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POLICY PAPER ON AUTOMATIC TAX INFORMATION EXCHANGE BETWEEN NORTHERN AND SOUTHERN COUNTRIES- Prepared by Markus Meinzer, TJN-IS

Contents

1. Introduction

1.1 We have a problem

1. Since the UN-Financing for Development Conference in Monterrey 2002, domestic resource mobilization has been put high on the international development agenda. In this context, the important role of raising tax revenues in developing countries (DC) has been increasingly acknowledged. While the design and functioning of domestic tax systems attracts increasing attention, the international dimension to the problem is much less discussed. The problem becomes apparent when looking at phenomena such as "capital flight" and illicit financial flows which often result in massive cross-border tax evasion by tax-residents of DCs, much to the detriment of their public finances and prospects of economic development. One step to solve the problem is automatic information exchange between destination countries of "tax flight" (such as Europe and North America) and developing countries. Automatic tax information exchange (AIE) exists today for example in the European Union (EU) under the EU-Savings Tax Directive (EUSTD).

Definition of AIE by OECD: "Information on one or various categories of income[1] having their source in one Contracting State and received in the other Contracting State is transmitted systematically to the other State." (OECD 2001: 1, FN1).

1.2 Proposed solution

2. In order to raise awareness and remedy the apparent lack of information about and understanding of AIE, TJN has started a precedent case project in early 2010. Ultimately, its aim is to accompany a small group of developing countries applying for the extension of the automatic information exchange mechanism under the EU-Savings Tax Directive or another international legal instrument that results in a similar AIE-mechanism. This paper is one stepping stone in this process and seeks to comprehensively introduce policymakers in North and South and civil society organisations to the subject.

3. There are three reasons for choosing the EUSTD as the AIE mechanism to start with. Firstly, with 27 (42)[2] member states it is the largest (by number of states) multilateral arrangement providing for a working system of AIE, with large amounts of portfolio investments of developing country residents being on deposit in Europe (see chapter 2.4). Secondly, the coverage of the EUSTD is not limited to EU-member states but extends to other secrecy jurisdictions, such as the Cayman Islands and Switzerland. Therefore, it promises to result in even higher net marginal revenue for developing countries. Thirdly, the EU appears to be politically approachable about this matter because it is currently aiming to enhance policy coherence between its tax and development policies and the EU-Commission indicated a general openness towards exploring the participation of developing countries in AIE along the lines of the EUSTD[3] (e.g. EUC 2010: 10).

[1] Income can take various forms, such as business profits, interest, dividends, capital gains, royalties.

[2] While 27 is the number of member states of the European Union, 15 additional of jurisdictions are covered by equivalent or similar measures. See Chapter 5 and Spencer (2003) for details.

[3] Apart from the available written evidence, Mr Philip Kermode, Director of the EU-Commission's Directorate D on Direct taxation, Tax coordination, Economic analysis and Evaluation (in TAXUD), said during a public conference held at the European Parliament in December 2009, that there are no fundamental objections from the European Commission for developing countries asking to become part of automatic exchange mechanisms similar to those established under the EUSTD. He emphasized, however, that this question will need to be further discussed within the corresponding European institutions once developing countries have expressed their interest to become part of these mechanisms (Conference on Tax and Development, 9.12.2009, Brussels, see http://ec.europa.eu/development/services/events/tax_development/td_agenda_en.htm; 12.7.2010).

1.3 State of play

4. In September 2010, commitments by developing countries to take part in such a precedent case project have not yet been secured. Instead, informal contacts have been established and talks held with a wide range of stakeholders, providing a promising point of departure for future efforts. During a session of the Committee of Tax Planning Control of the Inter-American Center of Tax Administrations (CIAT) in April 2010 in Argentina, a presentation has been given to the delegates[4]. Similarly, the idea could be presented to an appropriate Committee of the African Tax Administration Forum (ATAF) before the end of 2010. In December 2009, the UN-Committee of Experts on International Cooperation in Tax Matters has been informed about the widespread use of AIE through a letter sent by senior TJN-experts (TJN 2009; see chapter 4). Ongoing exchanges have started with a variety of stakeholders within the European Commission and technical staff of several tax administrations. An IT-system mirroring the AIE-mechanism of the EUSTD for demonstration purposes is ready to be developed within few working days in cooperation with an IT-consultant for usage in future presentations.

1.4 Structure of the paper

5. The following second chapter gives an overview on the different causal mechanisms AIE relates to. It embeds the paper in the current development and finance debates and sheds light on the fiscal and macroeconomic effects AIE is likely to have. In addition, it explains existing and introduces new empirical material to substantiate the claim on the weaknesses of the current international rules. Chapter three introduces the concept of automatic tax information exchange in detail and analyses its comparative merits. Chapter four points the reader to a variety of examples of implemented AIE and summarizes its status under international law. Chapter five presents the EU-Savings Tax Directive in some detail and highlights the related potential for developing countries. A section on IT-details is intended to familiarize practitioners with basic information on the hard- and software in use. The paper concludes in chapter six.

2. Economic Development, Financial Flows and Cross-Border Tax Evasion

2.1 The role of tax in development

6. It is now widely agreed that high levels of income inequality hinder economic growth, as do high levels of foreign denominated debt[5]. At the same time it is evident that the revenue needs of developing states can only be met either from tax revenue, or by raising (foreign) debt, or by receiving foreign aid[6]. Of these it is suggested that only tax is an ultimately desirable, reliable and sustainable source of financing for economic development and the combating of poverty.

7. In consequence, raising tax revenues is an imperative for spurring economic growth in developing countries. In this context special attention should be given to taxes that have the highest potential to reduce inequality, thereby harnessing further positive effects (externalities) for economic growth. Apart from targeted wealth taxes, direct taxes such as personal and corporate income taxes have the highest redistributional capacity, while VAT- or consumption based taxes are associated rather with regressive effects, falling disproportionately on the poorest segments of society (CEPAL 2006: 95-102;

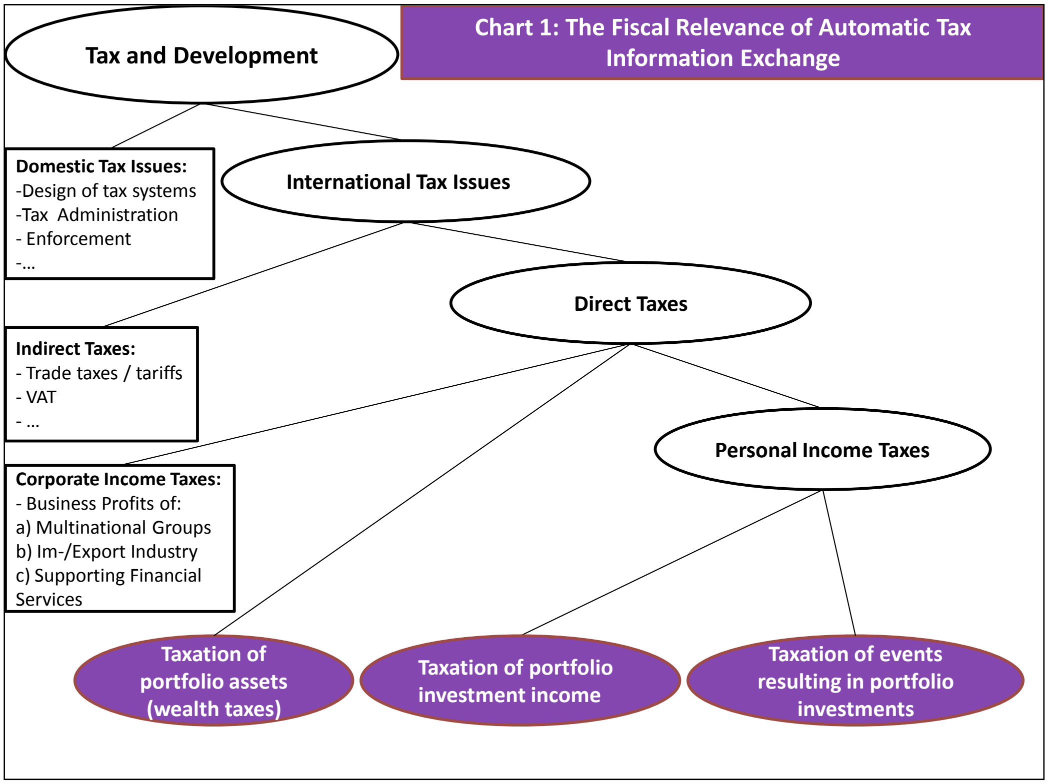
[4] An article elaborating on the presentation can be found here: http://www.taxjustice.net/cms/upload/pdf/Meinzer2010_Observatorio_11.5.2010; 16.7.2010.
It has been published in the online-publication of the Argentinean Tax Authority AFIP, *El Observatorio del Instituto*. The issue can be found here: http://www.taxjustice.net/cms/upload/pdf/AFIP2010_Observatorio_14.5.2010; 16.7.2010.

[5] Perry et al. 2006: 11-12, 115-127; Eichengreen/Hausmann/Panizza 2002; Pattillo/Poirson/Ricci 2002; Fritz 2004.

[6] Ignoring money creation as a clearly unsustainable fourth alternative.

Christian Aid 2005: 5, 16, 18; Cobham 2007: 2).

8. In developing countries, revenues from direct taxes are those that fall furthest short when compared with the average OECD-country tax mix (e.g. Cobham 2005a: 15). Prioritising these appears justified for another set of reasons. There is an increasing body of plausible evidence about the staggering magnitudes of lost tax revenue in developing countries due to tax evasion and avoidance of direct taxes (in the main) through abuse of cross-border transactions. It follows that any short- and medium-term developmental strategy has good reasons to prioritize the collection of direct taxes[7]. Focusing on direct taxes brings personal income taxes (PIT) and corporate income taxes (CIT) to the centre of interest.



9. However, AIE and therefore this paper's concern is limited to the effects of individuals' tax evasion through holdings of foreign portfolio assets (and excludes the corporate tax avoidance and evasion). The common background for this kind of tax evasion to occur is today's widespread use of the residence principle of taxation, meaning that a resident has to pay tax in her country of residence on her worldwide income, no matter where the source of the income is located (Ligthart/Voget 2008: 1). Chart 1 (below) summarizes the logic laid out so far.

2.2 Direct fiscal effect of tax evasion

10. The possibility of holding portfolio assets in (banks in) Northern Europe without paying taxes either in the source countries (e.g. withholding taxes in Europe) or in the countries of residence of the asset owners (developing country) has two separate economic effects on southern countries. The first is the direct loss of public revenue due to the tax evasion and the second are the macroeconomic opportunity costs of capital being invested tax free abroad rather than in the domestic economy where capital (foreign currency) is scarce. As regards the direct effect, the income of the portfolio investment located abroad (e.g. interest on bank deposit) would be generally subject to the domestic income tax. Estimates attribute an annual loss of 255bn US$ to this kind of tax evasion by wealthy individuals hiding their

[7] Except if there are specific circumstances are warranting a deviation, e.g. if there are concrete hints at systematic and substantial evasion/avoidance of tariffs, consumption-based taxes, etc.

assets "offshore"[8] (TJN 2005: 12). The underlying research uses data on foreign portfolio investments published by, among others, the Boston Consulting Group and Merrill Lynch (ibid.: 12), and applies conservative assumptions on evasion rates, economic return rates, and tax rates. The fraction of this loss attributable to developing countries is estimated by Cobham (2007: 6) to amount to 50bn US$.

11. However, with respect to the total loss of tax revenue for developing countries by foreign holdings of portfolio assets, this number is likely to be an underestimate for a variety of reasons. First, it does not include private banking in all developed countries as destinations of portfolio investments, where much of the foreign portfolio assets are believed to be on deposit[9]. If the foreign assets under consideration were extended to include those invested in rich countries usually not considered to be offshore, both the amount invested and the annual cost through evasion is likely to greatly increase. Second, these numbers do not account for the fact that developing countries sometimes levy a wealth tax on the value of the portfolio assets and therefore understate the total revenue loss to them. Third, these numbers do not include the tax loss that may occur if the assets invested offshore have been earned without paying the appropriate (income or capital gains) tax in the first place when the assets were created.

12. In a time of open capital accounts, a developing country resident can invest in northern financial markets by different mechanisms. For example, she can hold a bank or brokerage account directly in her name, the transfers to which are instrumented through banks (wire transfers) or currency exchange houses. Alternatively, she can use more complex arrangements including private companies and trusts to hold the bank account in the name of nominees (shell companies, trustees).
The northern countries where the account is located often exempt income on this non-resident account from any (withholding) tax, as for example the USA, Germany and France (Carstens 2009; IBFD database 2010). In addition, capital gains by non-residents may also often be left untaxed in and by the northern country (example of Germany, see IBFD database 2010). Such absence of taxes at source has an impact on the investment decision of non-residents if it is combined with factual financial and tax secrecy in the northern country.

Box 1: Tax Evasion through portfolio investments by individuals
Consider the following example for illustration purposes: Assuming an "offshore" deposit of 1 million US$ and an annual rate of return (interest) of 5%. Annually, this wealth creates 50.000 US$ of returns. Assuming a top income tax rate of 50%, the annual revenue lost to the developing country would amount to 25.000US$, a sum growing each year through the received interest. However, the developing country may levy a wealth tax of

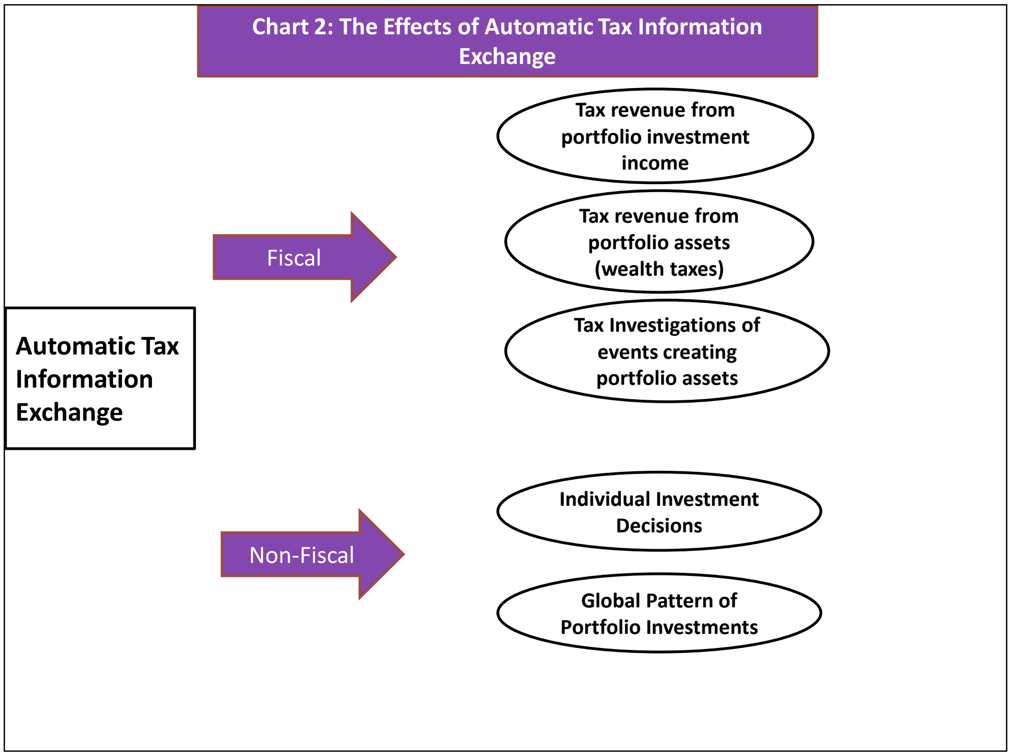
[8] This number is widely accepted and was used, for instance, by current EU-Commissioner for Trade (former Commissioner for development), Karel De Gucht, during the Conference on Tax and Development, 9.12.2009, Brussels.
[9] The definition of "offshore" used in the data underlying TJN's research has not systematically included all non-resident assets on deposit in developed countries (Email-Exchange John Christensen June 2010). For the importance of "First World Banks" in the offshore business, see for example Henry, James S. 2010: Tax Offshore Wealth Sitting in First World Banks, in: Forbes Magazine (19 July 2010), in: http://www.forbes.com/forbes/2010/0719/opinions-taxation-tax-havens-banking-on-my-mind.html; 7.7.2010. Other anecdotic evidence for the importance of the "developed world" as a destination of foreign portfolio investment of developing country residents is a piece of research on Argentina. Gaggero et al. (2007: 59) estimates that 100bn US$, beneficially owned by Argentinean residents, are invested in portfolio investments abroad and that 85% of the income deriving from this sum is not declared in tax returns. If a remaining rate of evasion of 20% is assumed (below which tax evasion can hardly be reduced), this results in an annual loss of around 735 millions US$ of foreign currency earnings to the Argentinean budget (not including the tax on wealth/assets, which would generate another 520 million US$ per year; ibid.).

0,5% on the value of the assets. This would add a revenue loss of 5000 US$ each year. In addition, assume that the entire million is the result of a sale of shares the profit of which would be liable to capital gains tax at a rate of 30%. Then the one-off revenue loss due to the offshore investment amounts to 300.000 US$. Automatic information exchange under the EUSTD would directly address the first kind of revenue loss (through evasion of tax on portfolio income), and indirectly help tackling the latter two kinds of evasion. In this example, AIE could result in additional revenue of up to 330.000 US$ in the first year, and 30.000 US$ in the following years.

13. As developing country residents will be aware that they need not pay any tax at source for "safe" investments in bonds, bank deposits or brokerage accounts for example in Europe, they face an incentive to invest there if a safe way of transferring the amounts without major risks of detection is available. This risk is low indeed, as recurrent evaluations on the implementation of anti-money laundering regulations in the financial sector show across the board, and the means of slipping through the piecemeal safeguards against criminal funds in developed countries are enormous (Global Witness 2009; Anti Money Laundering Task Force 3L3: 15-20). Given this leniency in regulations as regards outright criminal funds, it seems fair to suggest that it is relatively easy to hide tax evading monies in Europe[10]. On the other side, the dismantling of capital (outflow) controls over the last 30-40 years (Miniane 2004) reduced the likelihood of detection of such transfers by developing country administrations (Cobham 2002: 180-182). Therefore, the incentive to transfer funds out of developing countries for tax evasion purposes has grown over this period of time.

2.3 Tax competition and south-north capital flows

14. The second effect of tax evasion through individual portfolio holdings is the indirect effect on geographical investment decisions. All other things being equal, if an investor can choose between a portfolio investment in two jurisdictions, and in one of them it will be possible not to pay tax and thus yield higher net-returns, economic theory predicts that the choice is likely to fall on the jurisdiction which offers the option of tax evasion. Given the absence of an effective international regime to counter tax evasion, and given a demand to hold foreign portfolio assets by developing country residents, the potential of tax evasion is both one important cause exacerbating this demand and a determining factor for the location decisions of the foreign portfolio assets. The result is a drain of capital and



[10] While tax evasion can be a crime in many jurisdictions, so far it has not been consistently included as a predicate crime under the applicable FATF-recommendations.

foreign currency out of developing countries (see chapter 2.4). This drain in turn has serious additional implications for the economic development prospects of southern countries.

15. It is widely agreed among scholars working on tax competition that an important determinant for the location of foreign portfolio investment is the effective tax incidence on the concomitant income[11] (Rixen 2008: 43; Dehejia/Genschel 1999). Integrating both of the aforementioned dynamics of cross-border tax evasion (revenue loss and investment decisions), US-tax expert Slemrod (1990) develops a specific north-south model of taxation and portfolio investment flows from the more generic tax competition literature[12]. The assumptions he makes accurately reflect the current real-world setup of international tax rules, if it is taken into account that a) capital controls have been widely dismantled (Miniane 2004, Epstein 2005: 24; Cobham 2002: 167-168), b) there is no multilateral automatic information exchange, and c) even if withholding taxes are levied, these are usually far lower than top (income) tax rates. Out of this model, Slemrod draws some clear conclusions:

> "The world equilibrium in the model is characterized by excessive (by the standard of global efficiency and Southern welfare) flows of capital across borders, and insufficient investment located in the South." (Slemrod 1990: 1).

16. Evidence for this hypothesis is debated and no consensus exists about the empirical reality and implications of the **net** capital or financial transfers between northern and southern countries.
One reason for the difficulties in finding empirical evidence relates to a lack of data. Another reason may be the opposite theoretical claim by neoclassic and neoliberal economics. Their growth and economic models predicts the opposite: net capital flows from countries with relative abundance of capital to countries with a relative scarcity of capital. Conflict has ensued over the interpretation of the available empirical data[13].

17. A truce between both contending schools can sometimes be found by emphasizing the general pro-cyclicality of private capital inflows[14] that results in increased financial volatility and in widening external financing gaps for developing countries in times when they are experiencing economic downturns and declining export earnings (Worldbank 2009: 39, 80). According to the Worldbank, the lack of fresh private capital inflows to developing countries amounted in 2009 to 352 to 635 bn US$, predominantly needed to refinance old debt (ibid.: 84). As these gaps in the balance of payments cannot be closed by

[11] There are a number of other assumptions underlying this literature, some of which may be contested, such as that the attraction of foreign capital is a worthwhile policy goal in itself (Rixen 2008: 43).

[12] He assumes that the Southern country is unable to effectively tax its residents' foreign source income, while the Northern country chooses not to levy a withholding tax on the portfolio income of foreigners and disposes of a technical advantage.

[13] This conflict is particularly visible and condensed in the question if opening up to foreign capital inflows spurs economic growth (e.g. Herkenrath 2010; Cobham 2002: 182; Lee and Jayadev 2005: 46; Epstein 2005: 24; Quinn 1997: 541; Quinn/Toyoda 2008: 25). No research programs are known to me that address the more fundamental question if actually there are net-capital transfers from north to south, and what implications net-financial transfers in the same or opposite direction may have.

[14] The Worldbank provides evidence as regards bond and equity financing (2009: 39), bank lending (ibid.: 39, 49), FDI inflows (ibid.: 52, 54) and increased ratios of repatriation of earned profits instead of reinvested profits (ibid.: 52). The Worldbank writes: "Net portfolio equity flows plunged by almost 90 percent from $139 billion to a mere $16 billion in 2008. Similarly, private debt flows declined substantially to $108 billion from $499 billion, driven by the sharp fall in short-term debt flows, which moved from $202 billion in 2007 into negative territory ($16.3 billion), and in bond financing, which came to just $11 billion in 2008, compared with $85 billion in 2007." (Worldbank 2009: 39).

selling off of foreign currency reserves (ibid.), the IMF and the Worldbank stepped in as the only available lender of urgently needed funds preventing illiquidity or insolvency. As is widely known, these loans come with political conditionality, have a dubious record and seldom allow a country to choose a sustainable development path. More recently, the IMF published a working paper that emphasized the enormous economic cost to developing countries facing a sudden stop of international capital inflows if compared to a domestic financial shock (Ozkan/Unsal 2010)

18. Against this background, it becomes obvious that capital flight induced by the option of tax evasion bears an important macroeconomic significance because it increases the external financing gap in the balance of payments. Therefore, it is warranted to explore the role of tax evasion not only in a strictly fiscal context, but also in the context of macroeconomic stability when considering the costs and benefits of cross-border financial flows or capital flight and when analysing global investment patterns.

19. Two different macro-economic aspects of foreign portfolio asset holdings need to be differentiated. The first relates to the plain loss of investment capital that will result to a reduced growth rate of the economy if cleaving to the standard classic economic model. Domestic savings are not available to the domestic financial system to be invested in the domestic economy but will rather contribute to low interest rates and investment abroad. The second aspect relates to the balance of payments-effects and can be summarized succinctly as adding to the problem of foreign indebtedness or "original sin" (Eichengreen/Hausmann/Panizza 2002; Fritz 2002; Pattillo/Poirson/Ricci 2002).

20. Given that foreign portfolio investment must be made in foreign currency, capital flight represents a drain on the foreign currency position of the developing country. By increasing the demand for foreign currency, the domestic currency is depreciating and/or the domestic interest rate will rise. Even if the exchange rate is free to depreciate, increases in export earnings and falls in the demand for imports (in response to a depreciated exchange rate) take time to materialize. Therefore, the developing country will need to borrow foreign denominated debt irrespective of the domestic fiscal position.

21. On the other hand, if exchange rate volatility is to be avoided, in order to equalize the balance of payments and be able to pay for the imports (in foreign exchange) more debts denominated in foreign currency need to be contracted. In either case, the "revolving door phenomenon" with foreign debt fuelled capital flight is set in motion (Cerra/Rishi/Saxena 2005). Excess foreign denominated debt in turn is now generally accepted as a common cause for many of the emerging market crisis of the 1990s and 2000s.

22. In order to address these matters, Slemrod explores two different policies. First, the North could impose a withholding tax on portfolio income paid to non-residents. He concludes that under this assumption, and adding further conditions, the national income of the southern country could be improved despite tax revenue be allocated to the north. Alternatively, Southern countries could levy a tax on foreign source income, the result of which depends mainly on the cost of enforcing the tax. AIE is intended to reduce this cost to near zero. If the tax evasion component of the incentive to hold foreign assets is removed by automatic information exchange, a structural change in the investment patterns would start and the vicious circle of foreign debt and capital flight could be broken more easily.

2.4 Magnitudes and destination of south-north capital flows

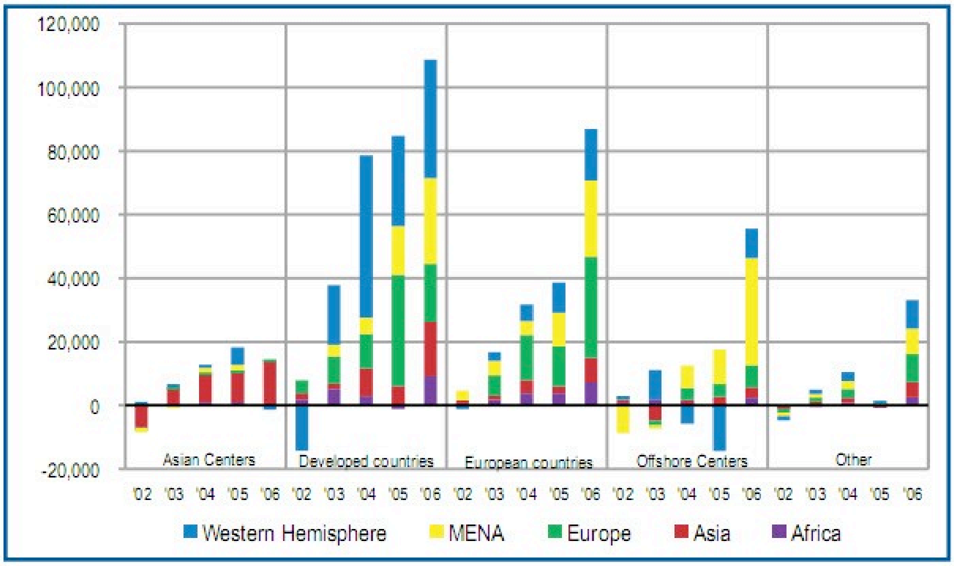
23. What are the magnitudes involved? The data available on cross-border financial investments and banking assets convey a picture with many holes. In May 2010, Global Financial Integrity (GFI), a Washington-based think tank, published a study on the destinations and origins of private banking deposits, largely based on special BIS-data[15]. The summary notes:

> "Our work demonstrates that developed countries are the largest absorbers of cash coming out of developing countries. Developed country banks absorb between 56 percent and 76 percent of such flows, considerably more than offshore financial centers. Thus, the problem of absorption of illicit financial flows is one that rests primarily with Europe and North America, rather more so than with tax havens and secrecy jurisdictions. " (Kar/Cartwrigth-Smith 2010: iii).

This finding can be revisited and is broken down in countries of origin of banking deposits in Graph 1 below. As becomes immediately obvious, "developed countries" followed by "European countries", represent the lion's share of absorption.

24. If we neglect methodological difficulties

Graph 1: Banking asset flows by banking region and split by country of origin (2002-2006); Source: Kar/Cartwright-Smith 2010: 23; based on BIS-data.



Caption for Graph 1: Country Groupings	
European Reporting Countries	Austria, Finland, France, Germany, Greece, Ireland , Italy, Luxembourg, Netherlands, Portugal, Spain, Switzerland
Developed countries	Australia, Japan, United Kingdom, United States
Offshore Reporting Centres	Bahamas, Bermuda, Cayman Islands, Netherlands Antilles, Panama, Guernsey, Isle of Man, Jersey, Bahrain
Asian Financial Centres	Hong Kong SAR, Macao SAR, Singapore, Taiwan
Other	Andorra, Anguilla, Antigua and Barbuda, Aruba, Barbados, Belize, British Virgin Islands, Cook Islands, Costa Rica, Cyprus, Dominica, Gibraltar, Grenada, Lebanon, Liechtenstein, Malaysia, Malta, Marshall Islands, Mauritius, Monaco, Montserrat, Nauru, Niue, Palau, Samoa, Seychelles, St. Lucia, St. Kitts and Nevis, St. Vincent & the Grenadines, Turks and Caicos Islands, Vanuatu
Source: GFI 2010, and Email-communication with authors in June and July 2010.	

(e.g. differing listings of countries counted as offshore) it becomes evident that the amount of funds originating from developing countries that are invested in developed countries and Europe are more than three times greater than the corresponding amount invested offshore (Kar/Cartwright-Smith 2010: 23-24). This finding of a relatively bigger proportion of banking deposits being located in developed country and European banks than in "traditional" offshore centres is greatly exacerbated if looking at funds originating

[15] Bank for International Settlements. As prior research of the same organisation has shown, the illicit financial flows annually leaving developing countries amounted to 612bn to 716bn US$ between 2002 and 2006 (Kar/Cartwright-Smith 2008: 9). These illicit financial flows involve "illicit money that is illegally earned, transferred, or utilized" (ibid.: vi). The new research shows that between 46% and 67% of these illicit financial flows are absorbed by developed country banks (Kar/Cartwright-Smith 2010: 30).

from African and Latin American countries. The lion's share of the problem here clearly lies with developed and European countries (from Africa 75%; from Latin America 76%) as the main recipients of foreign bank deposits (from Latin American countries in 2006: 37,3bn US$ to developed countries, plus 16,1bn US$ to European countries; sum equals 76% of total from LA-countries in 2006: 70,4bn US$; from African countries in 2006: 9,1bn US$ to developed countries, plus 7,2bn US$ to European countries; sum equals 75% of total from African countries in 2006: 21,7bn US$; Kar/Cartwright-Smith 2010: 35).

25. It is important to bear in mind that the displayed flows add to the deposits already invested (not only) in the developed country banks and include the payments of returns on already invested funds in the same banks. Therefore, a system of automatic information exchange would not directly uncover these flows but would transmit information on the returns paid on the deposited funds in the following period. By inference, this automatic information transmission could allow tax or prosecutorial authorities to investigate the issue of the origin of these funds as well (see Chart 2).

26. While on a macro-level it is reasonable to analyse the patterns of wholesale financial flows between originating country (source of funds) and destination country (bank deposit), for legal and taxing purposes with respect to the resulting portfolio assets, a more detailed level of analysis would need to be available. In order to econometrically estimate the extent to which developing countries are affected by tax evasion on the proceeds of these foreign portfolio investments, two more details in particular would need to be available. First, the share of interest in the net change of deposit would need to be known in order to identify the potential tax base. Second, the countries (or regions) of residency of the beneficial owners of the deposits would need to be known. The BIS-data about origin of funds does not give definitive certainty about the country of residency of the beneficial owners of these funds. Given the absence of meaningful data, research has not been conducted systematically on this question as yet and promises to be fruitful only if new data breakdowns are made available.

27. A similar conclusion can be drawn from a prior study published by GFI in March 2010 on privately held non-resident deposits (both corporate and natural persons; Hollingshead 2010: 5). Looking at deposits in banking institutions as defined by the BIS (ibid.: 6), and using data of the IMF and the BIS, this report departs from the contention that "private, non-resident deposits are highly correlated with tax evading offshore deposits" (ibid.: 1). Developed countries account for more than half of privately held non-resident deposits (Hollingshead 2010: 20-21). Out of 67 analysed jurisdictions, eleven developed countries[16] accounted for 51% of total private non-resident deposits (ibid.). While this research does not allow for analysis of the origin of funds, and differs in the country groupings from those in the other GFI report[17], there is no reason to believe that the investment pattern differs from the more nuanced study. Both studies confirm that the main destination for non-resident banking deposits are financial institutions of developed or "northern" countries[18].

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[16] These countries were Belgium, Germany, Iceland, Israel, Italy, Japan, Netherlands, Portugal, Spain, United Kingdom, and the United States (Hollingshead 2010: 20).

[17] Particularly the group of developed countries differs between both reports. Compare the footnote above with caption for Graph 1 (Kar/Cartwright-Smith 2010, see Box 2; Hollingshead 2010: 20).

[18] It is not straightforward to infer revenue losses from this annual deposit data. This is because many variables are unknown and would require to make heroic assumptions in order to arrive at some notion on the amount of revenue loss to be expected to southern or developing countries. These include for example: (i) It is not clear what share of the bank deposits recorded as originating from the developing country regions are beneficially owned by residents of the same developing country. It may be more accurate to assume this share to be somewhat lower because non-residents' transfers can also be recorded as money deposited abroad. (ii) The stock of the flight capital invested in northern countries is not

28. While currency risk and portfolio diversification considerations may represent factors that pull investment of wealthy elites out of developing countries, the potential tax-free nature of these investments exacerbates this incentive. If the incentive to invest capital abroad was decreased by the factor of tax evasion, a significant share of funds on deposit in northern countries would start to migrate back to the country of origin. Not over night, because the decision for investment in the northern banking systems is more than just tax-driven. A smooth transition could start. The currently "hard" currencies would start to slowly depreciate because of the outflow and decreasing demand for these currencies. At the same time, it would become more attractive in northern economies to produce labour intensive goods domestically instead of importing them from far away.

2.5 The inadequacy of the "upon request"-standard

29. Without international cooperation, the cost of enforcing a tax on foreign source income is infinitely high in an age of open capital accounts. However, there have been piecemeal attempts at cooperation taking place through bilateral information exchange treaties or treaty provisions. After the Second World War, western countries chose the OECD as an exclusive club of rich nations to take over the responsibility for international tax matters from the League of Nations. This organisation's Committee of Fiscal Affairs henceforth was responsible for drafting model texts for the so called double tax avoidance conventions (DTCs). These are treaties between two countries and regulate a broad range of cross-border tax issues. For example, the treaties allocate taxing rights between two countries relating to cross-border economic activity and investment. In their article 26, information exchange has been addressed and the "upon request" exchange form has become the tacit norm.

30. In the development process, DTCs play a contested role in their own right (e.g. UN 2009c: 5, FN 9). Importantly, their alleged economic benefit depends to a large extent on two assumptions. The first assumption is that hosting foreign investment is *per se* desirable for economic development. As has been argued in the previous chapter, no international consensus has been achieved on the interpretation of the available empirical evidence so far. The second implicit assumption is that in the absence of a DTC, income of cross-border investment will be taxed twice, by the country of residency of the investor, and by the host country of the investment (source country of income). However, this second assumption does not hold true as developed and developing countries usually provide for unilateral rules to avoid double taxation by granting either a credit against taxes paid to foreign governments, exempting foreign-source income from tax, or at least offering deduction of foreign taxes paid when computing the tax base (UN 2009c: 7). For example, out of 30 European countries, 20 offered unilateral credit and another five offered deduction of the paid foreign taxes (IBFD-database 2010).

31. In 2002, the Global Forum on Taxation hosted by the OECD, and made up of many notorious tax havens, published a text for a model of a new type of treaty with a narrower scope, called "Tax Information Exchange Agreement" (TIEA). While DTCs leave some discretion about what kind of information exchange can take place (not ruling out automatic information exchange), the new model TIEA of the OECD exclusively allows for information exchange "upon request". In 2009, under the auspice of the G20, signature of twelve of these TIEAs has become the threshold on which a jurisdiction moves to the "white list" of the tax haven progress reports of the OECD.

32. As most experts agree, this "OECD-standard" is inadequate to ensure effective international information exchange (Sheppard

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available as split by origin. The BIS only provided for a breakdown of the flows between 2002 and 2006. (iii) The average annual return on the deposited funds varies.

2009). While all of the flaws cannot be explored in detail here[19], the core problem is that it remains very costly to draft a request for information and implies building a detailed single legal case with a lot of prior information on the suspected tax evader being required. As a result, the information exchange clauses are seldom used.

33. For example, the TIEA between the US and Jersey has been used only four times in 2008, although the most sophisticated tax administration in the world is party to the agreement (Meinzer et al. 2009: 4). Other examples include data reported by the secrecy jurisdictions reviewed by the Tax Justice Network within the framework of the Financial Secrecy Index (See Table 1[20]). Out of the 60 jurisdictions reviewed, only seven provided information on the empirical use of tax information exchange arrangements. Although these seven jurisdictions host major international financial centres in 2008, they were asked for information only in 338 cases and provided information in 280 cases. These low levels indicate the difficulty and high cost of drafting single case information requests in a context where the likelihood of abuse is rampant.

34. The relative irrelevance of information exchange upon request can be substantiated by research on the pattern of tax information sharing between the Netherlands and its treaty partners between 1992 and 2005 (Ligthart/Voget 2008). On average, the Netherlands tax authority was provided with information in 863 cases after a request has been submitted (ibid.: 28). Most of this data, however, is not fruit of bilateral treaties, but of special mutual assistance rules within the European Union (ibid.: 3, 11). Putting these numbers in perspective, the authors note that "the average number of exchanges is extremely small compared to the number of Dutch income tax payers (8.86 million in 2004) and completed audits in the Netherlands (66,428 in total in 2004)." (ibid.: 10). Comparing these numbers with automatic and spontaneous information exchange, the disproportion grows wider:

> "On average, automatically received information amounts to 85.4 percent, spontaneously received information is 14.3 percent, and requested information amounts to 0.3 percent of the total amount of information received by the Netherlands." (ibid.).

35. The inadequacy of the standard can be further illustrated if taking into account that this trickle of information exchange takes place only if a treaty has been signed (either of both types). So far, it is not certain how developing countries benefit from this process. Research dating from June 2009 analysed the distribution of recently concluded bilateral treaties for information exchange (Misereor 2009). The paper concludes:

> "While G20 and OECD are promoting DTTs [Double Tax Treaties; MM] and TIEAs as centrepieces of a global standard on transparency and cooperation in tax matters statistics show that poor developing countries are simply left out in this picture. How

Table 1: Use of Tax Information Exchange Arrangements (2008)

Year 2008	Number of DTC	Number of TIEA	Number of Requests Received	Number of Answered Requests
Cyprus	41	0	90	50
Guernsey	2	1	34	31
Hong Kong	3	0	9	9
Isle of Man	1	8	28	28
Jersey	2	1	27	24
Malta	48	0	32	27
Mauritius	33	0	118	111
Sum	**130**	**10**	**338**	**280**

Source: TJN - Mapping the Faultlines – www.secrecyjurisdictions.com

[19] It has been done elsewhere, see for example Sheppard 2009. Tax Justice Network has published a freely available briefing paper in 2009 analysing these agreements in detail (Meinzer et al. 2009).
[20] In some cases this data includes information requests that relate to non-tax criminal matters.

> these countries should get access to 'the benefits of a new cooperative tax environment' (G20 London Summit) according to the recipes of the G20 and the OECD remains an open question." (Misereor 2009: 4).

Powerful northern countries like the USA or European nations may be in a position to force secrecy jurisdictions into such agreements. For developing countries, this may be far more difficult because secrecy jurisdictions expect little economic benefit from such information exchange arrangements no matter with whom they are struck[21].

36. Exploring a potential "tax treaty light" from a developing country perspective, the UN-Committee of Tax Experts concluded in its fifth session in 2009 that a multilateral tax treaty solution would be beneficial to developing countries, but that developing countries might be concerned about the cost information requests could impose on their administrations (UN 2009c: 12). As a solution, the Committee proposes automatic data exchange:

> "In addition, the extent of the **administrative burden could be reduced** if information were provided automatically by financial institutions (analogously, information concerning account holders and payments made to them is reported using a standard format under the **European Union Savings Directive**). **Automatic provision of information could substantially benefit developing countries**, since it would provide them with information even in the absence of an investigation." (UN 2009c: 12; emphasis MM).

37. While much of this chapter's thrust was to demonstrate the insufficiency of the "upon request" standard, a word of reconciliation is necessary here. As we will see later (chapter 3.4), AIE does not replace information exchange upon request, but ultimately requires the availability of "upon request" information exchange. Therefore, the progress made during 2009 and 2010 to increase the scope and effectiveness of information exchange upon request is not in vain, but can become an important building block for fundamental progress in international tax cooperation.

3. Mechanics and Effects of Automatic Information Exchange

3.1 What would AIE change?

38. It is the cost of enforcing a tax on foreign source income by southern countries that AIE between developing countries and OECD or EU-countries would reduce dramatically. As we have seen (chapter 2.1), most developing countries have switched to the residence principle of taxation which includes a liability to tax of all of a resident's worldwide income (Ligthart/Voget 2008: 1). However, the enforcement of such a tax is virtually impossible, helped by the dismantling of capital controls during the last 30 years. Without detailed and bulk information about resident owners of foreign assets, developing countries' tax authorities cannot equally enforce the tax law and the residents have little incentive to repatriate foreign wealth because its income goes tax free as long as it is abroad, and it may have been created in the first place without paying tax.

39. In practical terms, automatic information exchange would provide tax administrations in the participating countries with systematic data they can use to match with tax returns submitted by their tax residents. The data would represent a completely new source of information on a kind of income payments about which information has so far been nearly non-existent. The OECD defines automatic tax information exchange as follows:

> "Information on one or various categories of income having their source in one Contracting State and

[21] The finding that tax havens or secrecy jurisdictions provide less information than others is confirmed in Ligthart/Voget's research (2008: 11).

received in the other Contracting State is transmitted systematically to the other State." (OECD 2001: 1, FN1).

40. The introduction of AIE is likely to be known to the wealthy developing country residents and they will take appropriate steps to avoid prison terms. Wealthy investors in developing countries are usually receiving advice on tax and finance by highly professional firms and banks with strong links to northern financial centres. They are likely to pre-empt the legal changes and find strategies either to circumvent the new system (geographically) or to declare the assets before they are uncovered by AIE. In consequence, few of them will be directly imprisoned for tax evasion by evidence collected through AIE. In the medium term, however, tax compliance can be expected to drastically increase according to research findings in a national context presented in more detail below.

41. While voluntary compliance is most desirable, unfortunately there is little evidence that it works absent control mechanisms. Bloomquist (2007: 5) carried out a study on behalf of the US tax authority IRS, whose main findings are summarized below.

> "Noncompliance rate is:
> * 53.9% when "little or no" information reporting;
> * 8.5% when "some" information reporting;
> *4,5% when "substantial" information reporting;
> * 1.2% when there is both withholding and substantial information reporting."
> (Bloomquist 2007: 5).

42. These numbers show (for the US example) that tax compliance increases by almost 50% if an automatic reporting element exists (and the surge in the compliance ratio is 207%, from 46,1% to 95,5%). These numbers apply to a national context only. In an international context, the discrepancies of compliance between "little or no" and "substantial" information reporting are very likely to be more pronounced because the risk of detection is far lower internationally than domestically. Furthermore, the level of voluntary compliance depends on the perceived compliance by others (Torgler/Schneider 2006: 3, 18), and since tax evasion is rampant in many countries[22] it can be concluded that - particularly in a developing country context - voluntary compliance by wealthy elites is somewhat implausible, but would be significantly boosted by AIE.

43. An evaluation of the experiences of the EUSTD confirms the contention about the relevance of AIE for investment decisions and the anticipatory adjustment of these investments. The investment pattern changed in reaction to the new automatic information exchange provisions both in geographical and in terms of types of investment (EUC 2008; Schwarz/Rixen forthcoming; details in chapter 5.1). Given that these changes were significant in macroeconomic terms, the contention of widespread tax evasion on cross-border portfolio investments, the comparative effectiveness of AIE and the behavioural adjustment of investors pre-empting imprisonment are confirmed by this finding.

44. As regards the efficiency of automatic information exchange versus upon request, TJN has been provided with some data by a European middle-sized country. It reported data on automatic and upon request information exchange with three developing countries in 2008, with a combined population of around 170 million in 2010. The numbers are displayed in table 2. As can be seen, the number of taxpayers about which information has been provided to the tax administrations is far higher in the case of AIE than in the case of "upon request" information exchange. The ratio of pieces of information exchanged under "upon request" mechanisms to those exchanged automatically is approximately

[22] See for example Lledo/Schneider/Moore 2004; Perry et al 2006: 101; Gaggero/Casparrino/Libman 2007.

1:20.000 for the three years under consideration.

45. While the cost of providing information automatically is not detailed or estimated, it is obvious that an automated process of data collection and transmission cannot create significant marginal costs. As regards the fix costs, no disproportionate costs are to be expected, given that the collection of most information is obligatory anyway under international anti-money laundering regulations, especially with respect to the beneficial owners of financial accounts (recommendation 5 of the FATF on know-your-customer procedures for financial institutions[23]).

Table 2: Information exchange and number of covered taxpayers

Year 2008	Information requests submitted "upon request"	Number of taxpayers, "automatic exchange"
Developing Country A	6	265953
Developing Country B	4	16266
Developing Country C	7	57180
Sum	**17**	**339399**

Source: Tax Administration of a European Country

3.2 Information subject: What information is exchanged?

46. In principle, the automatic exchange of tax information can entail two different kinds of information. Firstly, information can relate to the (identity of the) beneficial owner (BO) and secondly to the amount of income or payments. The FATF defines the beneficial owner as follows:

> "'Beneficial owner' refers to the natural person(s) who ultimately owns or controls a customer and/or the person on whose behalf a transaction is being conducted. It also incorporates those persons who exercise ultimate effective control over a legal person or arrangement."(FATF website - Glossary 49 Recommendations[24]).

Ultimate control over legal arrangements and persons and can be different from purely legal ownership. Legal ownership denotes those customers or persons whose name and identity is visibly associated with a bank account, legal arrangement, person, etc. They may be companies, nominees or straw men instead of the real beneficial owners on whose behalf the structure is run and managed.

47. The information on the beneficial owner typically includes data on the identity (at least name, birthdate and -place, address) of the natural person who owns or controls bank accounts, private companies, limited partnerships, trusts, foundations, anstalten, etc. If AIE is limited to the identity of the BO of domestic legal structures, the data exchange predominantly helps the detection of non-declared shareholdings, accounts and trusts of tax residents. It does not revealk whether all income of these legal structures has been correctly and in its entirety declared to the tax authority in their country of residence.

48. A broad coalition of civil society organisations asked the OECD end of January 2010 to develop such a system (CSO 2010), not least because it would be a first step towards a comprehensive AIE. It would provide the necessary triggering information to draft requests ("smoking gun") under the present "OECD-standard" of information exchange "upon request" (Murphy 2009). As we have seen before (see chapter 2.5), for a request to be answered, it has to be shown that the pursued information is "foreseeably relevant" to assess or enforce tax liabilities, and requires the names of account holders and of involved financial institutions (among many others). To successfully request information, ownership links between natural persons and legal structures located in another country are crucial to identify, a task

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[23] http://www.fatf-gafi.org/document/58/0,3343,en_32250379_32236920_43642938_1_1_1_1,00.html; 14.7.2010.

[24] See http://www.fatf-gafi.org/document/52/0,3343,en_32250379_32236963_45028276_1_1_1_1,00.html; 13.7.2010).

which AIE on beneficial ownership would accomplish.

49. In the second case of AIE on income payments, the exchanged information refers above all to the amounts of payments and income of prior precisely circumscribed categories within a predefined period of time. The EU-Savings Tax Directive is an example of such a system referring to savings income (interest). There is a threefold risk inherent in this approach. Firstly, not all essential types of income may be covered through such an AIE-system and avoiding reactions may set in to bypass the covered categories. Secondly, the legal concepts defining the categories may be watered down in ongoing negotiations or may be faulty from the outset. Thirdly, the differing national tax and legal systems can interplay so as to jeopardize an even and effective implementation and enforcement of the system, undermining its political support in the medium term. Picciotto (1992: 146-149) laid out clearly the potential problems arising because of divergent definitions of income and discrete national legal systems.

3.3 Information path: what does "exchange" mean?

50. AIE bundles two distinguishable processes. The first step is always a report or notification within a country. For example, a bank in country A will notify the tax authority (TA) in the same country about all account holders (or payments to them), who are residents of the country B or C. The TA in country A then assorts the received information of all banks of country A by the countries of residence of the account holders, and bundles them in packages for country B and C. After the information packages have been encrypted, they are ready to be exchanged.

51. In a second step, the information bundles will be sent to the TAs of the different resident countries of the taxpayers. At the same time, country A receives from countries B and C similar information packages about accounts of those tax-resident in country A. This is the cross-border information "exchange" in its narrow sense. Thereafter, the TA of country A decrypts and unpacks the information received from countries B and C and, in a federal tax system, assorts the data by the states (or *départements, Länder, Kantone*, etc.) of residency of the taxpayers and distributes them to the competent federal TA-offices.

52. For example, in the case of the EU Savings Tax Directive, the information exchange takes place once a year through an encrypted email-system. The system is prepared and administered by the EU-Commission. However, the Commission does not have access on this data, and the data is not stored there nor anywhere else in a centralised database. Thus, no huge database is created. Instead, speaking strictly, the information exchange takes place in bilateral packages that are multilaterally predefined and administered.

53. There is much evidence of the first component (notification and reporting) being a widespread feature of many national tax systems (OECD 2009: 176-179). For example, in the Swiss public pension scheme (second pillar, the obligatory professional scheme, and the third pillar, voluntary savings contribution) there is an automatic system requiring banks, foundations, and insurances to notify the tax administrations if the tax-free contributions are disbursed. Generally, this kind of automated reporting seems to be much more common for income derived from labour than income stemming from capital (ibid.).

3.4 Use of Information: what happens with the information?

54. In principle, the information that has been automatically received can be used in two different ways. First, all of the information can be used in order to systematically cross-check the information that has been filed by the taxpayers through tax returns. In a federal tax system, such a matching exercise is likely to be delegated to the subnational authorities (local tax offices), who receive the data for all the taxpayers resident in their domain. Second, instead of using all of the received

data, random sample checks can be carried out in order to check voluntary compliance in tax returns by matching them with data received from abroad.

55. Should a taxpayer be found misreporting her income, she will be sanctioned by the tax authority (fees, penalties, etc), with or without criminal charges. She may opt to appeal any decision by a tax authority or court against her on the grounds of data errors or technical failure. In such a case, ultimate enforcement of a tax claim may hinge upon access on original documents, bank statements and other files. These may be obtained through legal or administrative assistance. While some kinds of legal assistance may be granted even in absence of a treaty, only the existence of agreements or treaties on tax information exchange upon request or on administrative and legal assistance are a guarantor to obtain the required papers in a timely manner. Without agreements on the exchange of documents and files "upon request", AIE could soon be weakened by legal difficulties in the enforcement of tax claims that result from AIE. However, as previously described (chapter 2.6), the main effect of AIE is likely to be a pre-emptive adjustment of reporting of income and/or ownership, and not a widespread disclosure of tax evasion. Therefore, AIE does not replace information exchange upon request, but complements and facilitates the latter.

4. Implementation of Automatic Information Exchange

4.1 References in International Law

56. Contrary to the picture that is conveyed by most of the media and organisations such as the OECD, cross-border automatic information exchange is both an established concept and already widely implemented in practice. As regards references to AIE in international law, a letter TJN sent to the UN-expert committee on tax matters in December of 2009 gives an overview on the most important ones (TJN 2009). They are summarized below.

a) The commentaries to Article 26 on information exchange in both the model tax convention of the UN and the OECD mention automatic information exchange in addition to exchange upon request and spontaneous exchange of information. The Council of the OECD issued as early as 1981 a recommendation on "a standardised form for automatic exchanges of information under international tax agreements" (OECD Council Recommendation C(81)39, quoted in OECD 2008: 351).
b) In its report on access on bank information of 2000, the OECD emphasizes the benefits of automatic reporting by financial institutions to tax authorities "which greatly facilitates domestic tax administration and potentially expands the types of information that may be exchanged with treaty partners on an automatic basis. Such automatic reporting also may benefit taxpayers." (OECD 2000: 8-9).
c) The OECD analyzes the practical aspects of and provides IT-tools for automatic information exchange in its Manual on the Implementation of Exchange of Information Provisions for Tax Purposes (OECD 2006). In addition, the OECD together with the Council of Europe created a Model Memorandum of Understanding on AIE in 2001 "in order to improve the efficiency of automatic exchange of information […]." (OECD 2001: 1).
d) The preliminary recommendations of the so-called Stiglitz-Commission of the United Nations (UN Commission of Experts on Reforms of the International Monetary and Financial System) call for an amendment of Article 26 of the UN Model Tax Convention so as to "make the exchange of information automatic" in order to efficiently provide for domestic development finance (UNGA 2009a: 18, Para. 79).

e) The General Assembly of the United Nations voted unanimously the final report of the UN Commission of Experts on Reforms of the International Monetary and Financial System which calls for a new UN body to ensure that "all countries commit themselves to the voluntary automatic exchange of information that would help root out tax evasion and corruption and also the repatriation of illegal funds." (UNGA 2009b: 84, Para. 218). Given the high level of authority that rests with the General Assembly, this statement appears remarkable even though the word "voluntary" is clearly weakening the statement.

f) In its 2010- Communication on Tax and Development, the European Commission expressed its support for "Sharing experience in international tax cooperation gained through applicable instruments such as the EU Savings Taxation Directive, in order to explore the relevance and feasibility of multilateral agreements and automatic exchange of information for developing countries." (EUC 2010: 10).

4.2 Examples of implemented AIE

57. While a few examples of implmented AIE are publicly available for referencing, a major problem appears to be a measure of reluctance of states to publicly share experiences with or the mere fact of applying AIE. As a matter of fact, however, automatic information exchange is far more widespread than often believed. Below, five examples are summarized and the European Savings Tax Directive (EUSTD) will be dealt with in more detail in chapter five.

a) In the aforementioned OECD-report on "Improving Access to Bank Information for Tax Purposes" (2000 OECD: 40), automatic exchange of information is mentioned to be practised by eleven OECD-countries under bilateral income tax treaties. It is very likely that in the almost nine years that have past since the report was published, at least several other countries are exchanging information automatically pursuant to applicable income tax treaties.

b) A multilateral convention on Mutual Administrative Assistance in Tax Matters among Nordic states is in force since 1991 and requires automatic exchange of information on payments of dividends, interest and royalties, wages, salaries, fees, pensions, insurance and on real estate ownership (Art. 11; Nordic States 1989: 5-6; TJN 2009: 5).

c) In a letter of Mexican finance minister Carstens to his US-colleague Geithner it becomes clear that Mexico is already exchanging information automatically with the US (e.g. interest payments between corporations), but seeks to extend it to include all bank deposit interest (paid to natural and to judicial persons). Carstens expresses his conviction that the AIE on interest payments would "certainly provide us with a powerful tool to detect, prevent and combat tax evasion, money laundering, terrorist financing, drug trafficking and organized crime." (Carstens 2009: 2). This passage underlines the important secondary effect of automatic information exchange of thwarting illicit financial flows proceeding from other than tax related crimes.

d) Through its so-called "Qualified Intermediaries Program", the USA requires foreign financial institutions to automatically report information on US tax payers (either resident or non-resident) to the US-tax authority IRS. Financial institutions do have an incentive to become part of the QI because it entitles them at the same time to cast a veil of secrecy on investments (such as bank deposits) they make in the USA on behalf of non-US-taxpayers[25]. A law recently enacted under the Obama-

[25] For more background see http://www.secrecyjurisdictions.com/sj_database/USA%20%28Delaware%29.xml (1.6.2010).

administration, the Foreign Account Tax Compliance Act (FATCA), complements the mechanisms of the QI program, but only with view to US taxpayers. Financial institutions now also have to report foreign source income of US taxpayers and those financial intermediaries choosing not to participate in the revised QI program will face a 30% withholding tax on all payments relating to US-source income (Spencer 2010).

e) A few other examples are given in the aforementioned letter addressed to the UN-Committee of Experts on International Cooperation in Tax Matters, including automatic information exchanged between Canada and the USA, Canada and Mexico, and between Australia and New Zealand (TJN 2009: 6).

5. The EU Savings Tax Directive

5.1 Overview

58. One particular system for multilateral information exchange that includes secrecy jurisdictions (or tax havens) is the savings tax directive of the European Union (Directive 2003/48/CE[26]). A differentiation must be made between the current directive and how it is going to work once the proposal for revision will have been adopted. The European Commission submitted this proposal to the European Council in November 2009[27]. While described in more detail further below, it is important to bear in mind that the envisaged changes represent a substantial extension of the scope of the directive.

59. The savings tax directive came into force 1 July 2005 and, according to experts involved in the administration, functions today without major technical difficulties. The directive establishes an annual automatic information exchange on interest payments made by a financial institution located in one state that is a member of the European Union to natural persons resident in another jurisdiction. The geographical scope of the directive today includes firstly the 27 member states of the European Union, with the exception of two countries which implement a withholding tax on the same interest payments made to non-residents. For now, the applicable tax rate is 20% and from July 2011 onwards, it will be 35%. The corresponding tax revenue is shared between the country of residence of the recipient (75% of the sum) and the country where the paying agent (or financial institution) is located (the remaining 25%).

60. Equivalent or same measures (Spencer 2003: 8) have been established with 15 non-member jurisdictions. Five of these have been concluded through treaties between the European Union and the respective jurisdiction (Andorra, Liechtenstein, Monaco, San Marino, and Switzerland[28]), while ten were concluded bilaterally (Guernsey, Isle of Man, Jersey, Netherlands Antilles, Aruba, Anguilla, British Virgin Islands, Cayman Islands, Montserrat, Turks and Caicos Islands[29]). Of these fifteen countries, four implement automatic information exchange (Anguilla, Aruba, Cayman Islands, Montserrat), while the others operate a withholding tax as described above.

61. While the implementation is working smoothly on a technical level, a revision of the directive end of 2008 brought to light changes in the pattern of investments in response to the directive, the motivation of which is likely to be the avoidance of the directive[30]. These

[26] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32003L0048:EN:NOT; 1.6.2010.

[27] http://register.consilium.europa.eu/pdf/en/09/st16/st16473-re01.en09.pdf; 5.3.2010.

[28] http://www.consilium.europa.eu/showPage.aspx?id=916&lang=en; 20.1.2010.

[29] http://www.consilium.europa.eu/App/Taxation/Index.aspx?lang=; 20.1.2010.

[30] http://ec.europa.eu/taxation_customs/resources/documents/taxation/personal_tax/savings_tax/savings_directive_review/SEC%282008%292420.pdf; 5.3.2010.

changes took place predominantly in the type of investment. There was a relative flight from debt securities away into equity securities. The second observable reaction was a geographical displacement of funds in jurisdictions beyond the scope of the directive (Schwarz/Rixen forthcoming; EUC 2008). The current proposal to revise the directive is a direct result of this revision and aims at closing these loopholes.

5.2 The revision and its prospects

62. The current proposal extends the directive to legal arrangements and entities whose income is not effectively taxed (a threshold of 25% applies). This is implemented through automatic reports on payments to and reception of interest by a variety of entities. In addition to the financial institutions already covered, entities covered will include funds, trusts, foundations and private companies. A list of entities and arrangement is annexed to the current proposal. This list includes for example the limited liability companies of the US-states of Delaware and Wyoming in the USA. Implementing this would not impose extra cost or pose any problems because under current anti-money laundering regulations paying agents (such as banks) need to know all beneficial owners (or ultimate beneficiaries) of any payments they make. In addition, in order to avoid geographical avoidance, the proposal includes a stipulation to extend the obligation to report payments to all worldwide subsidiaries of financial entities whose parent companies are located in the European Union.

63. The revision of the directive as it is envisaged today would firstly end the option to use intermittent shell companies and/or trusts to shield the interest by declaring it to be dividend or unrelated trust income. Secondly, it would make the elusive dislocation of activity to afar territories more cumbersome because it would require to bank with a foreign credit institution if geographical elusion is intended. Thus, the directive is likely to develop into a powerful tool in the fight against cross-border tax evasion.

64. Politically, there seems currently to be a stalemate. While Belgium gave up its blocking position and adopted automatic information exchange in 2010 (EP 2010: 7), Austria and Luxembourg still use their veto-powers to block progress towards the revision of the directive. Linked to this question is the end of the transitional period. As detailed in the text of the STD (Art. 10, Para. 2), the transitional period shall end after the European Community has entered into an agreement for exchange of information upon request (conforming to the 2002 OECD TIEA) with the last of Switzerland, Liechtenstein, San Marino, Monaco and Andorra[31]. Since one of the key results of the G20-pressure following the UBS scandal and the tax evader CD of Liechtenstein has been a withdrawal of official reservations by Switzerland, Austria, Belgium and Luxembourg (EP 2010: 7) to Article 26 of the OECD model DTC (and concomitantly the 2002 OECD TIEA), a key obstacle for progress has been overcome.

65. It is important to explore with anticipation potential means for incentivizing both the five non-member states and Austria and Luxembourg to cooperate because these countries are most likely to form a blocking coalition if developing countries applied for AIE with the EU. In June 2010, the EU-Council discussed a resolution on anti-abuse measures in tax matters as relates to controlled foreign company-clauses and thin capitalisation rules[32]. In addition, a ruling of the European Court of Justice of 2009[33] may be explored as a potential route to apply counter-measures within the EU. This ruling concedes an exceptional possibility to curtail the freedom of capital circulation within the

[31] The second condition, that the US agrees to exchange information according to the 2002 OECD TIEA with the EU member states, has already been declared to be fulfilled by the European Council in January 2003 (Spencer 2003: 11-12).

[32] http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/10/238&format=HTML&aged=0&language=EN&guiLanguage=en; 15.6.2010.

[33] http://curia.europa.eu/jcms/upload/docs/application/pdf/2009-06/cp090052en.pdf; 15.6.2010.

EU in order to "guarantee the effectiveness of fiscal supervision" which may open the door for the application of (coordinated) measures towards Austria and Luxembourg[34].

5.3 Opportunities for developing countries

66. Apart from the indication of willingness on the part of various European institutions (see chapter 1.2), there are two other aspects to highlight from a developing country perspective. Firstly, there are plenty of good reasons why developing countries should not be denied access to AIE. For instance, there is already a precedent case of a non-member state of the EU applying for the inclusion to the information exchange systems of the European Union. Norway is currently engaged in negotiations with the EU in order to become part of the AIE under the EUSTD. This, taken together with the fact that 15 non-EU-member countries participate in the systems of the directive, provides a strong case for developing countries to also have the opportunity to participate in the information exchange.

67. Additionally, in the initial proposal for the directive of 2000[35], it was envisaged to start the information exchange without requiring every member state to reciprocally transmit data during a transition period (ending seven years after the envisaged date of entry into force of the directive; Spencer 2003: 6). Although this clause was not incorporated in the final directive voted in 2003, it supports the argument for allowing countries to become member of the directive's information exchange without requiring reciprocal capacity to be established beforehand. Conceivably developing countries could even ask for development funding to build such a system. Finally, during the transitional period Austria and Luxembourg could levy a withholding tax but receive automatically information from the other member states for domestic use (EUSTD Art. 3, Para. 1). It clarifies that the principle of reciprocity is not a non-negotiable.

68. A second aspect of the political developments in Europe relevant to developing countries relates to Switzerland. Switzerland publicly invited developing countries to approach the Swiss government in order to be included in the alternative withholding tax regime it is already applying with EU-members instead of automatic information exchange. As mentioned above, Switzerland currently withholds 20% of the interest payments made by its resident financial institutions to individuals who are resident in the participating countries and will increase this rate to 35% in July 2011[36].

69. In her official statement at the UN Financing for Development Conference in Doha in November 2008, Micheline Calmy-Rey, the Swiss foreign minister (who is also in charge of the main development agency), announced that Switzerland could well extend this agreement to countries outside the European Union[37]. As the conference was about financial resources for development, she must have meant developing and emerging market countries in particular. In a parliamentary hearing on May 25, 2009, the Swiss government, the Federal Council, reiterated their offer to extend taxation on savings income to developing and emerging

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[34] The possibility to limit the freedom of capital for fiscal reasons had been denied previously in 2006 through another ruling of the European Court of Justice in the so-called Cadbury-Schweppes-case. According to this ruling, unilateral defensive measures on controlled foreign companies (CFC-clauses) and thin capitalisation are only acceptable with respect to "wholly artificial arrangements", a term the European institutions so far failed to define meaningfully (http://curia.europa.eu/en/actu/communiques/cp06/aff/cp060072en.pdf; http://taxjustice.blogspot.com/2010/06/update-on-eu-anti-abuse-rules.html; 14.7.2010).

[35] http://ec.europa.eu/taxation_customs/resources/documents/taxation/personal_tax/savings_tax/savings_directive_review/annex_1_en.pdf; 10.5.2010.

[36] See Art. 1, Para. 1: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:385:0030:0042:EN:PDF; 15.7.2010.

[37] http://www.un.org/webcast/ffd/2008/statements/081130_switzerland_en.pdf; 2.6.2010.

market countries[38]. The text made it clear that Switzerland was not going to proactively push the issue, but was willing to give serious „consideration" to any request for a taxation on savings income by the global South.

70. Thus, countries of the "south" could obtain direct payments of the Swiss Treasury if their residents maintain bank accounts in Switzerland. If any developing or emerging market country governments would like to hold the Swiss Federal Council accountable to its previous offer and push for a taxation on savings income agreement, now would be the right time to place their request. Governments failing to do so risk to be soon perceived as being unwilling to fight for the taxation of black money stashed away in Switzerland. However, as the withholding tax option under the EU-savings tax directive is an exception and is bound to be replaced by automatic information exchange, and as the scope of the directive is to substantially extended in the near future, a "most favourite nation" should be included in any agreement with Switzerland that ensures to receive both the broadest available definition of covered income (all kinds of interest and dividend wrappers) and the highest standard of cooperation as and when it is made available to any third country (automatic tax information exchange). This is particularly important because Switzerland succeeded in narrowing the definition of "interest" in its agreement with the EU on the EUSTD so that income from Swiss government bonds is effectively excluded, thus greatly narrowing the tax base[39].

5.4 IT-Details of the EUSTD

71. The basic IT-standards for international transmission of tax related data between administrations have been developed by the OECD[40]. The old format "Standard Magnetic Format" (SMF) was launched in 1997 and is still in use. In 2005, a new format based on the modern XML-platform has been developed, the Standard Transmission Format (STF). Because the STF is quite a loose and liberal format that is not very specified and leaves discretion to authorities, the European Union developed a more specific data format for the EUSTD. This new EU-format is called FISC 153 and uses STF as a template[41]. There are differences between FISC 153 and STF, some questions are added and the answers to others are made compulsory. For example, in FISC 153 the answer to the question providing the taxpayer's ID is compulsory. If this field is not properly filled in, the entire file is rejected.

72. The exchange mechanism works through a virtual private network (VPN) that is currently used only by member states. It is used to transfer different kinds of sensitive data, including fiscal data. This VPN runs over a carrier network that is outsourced to a provider. Without guarantee, this VPN uses an encryption method called "triple DES". Currently the EU runs a project to extend the VPN to third countries. To extend this VPN proves not to be a problem, neither in terms of cost nor in terms of technical capabilities. The idea is to extend the VPN through the internet, by using a gate and a proxy server. For this to happen third countries need to express their interest in taking part in the VPN, and a Memorandum of Understanding is required to be signed between the interested party and the EU.

73. Currently, the dependent territories are mostly participating in the EUSTD through their larger associated EU-member states (particularly Netherlands and UK). Rather than using the VPN they are using OECD's PGP (pretty good privacy) encryption instead. Some other small dependent territories which are short of resources use CDs that are sent

[38] The French version of their response can be viewed here: http://www.parlament.ch/e/suche/pages/geschaefte.aspx?gesch_id=20093325; 2.6.2010.
[39] See Art. 1, Para. 2, in: http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:385:0030:0042:EN:PDF; 15.7.2010.
[40] The formats can be found here: http://www.oecd.org/document/18/0,3343,en_2649_33767_40499474_1_1_1_1,00.html; 14.7.2010.
[41] The format can be found here: http://register.consilium.europa.eu/pdf/en/05/st15/st15305.en05.pdf; 14.7.2010.

via secure courier or spreadsheets sent through encrypted emails. Whilst the EU-Commission (and presumably EU-member states) prefer other countries to use FISC 153 or the STF of the OECD, overseas territories of the UK have an arrangement to send their data through encrypted CDs, and the encryption method used is then CCN.

74. The backend IT-systems of the receiving countries vary, and some of them feed the data into integrated income tax systems which are usually domestically tailored IT-developments and not provided by global software firms. The usage of the data also differs. Some only take samples of the receiving data, while others do one-by-one checks. The XML-transmission format requires some common technical principles to be followed in order to process XML. The OECD has an infrastructure survey on the IT-systems (which is unlikely to be public). The databases in the national IT-systems may be supplied by Oracle or any other database provider, and the middle-ware can be based on Java, a standard development environment which can incorporate off-the-shelf components.

75. The typical number of records per transfer is difficult to tell. It may be only 20 or 30 records for an exchange between Guernsey and Cayman Islands, but it could well be millions between Germany and the UK. The point is that the FISC 153-format stores a record for each taxpayer, but then creates subentities in the XML-structure for every interest payment made. Thus, for a single account, if the bank pays interest on a quarterly basis, a record of one taxpayer may contain 4 subentity-records, one for each interest payments. Large investments may collect interest payments on a monthly basis, so one bank account record of a one taxpayer record could contain 12 payment records. Regarding the size of the transferred files, the physical limitation of the transmission system is 10MB per message. But the XML-files may have a compression rate of up to 1:10. Then there are rules on how to split the files which can be found on the Council website.

5.5 Institutional Setting AIE

76. It is argued here that the EUSTD is the most promising point of departure of any attempts of developing countries to establish AIE-mechanisms. This claim, explained in chapter 5.1, has to be considered in the light of recent developments on the level of the OECD and the Council of Europe, as well as in the USA. On 6 April 2010, it has been announced that the 1988 joint Convention on Mutual Administrative Assistance in Tax Matters of the Council of Europe and the OECD (CoE/OECD 1988) will be opened for all interested countries through an additional protocol[42]. On 27 May 2010, the amending protocol has been signed by 15 countries, eleven of which have already been party to the old 1988-Convention[43].

77. While this Convention may prove to be an important tool for multilateral information exchange upon request, it does not require multilateral automatic information exchange from its signatories. The provisions relating to AIE only **allow** the parties to the Convention to implement AIE. The countries that wish to implement AIE through the Convention would need to enter into additional bilateral agreements with each other in order to make it work, a situation which is very similar to the situation before the amending protocol of the Convention.

78. In brief, the Convention appears to provide a useful framework for information exchange upon request, for simultaneous and cross-border tax examinations, for the protection of data confidentiality and for a number of other important areas. It does not,

42 http://www.oecd.org/document/33/0,3343,en_21571361_44315115_44892193_1_1_1_1,00.html; 14.7.2010.

43 http://www.oecd.org/document/61/0,3343,en_2649_33767_45336893_1_1_1_1,00.html; 14.7.2010. There are a total of 14 parties to the old 1988 Convention. Of these, three are so far missing from the amending protocol: Azerbaijan, Belgium and Poland. Canada, Germany and Spain have signed, but not ratified the old 1988 Convention, and are neither party to the amending protocol.

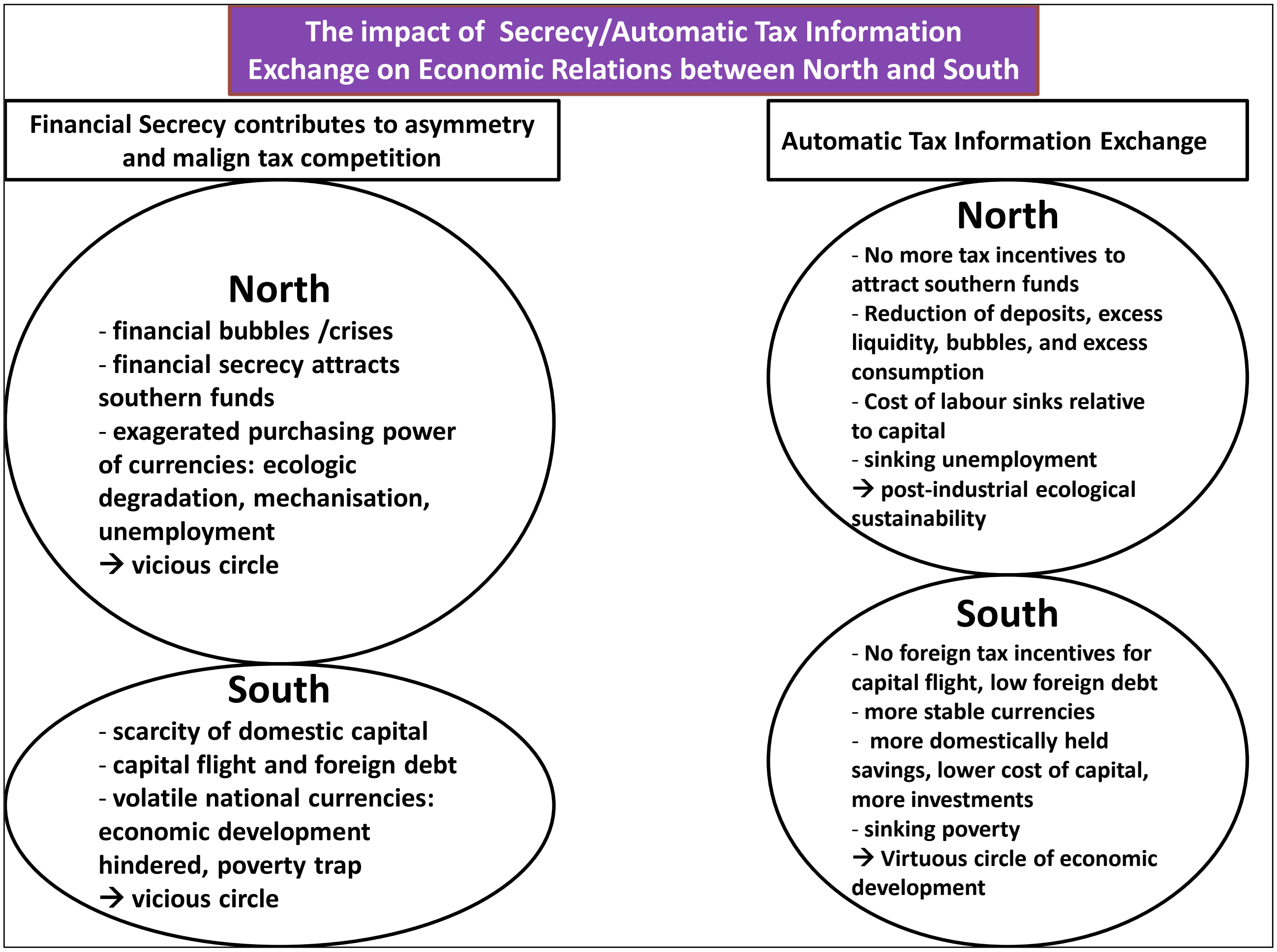
however, make material progress in the direction of automatic information exchange. If and when major developed countries agreed within the framework of the amending protocol to offer participants automatic information exchange, the attractiveness of this Convention as an alternative to the EUSTD would increase. So far however, the only existing multilateral system of AIE is the EUSTD.

79. The United States, in turn, recently enacted automatic tax information reporting between financial institutions and its revenue service through the Foreign Account Tax Compliance Act (FATCA, Spencer 2010). While this approach by the US-Treasury is innovative for a number of reasons, it does not offer developing countries a way of participating in its fruits. To the contrary, the Act assures non-residents of the US of their tax-free, secretive and anonymous investment opportunities within the USA through any foreign financial institution willing to cooperate with the US-government on US-tax citizens. It is questionable if developing countries have enough political leverage to do the same by asking all financial institutions investing in their country to disclose all foreign accounts of this developing country's residents. Therefore, FATCA does not seem to be of much direct relevance for developing countries looking for automatic information exchange. Indirectly however, FATCA may prove to be a catalytic event triggering the coordination of developing countries' positions, not least as FATCA undermines the theory of exchange on request being effective.

6. Conclusion

80. Beyond the fiscal revenue at stake, automatic tax information exchange has the potential to play a crucial role in bringing about overdue adjustments in the global economic balance. The gross distortion of international investment patterns is currently helped by financial and tax secrecy in the global north, as a result of which many southern countries find themselves entrapped in a vicious circle of underinvestment, volatile economic performance, capital flight, external financing gaps and increasing foreign debt. Similarly, the global north is affected by this misallocation of financial capital resulting in a vicious circle of financial bubbles, exaggerated purchasing power of its currencies, overconsumption, exploding health care costs, environmental degradation, soaring inequality and unemployment.

81. Much confusion about what automatic information exchange entails can be observed in presumably technical debates. This paper tried to clarify the most pervasive misunderstandings on AIE. For example, it has been shown how international automatic information exchange is nowadays a daily reality for many tax administrations around the world. For this to be possible, no centralized "mega-databases" need to be created, but information can be and is exchanged in bilateral packages under a multilateral legal umbrella. Similarly, the most crude of the counter-arguments against automatic information exchange, claiming that the private sphere would be lost as a consequence and that a "crystal" citizen would be created, is rooted in misinformation. This claim seems to be playing more on fears than resting on any serious arguments because only administrations would have access on financial information, not fellow citizens or newspapers. Automatic income reporting is daily routine in many OECD countries, the more so with respect to income stemming from labour.



82. Neither does it seem plausible that there is a risk of an information overflow for the receiving tax administrations in developing countries. Firstly, some of the participating countries of the EUSTD do only use the received data to carry out random checks, therefore not adding to administrative costs. Secondly, many of the countries most affected by capital flight do have sophisticated tax administrations and integrated income tax systems into which this data can be easily fed and analysed. Thirdly, the potential absence of such data management systems is rather an argument in favour of offering support in developing such capabilities than for claiming inadequacy. If the by-product of introducing developing countries to automatic information exchange is a more efficient tax administration because new IT-hardware and skills have been acquired, an important contribution to the development process has been made. In any way, automatic information exchange could be started with the most technically capable developing countries and be implemented in a step by step process.

83. Another set of unwarranted concerns relates to data protection and confidentiality issues, as well as to human rights. This kind of problems also exists with bilateral information exchange context "upon request", and is regularly dealt with without major problems. For example, article 8 of the OECD model-TIEA of 2002 limits the use of the information to those authorities, which are involved in the tax administration or the enforcement of tax laws. However, accidents can happen wherever human beings are involved. But these occur also without AIE. The British tax authority HM Revenue and Customs, for example, lost in 2008 personal details of 25 million taxpayers by mail. This and other recent examples show that developed countries experience accidents and

data leakages even with highly sensitive data. For this reason, any pointing of fingers towards allegedly “unreliable” southern countries should be avoided. The relevant passages in the 2010 amending protocol to the CoE/OECD Tax Convention can provide a quick and easy solution to the legal side of the problem.

84. What has been achieved with respect to international tax cooperation in the last few years is enormous when compared to the previous 50 years. From another perspective, it is merely a first step. Developing countries and their citizens have not yet seen palpable improvements through the recent changes. To introduce automatic information exchange in an era of liberalised international capital flows can be compared to the development of traffic lights in response to the introduction of cars. While equipping cars with brakes (equaling information exchange upon request) is a reasonable and necessary step for safe transport, only traffic lights assure that traffic can flow and accidents can be avoided. Currently, the international traffic is afflicted with accidents and going dead-end. Accidents will most likely increase in frequency and severity unless AIE is implemented.. At the same time, it is clear that traffic lights do not replace car brakes. Both are necessary and complementary for safe and respectful interaction. The large grey elephant on the roads, however, will only be dealt with once AIE is implemented.

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