Plugging the Leaks

A very short paper on curbing capital flight, tax avoidance and tax evasion

For

International Policy Dialogue

"New Sources of Development Financing"

Organized by

InWEnt and the Federal Ministry for Economic Cooperaton and Development (BMZ)

By

Sony Kapoor

Sony.Kapoor@gmail.com

August 2005

Senior Policy, Advocacy and Economic Advisor

International Finance, Development and Environment Consultant

International Tax Justice Network

Summary

There are three main issues in financing development. One – how to enable developing countries to maximize the resources they can mobilize domestically, two – what mechanisms and source of external funds can be used to supplement these domestic resources effectively, three – how to ensure that these resources, both domestic and external, stay within the developing country and are used to finance development in an effective and efficient way.

The recent G8 announcements were limited to addressing the question of external resources and that too very inadequately. Not only did they fall far short of what was needed on debt, aid and trade but they completely ignored the equally important issue resource outflow in the form of capital flight, tax avoidance and tax evasion.

Developing countries are losing $500bn (£288bn) to $800bn in untaxed money that is leaving their economies unchecked. This flight of capital is up to 10 times the $78bn that developing countries currently receive in aid.

The much publicised G8 deals will deliver about $1bn in debt cancellation and $25bn in aid flows mostly to sub-Saharan Africa. But this is dwarfed by the $50bn the region loses in capital flight. Disturbingly, this capital flight out of Africa is on the rise so any rise in aid threatens to be eroded by money flowing out. Clearly, plugging the leaks must be the top priority.

By far the biggest leak is the widespread and pernicious mispricing of exports and imports to shift profits out of the country. For example, African diamonds have been exported by businesses at a book price of a fraction of their true value so the real profits only show up in offshore locations.

Firms, especially multinationals, are the biggest culprits using a sophisticated network of notional companies in tax havens to hide billions of dollars of profits from the taxman. The secretive practices of banks in these jurisdictions make it almost impossible to bring the culprits to book.

Other leaks such as criminal proceeds from trafficking and racketeering, and corrupt proceeds from greedy officials are important but much smaller and piggyback on the sophisticated money-moving apparatus set up by western banks and businesses.

Plugging the leaks would allow developing countries to cut their reliance on western governments and the IMF, and reject damaging enforced privatisations and trade liberalisation so often attached as conditions to aid and loans.

Tax havens and banking secrecy cause poverty by facilitating the leakage of scarce money out of developing countries. They also help rich elites and businesses avoid billions of dollars in taxes that could otherwise finance the building of hospitals and schools.

Co-ordinated international action towards shutting down tax havens, eliminating banking secrecy and automatically exchanging information between tax jurisdictions would plug the biggest leaks.

While the incentive for developing countries to act is clear, the hundreds of billions of dollars that rich countries lose in tax revenues are now threatening the very existence of the welfare state. For example Britain alone loses as much as £100 billion in taxes every year.

Following Gleneagles, the time is ripe to add the issue of capital flight to the debt, aid and trade triumvirate. With co-ordinated action it is possible to tackle poverty in the developing world and

halt the erosion of the welfare state in developed countries. Messrs Blair and Brown can lead the way - 35 of the 72 tax havens are British territories, dependencies or ex-colonies. Action is needed on increasing aid, cancelling debt and making trade fair. But to really make poverty history the G8 must also plug the leaks.

The channels that facilitate resource leakage from both developing and developed countries are the very same channels that facilitate terrorist financing networks. The horrible events in London lend a fresh urgency to the need for immediate action against tax havens and banking secrecy. Mr Blair's announcement to crack down on terrorist financing networks using Britain's EU presidency provide a unique opportunity for actions that if done right can achieve three goals. These are safeguarding the structure of our welfare state and having a more equitable tax system, helping developing countries plug the leaks and perhaps most urgently make Britain more secure against terrorist attacks.

The Issue

Taxation is at the heart of the 'social contract' between a modern sovereign state and its citizens. In return for fulfilling duties such as 'paying a fair share of taxes' citizens are provided with security, infrastructure and essential services such as education and basic health services.

Taxation is the primary source of revenue for governments and provides them with funds they need to provide infrastructure, security and amenities to their citizens. The role of governments is especially important in the most impoverished countries where the income level of average citizens is so low that they cannot afford to purchase even the most basic services through private means even in the few cases where such a choice exists.

It is widely acknowledged that without active state intervention and participation in basic health, education and infrastructure services the development of the least developed countries could not be envisaged. It is a very serious matter then that the resources available to them to fund development expenditure are diminishing.

There are three relevant themes here with implications that go far beyond just the effect on developing country government revenues. The three are 'tax avoidance', 'tax evasion' and 'tax competition'. Related themes include 'tax havens', 'transfer mis-pricing' and 'capital flight'.

One major route by which foreign direct investment (FDI) is expected to contribute to development in a country is through the tax revenue that is generated on the profits of the FDI which then can be used by the government to finance development expenditure. However, faced with an ever increasing negotiating power wielded by multinational corporations (MNCs), desperation for scarce foreign exchange which is needed to pay off huge outstanding debt burdens and severe competition amongst themselves, developing countries are offering increasing sops to MNCs to invest in their country.

A typical example could look like this: MNC XYZ wants to put a $100 million bottling plant in East Africa to cater to regional demand. It goes to country A and negotiates a 20% concessional tax rate instead of the standard 30%. It then goes to country B and gets them to offer a 10% tax rate using country A's offer as a bargaining chip. With these deals in hand it finally convinces country C to charge only a 5% tax rate and offer the company free land and infrastructure facilities where the costs of these is greater than any tax revenue that would be generated on company XYZ's profits. Thus, country C ends up with a negative effective rate of taxation and countries A and B having lost the investment would offer even steeper tax discounts next time there is an expression of interest from a foreign firm. This example is not academic but reflects the reality on the ground in several impoverished countries where effective tax rates are now turning negative.

Trade is supposed to contribute in a major way to development primarily through revenues generated for the governments as well as through private profit that accrues to the country. More than 60% of international trade is actually intra-company trade – transactions between subsidiaries of the same firm. More than 55% of international trade (in fact most of the intra-company trade) passes through offshore tax havens providing perfect opportunities for transfer mis-pricing and profits laundering. Ball point pens (not made from gold) priced at $800 per piece, a litre of apple juice priced at $1,012, a plastic bucket priced at $725 – these are some extreme but real examples of transactions that are used to transfer profits out of countries (both developing and developed) to zero tax fiscal paradises (tax havens). The effect on developing countries is more severe as their tax authorities lack the resources or the sophistication that tax authorities in developed countries have, and hence MNCs find it easier to get away with mis-priced transactions.

Tax evasion and tax avoidance for both companies and rich individuals in developing countries is also widespread with tax havens playing a very major role in facilitating capital flight and money laundering which depletes the governments and countries of scarce resources needed for development. It has been estimated that developing countries collectively lose as much as $500 billion of money every year to dirty money flows.

This is an order of magnitude higher than current ODA levels, and if even a fraction of these resources can be tapped for development, the level of funding for the MDGs would receive a big boost. These monies are also ideally suited for development as a large fraction of this is money owed to governments in developing countries – i.e. money that can then be directly used to fund development expenditure. It is also better quality money because unlike ODA – which carries with it the weight associated with a donor-recipient unequal relationship – capturing dirty money flows for development empowers developing countries as they get a larger share of what is rightfully theirs. Actually, it is a form of domestic resources – which, as the Monterrey Consensus highlighted, were ideally suited for development.

The actions needed to tackle these issues would benefit both developing and developed economies tremendously. The only real losers might be the small island tax havens which would then need to explore other avenues for raising resources. It is extremely important to note that the gains that tax havens derive from haven-related activities are a very small fraction (much less than 1%) of the losses that these actions inflict on other non-haven nation states. That is why a strong case can be made for the creation of a fund that will help facilitate the transition from a haven economy to a more sustainable and diversified one. This fund could easily be financed out of the proceeds of the gains accruing to developed economies from the abolition of tax haven related activity. This suggestion for a generous fund for tax havens that renounce haven activity would go a long way in reducing the opposition from these countries to moves to crack down on tax haven activity.

Amongst the steps that need to be taken are

- **Establishing a forum for international tax co-operation not just between the OECD countries** that would facilitate an automatic exchange of information between tax authorities so that tax evasion cannot happen through the exploitation of the gaps between various tax jurisdictions. It would lower the incentives and opportunities for tax evasion, tax avoidance and transfer mis-pricing.

- **Having an agreement on a minimum rate of corporation taxation** would be very helpful to put limits to tax competition. The rate does not need to be very high as even a low rate could prevent tax rates from becoming negative.

- **Legislation of a general anti-avoidance principle** would help clamp down on tax avoidance activity by making it illegal to indulge in activities aimed primarily at reducing tax liabilities.

- **Eliminating bank secrecy** would go a long way in catching perpetrators that are currently able to hide behind this secrecy and be safe from being prosecuted for laws they have broken. This would also be a very significant step in tackling the problems associated with terrorist financing, money laundering, smuggling and capital flight.

- **Having an international agreement on company accounts** that give a detailed breakdown of economic activity, profits and taxes paid in each jurisdiction would make it much harder to avoid and evade taxes and engage in transfer mis-pricing at a large scale.

- **Domestic action such as the introduction of an alternative minimum tax based on sales or turnover**

Some of these measures such as the legislation of a general anti-avoidance principal and an alternative minimum tax regime can be unilateral but most others need to have at least a degree of international co-operation. This is where the G-7 and OECD countries can take a lead and support these issues not just from a development perspective but also as issues that would simultaneously have significant advantages for their own citizens.

Political Feasibility of Action on Tax Justice

Walking down the path of 'international tax co-operation' is in many ways easier and more significant than pushing 'international taxation'. This is especially so as 'international tax co-operation' is a prerequisite to any form of 'international taxation' with a view to developing platforms for implementing such taxes and preventing widespread evasion and avoidance if and when they are implemented.

Also, politically it is much more realistic to expect an agreement or consensus on the need and mechanisms for 'international tax co-operation' than for 'international taxation'. The magnitude of monetary flows that can be mobilized for example by concerted and co-ordinated action against tax havens, are also an order of magnitude higher than the revenue estimates from many of the proposed international taxes such as the 'Tobin Tax'. For example, a combination of measures suggested in the above section could easily result in as much as $250 billion additional resources becoming available to developing countries in the medium run.

Unlike most other sources of development funding which imply a zero sum game – both ODA and debt cancellation for example imply a transfer of resources from citizens in the OECD countries to citizens in the developing world – money accruing from international tax co-operation is a win-win game. The same issues which are inhibiting development in countries as diverse as Brazil and Kenya are the factors which are leading to an erosion of the welfare sate in OECD countries. The interests of a majority of citizens in both the developing and developed world are then aligned, pitting them against the interests of the super rich elite who number a few million at most.

The very structure of the German welfare state, for example, is being threatened by these phenomenons of tax avoidance, tax evasion and tax competition. Rich German citizens have put billions of dollars of money into secret bank accounts in Luxembourg and Switzerland to avoid paying taxes. Large companies operating in Germany are able to shift profits out of Germany to low tax locations such as Estonia and to tax havens.

It is easy to get diverse constituencies such as labour unions and religious groups mobilized on the issue, and parties from both the right and left end of the spectrum have much to gain. The left can use the additional monetary flows to increase welfare and infrastructure spending without unpopular tax rate hikes, and the right can cut tax rates without unpopular cuts in the welfare state. Additionally, security issues such as closing down channels which can be used for terrorist financing and money laundering are now a priority in the wake of terrorist attacks in New York, Madrid and London.

In fact, tax avoidance and tax evasion cost OECD governments much more than $500 billion every year. Co-ordinated action on international co-operation on tax matters could easily net these governments at least about half billion of this money in new income every year. For example, the unpaid income tax on income of the more than $11.5 trillion dollars of assets held offshore alone is estimated to be about $255 billion every year. Using even $50 billion or 10% of these new tax revenues for increasing ODA flows can easily help finance the MDGs. Of course, this action will also help release tens of billions of dollars of developing countries' own money too.

The issue of tackling tax avoidance and tax evasion is thus something that has a lot of latent public support as well as support from both developing and developed country governments. The sheer size of the problem and the positive impacts on both developing and developed countries mean that this is an issue that is likely to be politically feasible in the medium run.

Policy makers and campaigners should push for the tax justice to be included as a financing for development theme because it is so central to the development debate and because the issue has not yet got the kind of attention that it deserves. So short term action can lead to some easy wins (such as the enactment of legislation enshrining the general anti-avoidance principle in law by developing countries) and create the momentum and profile needed to achieve co-ordinated action in the medium term with the potential to generate hundreds of billions of dollars for both developing and developed nations.

The channels that facilitate resource leakage from both developing and developed countries are the very same channels that facilitate terrorist financing networks. The horrible events in London on the 7th of July 2005 lend a fresh urgency to the need for immediate action against tax havens and banking secrecy.

Tony Blair, the British Prime Minister, recently announced plans to crack down on terrorist financing networks using Britain's EU presidency. This provides a unique opportunity for actions that if done right can achieve three goals. These are safeguarding the structure of our welfare state and having a more equitable tax system, helping developing countries plug the leaks and perhaps most urgently make us more secure against terrorist attacks.