companies. A snapshot of the main different estimates is provided here.

CAPITAL FLIGHT FROM DEVELOPING COUNTRIES

UNCTAD: More than $13billion per year have flown from the African continent between 1991 and 2004. This represents 7.6% of the annual GDP of the region.

African Union: More than $150billion/year flies out of Africa, out of which 80% finds its way to offshore financial centres.

About 30% of Sub-Saharan Africa's annual GDP has been moved to secretive tax havens.

World Bank: Illicit money in circulation is estimated at $1,000-1,600 billion out of which 50% come from Southern countries.

Others: Real capital flight from 40 African countries between 1970 and 2004 amounted to about $420 billion. Including imputed interest earnings, the accumulated stock of capital flight was about $607 billion as of end-2004.

Some 17 SSA countries are estimated to have lost in excess of 100%GDP since 1970 (Boyce & Ndikumana).

Developing countries can loose as much as 5% to 10% GDP annually in capital flight. (Sony Kapoor, Independent Consultant).

THE SCOPE OF TAX HAVENS

IMF: Tax havens account for more than 1/3 of global Investment Portfolios; At least 50% of financial flows are channeled through tax havens.

UNCTAD: More than 1/3 of FDI goes to tax havens, and this trend has increased since the 1990's.

Others: The assets held in offshore centres are an estimated $2.7 trillion (2004), which corresponds to about 20% of all deposits world-wide (Peter Wahl, World Economy, Ecology & Development (WEED)).

Closing the floodgates: Proposals for change

European governments should take vigorous actions, at national and regional/international levels aiming at preventing capital flight from poor countries. These measures will also benefit European citizens directly by reducing leakage on transactions within Europe. German Finance Minister Mr Steinbruck says tax evasion costs Germany about €30bn a year in lost revenue; the UK loses a similar sum; the EU may lose €100bn in all.

Who needs tax havens? They are mostly used by rich individuals and companies wanting to hide their money from tax authorities and by criminal groups for money laundering purposes. There is no reasonable economic point in maintaining such pactices and therefore tax havens should be closed down. Some interim measures that would make the use of tax havens less profitable are automatic disclosure of information that would put an end to bank secrecy and levies on transactions with tax havens. These measures would dramatically curb capital flight and prevent capital drain from the South towards the North.

European governments can act at the national, regional and international level to:

- Improve the international accounting system: Accounting standards have for a long time facilitated TNC's ability to avoid paying taxes in the country where they operate by transferring those resources to tax havens. Forcing companies to report their financial activities with a breakdown for each country they operate in is a first step towards prevention of illicit cross-border capital flight. The European Parliament has approved a resolution calling on multinational corporations to report on a country by country basis on the extractive industry sector. This must be strictly implemented and further extended to other economic sectors.

- Impose sanctions on tax havens that do not actively cooperate on information exchange. The EU Savings Tax Directive obliges information exchange between most EU countries but needs to be expanded and strengthened to plug loopholes which allow companies and individuals to get round it. CSOs call for automatic exchange of information without exemptions, the inclusion of all revenue sources and the expansion to non-European countries.

- Encourage the adoption of codes of conduct by tax administrations which make clear that tax avoidance is unacceptable and ensure disclosure of information and fiscal cooperation aiming at eliminating bank secrecy.

- Support capacity building of tax authorities in developing countries in order to prevent tax avoidance and tax evasion. Rich countries should make specific efforts aiming at recovering and repatriation of stolen assets to Southern countries.

- Implement a currency transaction tax, starting with the Eurozone, that would play a regulatory role by restraining speculation on currencies and at the same time would raise extra resources to finance development.

- Approve and apply responsible financing standards: shared responsibility between borrowers and lenders, transparency and other provisions as highlighted in the Eurodad responsible finance charter should be adopted by lender and borrower governments.

European governments should also act at the multilateral level to:

- Ensure the IMF, World Bank and others do not pressure governments to liberalise capital controls, sector regulations or other economic policies in such a way that will permit greater capital flight.

- Strengthen the constitution, the agenda and the mandate of the UN Tax Committee[9]. CSOs are calling for this committee to establish tax avoidance and tax evasion as a form of corruption. Other bodies such as the Financial Action Task Force, the World Bank and the IMF should enclose this in their definition of corruption.

- Promote a UN Code of conduct on Cooperation in combating international tax evasion and avoidance.

- Join the international taskforce on illicit flows led by the Government of Norway.

About EURODAD
EURODAD (the European Network on Debt and Development) is a network of 54 non-governmental organisations from 18 European countries who work together on issues related to debt, development finance and poverty reduction. The Eurodad network offers a platform for exploring issues, collecting intelligence and ideas, and undertaking collective advocacy.

For more information on this and other topics, please visit our website at: www.eurodad.org

9 Its mandate is enhancing and promoting international tax cooperation among national tax authorities, and providing technical assistance to developing countries.

Recommended reading and websites:

- Eurodad forthcoming report on, financial governance and development
- Tax Justice Network: Closing the Floodgates
- Christian Aid: plugging the leaks
- Léonce Ndikumana and James K. Boyce, "New Estimates of Capital Flight from Sub-Saharan African Countries: Linkages with External Borrowing and Policy Options", April 2008.
- Raymond Baker: Capitalism's Achilles' heel, 2005
- Christian Chavagneux and Ronen Palan, "Les paradis fiscaux", La Découverte, 2007
- Tax Justice Network : http://www.taxjustice.net/cms/front_content.php?idcat=2
- Tax research: http://www.taxresearch.org.uk/
- Global Financial integrity : http://www.gfip.org/
- SOMO: http://www.somo.nl/index_eng.php
- Plate forme paradis fiscaux et judiciaiers: "Paradis fiscaux et judiciaiers, cessons le scandale!"