NEW RESOURCES FOR DEVELOPMENT FINANCE

TAXATION MECHANISMS FOR ACHIEVEMENT OF THE MILLENIUM DEVELOPMENT GOALS

United Nations, New York, Tuesday 25th April 2006

WHY CAPITAL FLIGHT? HOW PLUGGING THE LEAKS COULD CONTRIBUTE TO POVERTY ALLEVIATION

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tax justice network

The dark side of financial liberalisation

The missing piece of the development equation is the impact of illicit capital flight and the associated tax evasion on global poverty. Capital flight is likely to have negative impacts on equality, with wealthy citizens escaping the tax burden and poorer citizens facing higher taxation and cuts in public services. In addition, capital flight contributes to financial

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crises and carries economic costs in the form of reduced investment, unemployment and slower economic growth rates.

In March 2005 the Tax Justice Network published a briefing paper— *The Price of Offshore* (appended) - which estimated the stock of private wealth held by individuals in offshore and onshore tax havens, and undeclared in the country of residence, at about US$11.5 trillion. We estimate the annual worldwide income on these undeclared assets at about US$860 billion, and that the annual worldwide tax revenue lost on such undeclared income is about US$255 billion.

That figure approximates the annual funds needed to finance the UN's Millennium Development Goals.

Whilst the majority of this $11.5 trillion of undeclared assets originates from developed countries, a significant proportion comes from developing countries. For example, over 50 per cent of the cash and listed securities of rich individuals in Latin America is reckoned to be held offshore. Data for Africa are scarce, but most analysts assume the ratio to be comparable to Latin America or higher. The most recent edition of Africa Report (March 2006) quotes banking estimates of capital flight from Africa at $30 billion annually. This loss easily eclipses the value of aid and debt relief promised to African leaders at last year's G-8 summit at Gleneagles.

But the figure of $255 billion in tax revenue lost to tax evasion on assets held offshore is only a part of the equation. In addition, developing countries lose out to tax evasion in the domestic context (often from activities in the informal economy), from tax avoidance on cross border trade, and from the pressures to compete for investment capital through offering tax incentives. In combination these issues are estimated to cost developing countries an astonishing $385 billion annually in tax revenues foregone.[2]

The International Conference on Financing for Development (Monterrey Mexico, March 2002) called upon developing countries to mobilize domestic resources for development. This was reaffirmed by:

- the special high-level meeting of the Economic and Social Council (ECOSOC) with the Bretton Woods institutions, the World Trade Organization and the United Nations Conference on Trade and Developments (New York, April 18, 2005);
- the High-Level Dialogue on Financing for Development in New York, June 2005;
- the 2005 World Summit Outcome.

The United Nation's Millennium Development Goals have also focused attention on the need to make resources available to developing countries.

In its latest report on Latin America called *Poverty Reduction and Growth: Virtuous and Vicious Circles,* published on 14th February 2006, the World Bank argues that governments must give higher priority to spending on infrastructure likely to benefit the poor and increase expenditure on education and healthcare. In practice a large proportion of government spending in Latin America is skewed in favour of the well off, and governments are collecting far too little tax, especially from the wealthy. The World Bank report therefore concludes that: *"on the tax front, first*

[2] Cobham, A. (2005) *Tax Evasion, Tax Avoidance and Development Finance* Queen Elizabeth House Working Paper Series No. 129, Oxford

items in the agenda would be strengthening anti-tax evasion programs and addressing the high levels of exemptions."[3]

The Tax Justice Network argues that in order to assist governments of developing countries with tackling poverty and freeing themselves from external debt and aid dependence, more emphasis must be placed by the international community on establishing transparent financial systems and tackling banking secrecy and secretive offshore trusts and companies which encourage and facilitate capital flight. Tackling the 'supply side' of the global money laundering market is crucial to combating capital flight and tax evasion, and we call upon the international community to specifically include capital flight and tax evasion in its efforts to combat organised crime and money laundering. The precedent for making this link exists. At the June 1999 summit of the G-8 countries a commitment was made to: *"deepen our cooperation on law enforcement, fighting organized crime and money laundering, including as they relate to capital flight."*[4]

Tackling the supply side

Any comprehensive solution to the problem of capital flight must include; (i) global implementation of international exchange of tax information, in particular automatic exchange of information; (ii) the overriding of bank secrecy in onshore and offshore financial centres; and (iii) improvements in tax administration in developing countries to assist with negotiating bilateral treaties and with tackling tax evasion.

[3] Lopez, J.H. et al (2006) *Poverty Reduction and Growth: Virtuous and Vicious Circles,* The World Bank, p101
[4] G-8 Press Communique (1999) Cologne Summit, June 18-20

The Tax Justice Network supports efforts by the UN Committee of Experts on International Cooperation in Tax Matters to strengthen the international framework for exchanging information between national tax authorities, and we particularly support efforts to require offshore tax havens to cooperate with the authorities of developing countries in their attempts to tackle tax evasion. We note that in December 2004 the Finance Ministers from the G-20 countries called for offshore tax havens to allow access to bank and entity ownership information and to adopt OECD standards on effective information exchange through legal mechanisms such as bilateral information exchange treaties.

The Tax Justice Network also supports efforts to strengthen national tax administrations in developing countries. For example, in a paper published in March 2002 paper, the IMF, OECD and World Bank said that they would commit to assisting developing countries in improving the effectiveness of their tax administrations, thereby increasing governmental revenues of those countries, and mobilizing domestic resources.

Suggestions for international action

The Tax Justice Network calls upon ECOSOC to take the following actions to combat capital flight from developing countries:

§ Require offshore tax havens to override bank secrecy in international tax matters, and to publicly disclose all relevant information relating to the beneficial ownership of offshore companies, trusts and foundations;

- Require offshore tax havens to take steps toward implementing automatic reporting of income, in order to facilitate automatic exchange of tax information.

- Urge the IMF, World Bank and OECD to combat capital flight from developing countries, and tax evasion in developing countries, in accordance with their commitments under the Joint IMF, OECD, IBRD Proposal, and to report at least annually to ECOSOC about their progress.

- Urge the IMF to include as a factor in its Reports on the Observance of Standards and Code for financial sector regulation, whether each offshore tax haven is implementing exchange of information on request, and also taking steps to implement the automatic reporting and automatic exchange of tax information, and to report at least annually to ECOSOC about the IMF's progress.

The Tax Justice Network further calls upon ECOSOC to explore measures to tackle tax avoidance on cross border business activities by:

- Supporting the introduction of an International Financial Reporting Standard on tax disclosure, as has been proposed, for example, in respect of the extractive industries;
- Support measures to strengthen the national tax administrations of developing countries and in particular to strengthen cooperation in matters relating to transfer mispricing of cross border trade.

Financial liberalisation has increased the opportunities for capital flight and tax evasion. Reducing capital flight and the resultant costs it imposes on developing countries is a major but not insurmountable challenge. We cannot turn the clock back to an earlier age when capital movements were totally controlled, but any strategy for promoting economic development through the mobilisation of domestic resource, which must inevitably include tax revenues for public expenditure, requires effective measures to fight capital flight and abusive tax practices which benefit the few and harm the many. Without effective measures to control capital flight and prevent tax evasion our promises to make poverty history in the coming decade are unlikely to be realised.

Appendix 1: The Price of Offshore

Data on the value of wealth held offshore is hard to come by since neither governments nor the international financial institutions seems either able or willing to research the global picture.

The Bank for International Settlements (BIS) records bank deposits by country. According to their estimates, in June 2004 out of US$14.4 trillion total bank deposits, some US$2.7 trillion were held offshore. This means that approximately one-fifth of all deposits are held offshore. However, this figure relates solely to cash. It excludes all other financial assets such as stocks, shares and bonds, and the value of tangible assets such as real estate, gold and even yachts held offshore as well as shares in private companies. These assets are typically controlled through offshore companies, foundations and trusts, the latter not even being registered let alone required to furnish annual statements of account. The value of these assets is therefore unknown and harder to determine.

In 1998, Merrill Lynch / Cap Gemini's *World Wealth Report* estimated that one third of the wealth of the world's high net-worth individuals (HNWIs) is held offshore. According to their most recent wealth report, the value of assets held by HNWIs with liquid financial assets of US$1 million or more was US$27.2 trillion in 2002/3, of which US$8.5 trillion (31%) was held offshore. This figure is increasing by approximately US$600 billion annually, which brings the current figure to about US$9.7 trillion.

A slightly lower estimate was published by the Boston Consulting Group (BCG) in their *Global Wealth Report* for 2003. BCG estimated the total holdings of cash deposits and listed securities of HNWIs at US$38 trillion, which is broken down by geographical region of origin as follows:

Continent	Total wealth (US$ trillions)	Probable amount offshore (US$ trillions)
North America	16.2	1.6
Europe	10.3	2.6
Mid East and Asia	10.2	4.1
Latin America	1.3	0.7
Total	38.0	9.0

These figures exclude real estate, non-financial assets and privately owned businesses.

There is a third way of estimating the value of liquid assets held offshore. Data published in a report by the research arm of the global consulting group McKinsey & Company, shows that the total global financial capital amounted to US$118 trillion in 2003. This was split by asset type as follows:

Asset type	Value $ trillions	Per cent of total
Quoted Equities	32	27
Private bonds	30	26
Gov't bonds	20	17
Bank deposits	35	30
Total	118	100

Whilst it might appear hard to reconcile the McKinsey figure for deposits with that of the BIS, it should be noted that McKinsey's figure apparently includes the balances banks owe to each other which are not included in the BIS data quoted earlier. This means that the BIS data is a reflection of the sums held by individuals, non-banking corporations and trusts and is therefore more accurate for these purposes.

The ratio of cash to total financial assets has, according to McKinsey's, ranged from between 3.3 to 3.85 over the past 4 years. An average of 3.5 would seem reasonable. Applying this average to the BIS offshore holdings yields a figure for total financial assets held offshore amounting to US$9.45 trillion. This provides a third estimate within the range US$9 to US$10 trillion. However, this estimate does not include real estate and other tangible assets, the ownership of private businesses held offshore, or other intangible assets such as the rights to receive royalties and licence fees. No one can be sure of the precise value of these assets, so they use a modest
estimate that would add no more than US$2 trillion to the value of offshore holdings (which in view of the value of real estate may well be very modest indeed).

This provides the basis for our estimate that the value of assets held offshore lies in the range of between US$11and US$12 trillion. We consider this to be a conservative estimate.

Income from offshore wealth

According to the various wealth reports already referred to, wealth holders currently expect their assets to grow at between seven and eight per cent annually. An average rate of return of 7.5 per cent would therefore seem appropriate. US$11.5 trillion invested at 7.5 per cent yields a return of about US$860 billion a year. This is a reasonable measure of the offshore investment income each year.

Tax lost on offshore income

The tax loss arising from US$860 billion being held offshore is estimated as follows. In 2003 Cap Gemini stated that 7.7 million people around the world held more than US$1 million in financial asset wealth. Normally these high net-worth individuals would be paying the highest rates of personal tax. Forbes magazine in 2004 stated that the average marginal tax rate for a person earning €100,000 that year was 37.5 per cent. However, this figure would be too high an estimate of overall tax losses since some assets held offshore will have been invested in ways that involve taxes being withheld from payments made. We estimate that the average withholding on a portfolio of the type Cap Gemini refers to would be in the region of 7.5 per cent. On this basis we use an average tax rate of 30 per cent to calculate the overall tax loss.

US$860 billion at 30 per cent yields an annual tax loss of approximately US$255 billion resulting from wealthy individuals holding their assets offshore. This estimate does not include tax losses arising from:

- tax competition
- corporate profit-laundering