Submission to the Parliamentary International Development Committee on Tax in Developing Countries: Increasing Resources for Development

30th January 2012

Submitted by the International Secretariat of the Tax Justice Network[1]

Scope of this submission

The terms of reference for the International Development Committee's inquiry identify five key issues:

- How DFID can better support developing countries to improve revenue collection;
- How DFID can support developing countries to use the revenue base responsibly in order to improve service delivery and development outcomes;
- Tax evasion and avoidance in developing countries by private individuals and companies;
- How effective international efforts to promote tax disclosure and tax transparency are likely to be;
- Capital flight and its implications for developing countries.

This submission will focus on international efforts to curtail tax evasion through effective tax information exchange processes. It will argue that illicit financial flows from developing countries are motivated by varying factors, but tax evasion is almost always an outcome of such flows, and revenue losses to developing (and developed) countries

[1] The Tax Justice Network is a global network of financial/legal specialists, development NGOs, faith movements, trade unions and others with a shared interest in tackling harmful tax practices and promoting just tax policies. The network has researchers and / or active partners in over 80 countries in 6 continents. The network has regional secretariats in Africa, Asia, Australia, Europe, and North and South America. Its international secretariat is located in London.

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run to many billions of pounds annually. The arising revenue losses are likely to exceed the value of aid flows by a significant margin.

The most effective means of deterring tax evasion involving offshore structures, typically located in secrecy jurisdictions, is through a system of multilateral automatic information exchange treaties. The European Union already has such a system in place (in the form of the 2005 Savings Tax Directive) and is pushing for various reforms to strengthen information exchange relating to legal entities such as trusts and offshore companies, and to broaden the types of income covered. TJN proposes that a variant of automatic tax information exchange can be adapted to meet the needs of developing countries with democratic and stable governments. Even a simplified approach to exchanging basic information would provide a 'smoking gun' to trigger investigations.

Adopting effective tax information exchange processes would deter and significantly curtail tax evasion. DFID might usefully take a part in supporting pilot projects with selected developing country partners to adopt automatic information exchange and build capacity to effectively handle the arising data flows.

Tax evasion: reaching epidemic levels

For obvious reasons it is hard to produce reliable estimates of tax evasion, either nationally, regionally or globally. In November 2011 the Tax Justice Network published estimates based on shadow economy data produced by the World Bank giving a global tax evasion figure of $3.1 trillion annually.[2] Only a small handful of countries (accounting for less than 2 percent of global GDP) were not included in this estimate.

The scale of tax evasion varies from country to country and from region to region. Africa, for example, is estimated to lose tax revenues amounting to approximately US$79 billion annually, representing 98 percent of total healthcare expenditures for that continent. In the case of Latin America the figures were US$376 billion and 139 percent respectively. Analysed at country level it is clear that developing countries are significantly more vulnerable to tax evasion than the majority of developed countries (see table starting on p.17 of TJN's report listed in footnote 2 below). At the most extreme is Bolivia, with a shadow economy estimated at 66 percent of total GDP, where tax losses due to evasion are over four times the annual healthcare budget.

Tax evasion arises at both the domestic level and from non-declaration of incomes and capital gains on assets held offshore. The ratios vary significantly from country to

[2] See http://www.tackletaxhavens.com/Cost_of_Tax_Abuse_TJN%20Research_23rd_Nov_2011.pdf accessed 25-01-2012

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country, and the available data on cross-border financial and non-financial investments and banking assets are filled with gaps. Estimates for Latin America, for example, suggest that over one-half of all financial assets of high net-worth individuals on that continent are held offshore, almost entirely evading taxes.[3] No comparable figure is available for Africa, but most specialists conclude that the figure is at least as high as that for Latin America, if not higher.

The scale of illicit outflows from developing countries has been estimated at between US$858 billion to US$1,060 billion a year. The large majority of these outflows are destined for banks and financial institutions located in developed countries. In May 2010, Global Financial Integrity, a Washington-based research advocacy group, used data from the Bank for International Settlement to estimate that developed country banks absorb between 56 to 76 percent (depending on source country) of cash flowing out of developing countries.

It is clearly not practicable to accurately estimate what proportion of the income from assets held offshore is not declared for tax purposes in the country of residence of the ultimate beneficial owner. Through extensive interviews with banking professionals and other wealth managers, TJN has estimated that the vast majority, exceeding 90 percent, of such income is undeclared. The scale of the problem is clearly immense. In 2005, TJN estimated the global volume of personal wealth of high net-worth individuals held offshore at US$11,500 billion (TJN, 2005) The Price of Offshore). The potential tax revenue losses arising from this offshore wealth holding were conservatively estimated at that time at US$255 billion annually. We stress this is a conservative estimate for two reasons: first, it was not possible at that time to estimate offshore wealth holdings of African HNWIs, and therefore the entire continent was not included in our estimate. Second, the figure relates only to HNWIs (super rich individuals) and therefore excludes a wide category of other users of offshore (the proverbial Belgian dentists with deposits squirrelled away in Luxembourg).

Since we published *The Price of Offshore* in 2005, new data has emerged concerning financial outflows from Africa. In April 2008 James Boyce and Léonce Ndikumana of the University of Massachusetts, Amherst, published fresh research which estimated that capital flight from 40 sub-Saharan African countries between 1970 to 2004 stood at US$607 billion in 2004 dollars (including interest earnings), compared to a total of US$227 billion external debt owed by those countries in 2004. An even more recent update has estimated the accumulated capital losses of 37 sub-Saharan countries

[3] See TJN (2005) *The Price of Offshore*, accessed here: http://www.taxjustice.net/cms/upload/pdf/Price_of_Offshore.pdf

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between 1970 and 2008 at US$944 billion.[4] This sum vastly exceeds the volume of aid flows over that period.

The Boyce/Ndikumana estimates reveal that Sub-Saharan Africa is a net creditor to the rest of the world in the sense that external assets, measured by the stock of capital flight, exceed external liabilities in the form of external debt. As Boyce and Ndikumana comment: *"The difference is that while the assets are in private hands, the liabilities are the public debts of African governments."* They further note: *"The real counterpart of many assets on the balance sheets of creditor banks is private deposits in many of the same banks by individuals belonging to Africa's political and economic elites."*

Since we published *The Price of Offshore* the scale of the problem appears to have increased. Recent unpublished research suggest that the sums being shifted offshore have accelerated in the past few years, partly in response to financial crises in many countries. One US expert has suggested that the stock of private wealth now held offshore may well exceed $US20,000 billion[5]. TJN has commissioned further research from this expert and we hope to be able to publish a revised estimate in quarter 2, 2012. What is indisputable, however, is that the sums involved are huge, tax evasion on cross-border wealth holdings is endemic, and developing countries are losing tax revenues on a massive scale.

What can be done to curtail cross-border tax evasion?

In the absence of effective exchange of information between tax authorities, the cost of enforcing tax compliance on foreign source income is prohibitive, especially for a revenue authority in a poorer country with limited capacity to mount time-consuming and expensive external investigations. The risk to tax evaders of being detected can be reduced significantly by using complex multi-jurisdiction structures involving offshore companies, offshore trusts, offshore bank accounts and similar legal devices structured through secrecy jurisdictions that provide legalised secrecy arrangements combined with weak or non-existent financial disclosure requirements. Such structures are the norm for most HNWIs placing assets offshore and, in the absence of cross-border cooperation between national tax authorities, tax evaders can be confident that the risk of detection, successful investigation and subsequent prosecution is low to infinitesimal.

The antidote to this generalised view that tax evasion using offshore structures is a relatively risk-free crime lies with reinforcing national sovereignty on tax matters

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[4] Ndikumana, L. and Boyce, J. (2011) *Africa's Odious Debts: How Foreign Loans and Capital Flight Bled a Continent,* Zed Books, London

[5] Jim Henry of Sag Harbor Consulting in a draft paper given at a research workshop at Essex University, 5th-6th July 2011

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through enhanced international cooperation and greater transparency of ultimate beneficial ownership of offshore legal structures. This is not rocket science. Information exchange processes have been negotiated in some double taxation agreements between countries, and bilateral tax information exchange agreements exist between some developed countries and some offshore secrecy jurisdictions. Since 2005, member states of the European Union have had a multilateral agreement for automatic exchange of tax information (known as the Savings Tax Directive), which, although deficient in some technical respects, represents the appropriate standard to which other regions should aspire. The United States has enacted the Foreign Account Tax Compliance Act (FATCA) which requires foreign registered banks to automatically share information about US citizens operating offshore accounts.

The advantage that the European Union model holds over alternative systems of tax information exchange lies with the exchange happening on a multilateral and automatic basis. A resident of country A opens an account in country B and the bank branch where the account is opened automatically informs the tax authorities of country B who in turn automatically shares that information (using suitable encryption technology to protect confidentiality) with the tax authorities of country A. Extended to cover all types of income or capital gains, and to include legal as well as natural persons (e.g. companies, trusts and foundations), this approach has the great advantage of having a strong deterrent effect on tax evasion. It is also far cheaper than the alternative approach to tax information exchange which involves detection, investigation, and a formal request for cooperation from the courts of the treaty partner through what is known as the 'on request' model for tax information exchange. This is the model currently promoted for over a decade by the Organisation for Economic Cooperation and Development and which is widely seen as cumbersome and inadequate.

To date no developing countries have provision with other countries for automatic exchange of tax information. The United Nations Committee of Experts on International Cooperation on Tax Matters has concluded that a multilateral tax treaty solution would be beneficial to developing countries and further proposed, in 2009, that automatic information exchange would be the preferred standard:

> "… the extent of administrative burden could be reduced if information were provided automatically by financial institutions. . . Automatic provision of information could substantially benefit developing countries since it would provide them with information even in the absence of an investigation."

This emphasis on using automatic information exchange as the effective international standard for curtailing tax evasion in developing countries was given further political momentum at the G-20 Summit in November 2011, when India's Prime Minister Manmohan Singh said:

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"The G20 countries should take the lead in agreeing to automatic exchange of tax related information with each other, irrespective of artificial distinctions such as past or present, for tax evasion or tax fraud, in the spirit of our London Summit that 'the era of bank secrecy is over'."[6]

TJN supports this position. We view automatic information exchange as the appropriate model for developing countries to adopt. We argue that automatic exchange has clear advantages over the 'on request' approach mentioned above in so far as it has a stronger deterrent effect – and will therefore work faster to shape a culture of tax compliance – and it is vastly easier and cheaper to implement.

Developing countries have already demonstrated their capacity to handle online cross-border automatic information exchange for security purposes (the use of passport swipe technologies at border controls has become a global norm), and there is no reason why tax authorities in developing countries should not be able to rapidly adopt technologies to make effective use of tax related information. Above all we would stress that the very threat of effective information exchange would go a long way to changing the attitudes of persistent abusers.

How would we go about the process of extending AIE to developing country partners? Larger and politically more powerful countries might initially be attracted to the unilateral AIE approach adopted by the United States through its Foreign Account Tax Compliance Act (FATCA).[7] Alternately, such countries might want to work with regional partners to emulate the EU's Savings Tax Directive (in its amended form once this has been adopted) and extend it to secrecy jurisdictions. Another alternative would be to participate in the 1988 joint Convention on Mutual Administrative Assistance in Tax Matters (OECD and Council of Europe), which since April 2010 has included a protocol that opens participation to non-OECD and non-European states.

Developing countries with limited tax administration resources would probably benefit from being able to use a more basic form of automatic information exchange involving exchange of limited information (e.g. citizen A, ordinarily resident at such-and-such address, has opened an offshore bank account at the following bank branch in jurisdiction X). Even this simple approach to tax information exchange would be sufficient to provide a 'smoking gun' for investigations if and when it subsequently becomes apparent that tax evasion might be happening. For such countries it would be helpful to provide technical support with negotiating tax information exchange

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[6] See http://taxjustice.blogspot.com/2011/11/india-demands-automatic-information.html accessed 25-01-2012

[7] See TJN briefing here: http://www.taxjustice.net/cms/upload/pdf/FATCA_1004_TJN_Briefing_Paper.pdf

agreements with offshore jurisdictions and with developing capacity to effectively use such agreements to gather the evidence required for a successful prosecution.

Concerns about information leaks from revenue offices are sometimes exaggerated, but steps can be taken to provide secure channels for tax information exchange and restrict access to data records to protect confidentiality. In some circumstances it might be appropriate to not share information with countries where human rights are not observed or are violated.

Concluding remarks

Effective tax information exchange could significantly reduce and deter tax evasion, and by curtailing illicit financial flows it could also achieve some of the macro-economic rebalancing required for the global economy. The current situation, in which the majority of developing countries are not party to effective tax information exchange processes, has trapped them into a vicious circle of capital flight, under-investment, economic volatility, and over-reliance on external debt. The other side of this particular coin is excessive inflows of hot money into speculative markets, harmful currency appreciation (as happened to the Swiss franc in 2011), falling aggregate demand and rising inequality.

Considerable progress has been made in the past five years towards creating information sharing processes between developed countries and cooperating secrecy jurisdictions. Developing countries generally suffer from larger illicit financial outflows and consequently higher levels of offshore tax evasion, but by and large have not benefited from the recent progress. Supporting such countries with creating effective information exchange processes would rapidly enhance tax compliance and reduce their revenue losses. Accompanied by other transparency-enhancing measures, e.g. requirements for disclosure of corporate ownership information, and a country-by-country financial reporting standard, effective tax information exchange would greatly assist many developing countries with building sustainable tax revenues.

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