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Financing for Development Series: Increasing Domestic Resource Mobilization by Tackling Tax Flight

Tax flight from developing countries is estimated to be several times higher than aggregate inflows from development assistance. It severely weakens domestic resource mobilisation and undermines good governance.

The main actors and mechanisms are companies that are mis-pricing trade transactions or financial transfers; banks, companies or individuals that are mis-reporting financial transfers; and outright smuggling of high value commodities. Tax flight is driven by a complex web of facilitators who exploit an increasingly sophisticated but poorly regulated international system to their advantage.

Tax flight could be reduced by decisive and internationally coordinated actions at the source, in transit, and at the destination of illicit transfers. This would entail the obligatory recording of beneficial ownership information of bank accounts, trusts, companies, foundations and other legal vehicles by financial centres including 'tax havens'.

On the international level tax flight could be tackled by information sharing agreements among countries, by compensating 'tax havens' for reduced income, and by including tax flight as a criminal offence in international regimes and code of conducts. Institutionally, there is a need for a permanent structure to help increase effectiveness, clout and institutional memory in tackling tax flight.

1. Why is taxation important and what is tax flight?

Tax systems lie right at the heart of domestic resource mobilization. Resources mobilized from taxation are the biggest source of money for financing development activities including the provision of public services such as healthcare, education and infrastructure. Moreover, transparent and effective tax systems are also an essential component of the social contract between citizens and their governments and they engender good governance.

However, it is no longer enough for a country simply to have good domestic policies on taxation because an increasing amount of tax revenue, even from in-country sources, relates in one way or another to the international economy. This could be, for example, because the economic actors are international (such as Multinational Corporations, MNCs) or have international linkages (such as importers and exporters) or have (legal or illegal) access to the international economy (rich individuals).

Changes to the international economy, such as growing cross-border trade and financial flows, increasing complexity of MNC operations and international production networks, the liberalization of capital and current accounts and the growth of jurisdictions such as 'tax havens' which legislate to help economic actors avoid regulatory and tax obligations in other jurisdictions, have significantly increased the opportunities for economic actors to legally and illegally reduce their tax payments.

The internationalisation of economic activity has not been accompanied by the internationalization of tax governance or even significant progress on cross-border cooperation on tax matters. This has allowed economic actors to use international economic linkages to escape paying taxes – a phenomenon called **tax flight**. This tax flight severely weakens domestic resource mobilization in both developing and developed countries and also damages the social contract and undermines good governance.

2. Why does tax flight occur?

Tax flight takes place most frequently through the unrecorded or mis-reported cross-border transfer of resources, also known as **capital flight**. Tax flight can either be the driving force behind capital flight or a by-product of it. However, the tax reduction motive is by far the biggest driver of capital flight. The main motivations for engaging in capital flight belong to two categories – the push factors and the pull factors.

The main push factors are 1) the economic actor does not want to pay taxes on otherwise legitimate wealth; 2) the wealth was acquired illegitimately so there is a risk of confiscation; 3) the actor is trying to circumvent other domestic regulations such as restrictions on foreign exchange.

The main pull factors often are provided by 'tax havens' mostly as the combination of 1) zero or low taxation and/or lax regulation which are both financially lucrative; 2) anonymity provided through bank secrecy, shell companies and offshore trusts which minimises the risk of detection and 3) a lack of co-operation on tax matters with source country authorities which minimises the risk of prosecution.

3. How big is the problem of tax flight?

Country level estimates of capital flight show that it is not unusual for a developing country to lose as much as 5–10 % of gross domestic product (GDP) annually to capital flight. Globally, one set of estimates arrives at a figure between US$ 539 billion and US$ 829 billion of annual capital flight from developing countries. South Africa, for example, has been estimated to have been losing an average of 9.2 per cent of GDP (losing US$ 13 billion in 2000), China 10.2 per cent of GDP (losing US$ 109 billion in 1999), Chile 6.1 per cent of GDP (losing US$ 4.7 billion in 1998) and Indonesia 6.7 per cent of GDP (losing US$ 14 billion in 1997). Nigeria is thought to have lost more than US$ 230 billion over the past few decades.

While capital flight has accelerated in recent years, it has been happening for a long time. Much of the money that has been siphoned abroad in the past has been invested in various financial centres in assets, thereby generating returns. It is estimated that the stock of this wealth is of the order of US$ 4–5 trillion for developing countries alone. Based on various capital flight flow and stock estimates that exist for developing countries, there is a resultant annual tax loss to developing countries amounting to hundreds of billions of dollars. Clearly this undermines financing for development.

Tax flight is of course not limited to developing countries alone. As the recent high profile cases of secret Liechtenstein trusts uncovered by Germany and secret Swiss accounts investigated by the United States indicate, developed countries also lose large sums of money to tax flight. Tax flight from developed countries is likely to exceed the losses seen by developing countries. It undermines the welfare state, increases social tensions and drives higher inequality. That is why both developing and developed countries need to tackle tax flight urgently.

4. Which mechanisms are used and who are the main actors involved?

Some of the most common mechanisms used for tax flight (both by individuals and corporations) are listed below.

— *The mis-invoicing of trade transactions.* Under-pricing exports or over-pricing imports of goods and services is the biggest channel for secretly shifting funds across borders mostly into lower tax jurisdictions such as 'tax havens'.

— *Transfer mis-pricing.* When mis-pricing of the kind described above happens between international affiliates of the same MNC, it is referred to as transfer mis-pricing and is very hard to detect.

— *Using mis-priced financial transfers.* Another way of transferring profits abroad to reduce taxes is to mis-price financial transfers such as payments of interest, royalties and licence fees etc. and payments relating to asset purchase and sales.

— *Mis-categorized wire transfers.* These involve a bank or another financial institution transferring money out of a country illicitly through mis-reporting the source, destination or ownership of funds to disguise its true nature.

— *Other mechanisms such as smuggling.* The smuggling of cash, diamonds, gold, illegal drugs and other high value commodities such as arts, antiques and rare coins is a means to siphon wealth out of a country and it depresses tax revenues.

Tax flight and capital flight are driven by a complex web of perpetrators and facilitators who exploit an increasingly sophisticated but poorly regulated and badly co-ordinated international financial system to their advantage. These perpetrators include MNCs and domestic businesses seeking to reduce tax paid and circumvent regulations in a bid to maximise income; wealthy domestic business and political elites trying to evade taxes or hide ill-gotten money abroad to escape detection; criminals and terrorists trying to escape the clutches of law. However, without facilitators in the developed world, the means and incentives for tax and capital flight would not exist.

These facilitators include:

1) **complicit business counterparts** in developed countries (for domestic exporters and importers using trade mis-pricing); 2) **lawyers, accountants and company formation agents** who design aggressive tax evasion and transfer mis-pricing strategies and incorporate dummy corporations, form secret foundations and open secret bank accounts; 3) **'tax havens' and other financial centres** which legislate for low taxes and the existence of bank secrecy and provide services such as the incorporation of shell corporations and other impenetrable legal structures such as unregistered trusts; 4) **bankers and financiers** who solicit and enable the flight of capital and manage the illicit wealth once it has fled.

5. What can be done to tackle tax flight and capital flight?

Tax flight can only happen under a suitable confluence of conditions at the source, transit and destination points and in a suitable international environment.

That is why it can be mitigated by actions at one or more of these points. By changing the risk to reward ratio – increasing risk (the likelihood of getting caught and/or severity of consequences) and reducing reward (the economic benefits) – capital flight and associated tax flight from developing countries can be substantially reduced. Some of the main policy areas for action are:

At the source

— Addressing gaps in legislation would increase the risk of engaging in tax flight and reduce rewards. Adding tax flight to provisions under the Anti Money Laundering (AML) regime and the UN convention against corruption regime (UNCAC) would be an effective policy tool.

— Addressing the lack of capacity and expertise in developing countries by providing training, technical assistance and resources to tax and customs authorities, prosecutors and the judiciary increases the risks associated with tax flight.

— Adopting successful unilateral measures of the kind that many developing and developed countries have adopted would be effective even in the short term: 1) adopting a financial transaction tax (which generated information that helped substantially reduce domestic and cross-border tax evasion in Brazil) which increases the risk of detection; 2) adopting special reporting requirements and fewer exemptions for investments and financial flows to and from 'tax havens' (Argentina and Spain); 3) requiring accounting firms to register tax shelters before selling them (USA and UK); 4) initiating a cross-departmental program of the kind that exists in Australia (Project Wickenby – a task force that comprises the tax office, crime commission, security and investment commission and a number of other relevant governmental bodies) to tackle tax flight; 5) aiming for legal rulings (as done in the UK and Ireland) which would require banks to report customers with undeclared offshore bank accounts.

Box 1: International cooperation for combating illicit financial flows

The **Financial Action Task Force** (FATF) is an intergovernmental body whose purpose is the development and promotion of policies, both at national and international levels, to combat money laundering and terrorist financing. It was founded by the G7 in 1989. The primary policies issued by the FATF are the Forty Recommendations on money laundering (AML) and the Special Recommendations on Terrorist Financing. These set the international standard for anti-money laundering measures and combating the financing of terrorism.

The **UN Convention against Corruption** (UNCAC) came into force in December 2005. It is the first legally binding, international anti-corruption instrument creating the opportunity to develop a global language about corruption and a coherent implementation strategy. The main goal is to combat corruption by means of prevention, criminalization, international cooperation and asset recovery. As of February 2008 there were 140 signatories.

In transit

Tax flight cannot take place without the active facilitation of intermediaries both at the source and destination. Professionals such as accountants, lawyers and bankers usually structure tax flight through transactions in a way that minimises risks of detection and maximises rewards. So targeting them can significantly increase the risks for those engaging in tax flight. Some measures are: 1) Ensuring that tax crimes committed in foreign jurisdictions are a reportable offence; 2) targeting intermediaries to report suspected tax flight transactions at the risk of prosecution; 3) including tax flight in the AML and UNCAC regime will make it obligatory for intermediaries to report tax flight; 4) introducing professional codes of conduct for professionals which include not facilitating tax flight.

At the destination

— Making the recording of beneficial ownership information by financial centres including 'tax havens' obligatory. This would need to include bank accounts, trusts, foundations, companies and all other legal vehicles. Maintaining public registers on such real ownership interests so relevant authorities can access them would seriously reduce anonymity and the benefits it offers.

— Moving towards a better sharing of information on the ownership of financial flows/assets associated with bank accounts, investments, companies, foundations and trusts registered in these territories significantly increases the risks of detection and prosecution. The Tax Exchange Information Agreements being currently negotiated and the mutual legal assistance instruments are often not good enough tools for an effective exchange and sharing of information. Moreover, most developing countries do not have such tools. A multilateral agreement on effective exchange of information would be an effective tool.

— Developed economies should share information on suspected trade and financial mis-pricing with the source developing country.

— Sharing information on assets from developing countries (including bank accounts) with the relevant country authority.

International environment

Since tax flight arises mostly due to a co-ordination failure at the international level the best way to tackle it is also at the international level. Some of the policy measures that can change the present risk-reward balance to help reduce tax flight are listed below.

The adoption of a country by country accounting standard would be a very effective tool in tackling tax flight. 2) The extension of existing Organisation for Economic Co-operation and Development (OECD) and EU information sharing agreements to developing countries. 3) Restructuring and upgrading the UN Committee on Tax Experts and increasing its resources and authority. 4) Setting up a UN trust fund to finance alternative development paths for small island 'tax havens' which help tackle tax flight. 5) Redefining the AML regime to include tax flight as a reportable offence. 6) Reinterpreting the UNCAC to include tax flight as corruption. 7) Extending the remit of the Stolen Asset Recovery (STAR) initiative to include fled capital associated with tax evasion. 8) Building automatic exchange of information into the UN and OECD tax treaties, tax information exchange agreements and working on a multilateral effective exchange of information regime. 9) Constructing a policy map for successful unilateral policies which can be replicated. 10) Introducing the fair payment of developing country taxation into all discussions of Corporate Social Responsibility (CSR) and include a fair payment of taxes into the OECD guidelines for MNCs and the EU code on business taxation. 11) Adopting a UN code of conduct on co-operation in combating tax flight. 12) Giving tax flight a higher public profile including through governments producing estimates of losses to tax flight.

Improving the current institutional landscape

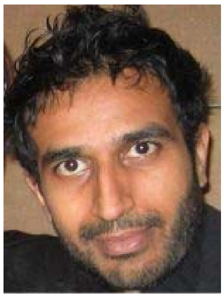
There are a number of inter-governmental institutions that currently deal directly or indirectly with the subjects of taxation, tax systems in developing countries and international co-operation on taxes: the OECD, the EU/EC, the International Monetary Fund (IMF), the Multilateral Development Banks, the UN committee of tax experts, the Financial Action Task Force (FATF) and ad hoc initiatives such as the International Tax Dialogue and the Norwegian led Task Force on Illicit Financial Flows. While there is a lot of competence in many institutions such as the OECD, these do not have the developing country focus. Others such as the World Bank have little technical capacity on tax and still others such as the UN committee and the Illicit Finance Task Force do not have sufficient political weight.

There is a need for a body that can 1) increase the visibility of the issue of tax flight from developing countries; 2) make existing relevant bodies divert some of their resources towards tackling tax flight from developing countries; 3) provide coherence to the various streams of tackling tax flight related work that is going on in various fora; 4) provide political clout and an influential international voice which can help translate technical work into action; 5) provide a permanent structure to help increase effectiveness, clout and institutional memory; 6) assist in developing relevant technical assistance tools.

Such a body could take the form of a new permanent secretariat on tackling tax flight which, once the UN committee of tax experts gets upgraded as has been suggested in the draft Doha outcome document, can be subsumed into the UN system at a later date.

6. Conclusion

Sustainable development can only take place in a context of *raising domestic resources* – helping build robust tax systems in developing countries; *retaining domestic resources* – addressing the problem of tax flight at its source, transit and destination; *recovering domestic resources* – helping identify, confiscate and repatriate fled capital and *reinforcing domestic resources* – with aid and other forms of assistance where resource gaps exist.



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